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BEFORE THE PUBLIC SERVICE COMMISSION

COMMONWEALTH OF KENTUCKY

IN THE MATTER OF	) **CASE NO. 2006-00464**
RATE APPLICATION BY	)
ATMOS ENERGY CORPORATION	)
MID-STATES/KENTUCKY	)

RESPONSE OF ATMOS ENERGY CORPORATION, KENTUCKY TO

KPSC DATA REQUEST DATED FEBRUARY 23, 2007

(KPSC DATA REQUEST NO. 2)

DR 37 CONT.

MARCH 16, 2007

Atmos Energy
Case No 2006-0046
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Our Financial Derivatives Policy sets forth the guidelines for using selected financial derivative products to support prudent risk management strategies within designated parameters. Our objective for using derivatives is to decrease the volatility of earnings and cash flows and to prevent speculative risk. The use of derivatives is permitted only after the risk exposures have been identified, are determined to exceed acceptable tolerance levels and are considered to be unavoidable because they are necessary to support normal business activities. We do not enter into derivative instruments for trading purposes and we believe that any increase in market risk created by holding derivatives should be offset by the exposures they modify.

Revenue Taxes

We account for utility revenue-based taxes assessed by governmental entities as a separate cost collected from customers for remittance to those governmental entities. Therefore our revenue taxes are accounted for as a cost of sale and presented separately on the income statement.

Income Tax Expense

NW Natural and its one active wholly-owned subsidiary file consolidated federal and state income tax returns. Current income taxes are allocated based on each entity's respective taxable income or loss and investment tax credits as if each entity filed a separate return. We account for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes." SFAS No. 109 requires recognition of deferred tax liabilities and assets for the future tax consequences of events that have been included in the consolidated financial statements or tax returns. Under this method, deferred tax liabilities and assets are determined based on the difference between the financial statement and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse (see Note 8).

SFAS No. 109 also requires recognition of deferred income tax assets and liabilities for temporary differences where regulators prohibit deferred income tax treatment for ratemaking purposes. We have recorded a deferred tax liability equivalent to $67.1 million and $65.8 million at December 31, 2006 and 2005, respectively, to recognize future taxes payable resulting from transactions that have previously been reflected in the financial statements for these temporary differences. Regulatory assets or liabilities corresponding to such additional deferred income tax assets or liabilities may be recorded to the extent we believe they will be recoverable from or payable to customers through the ratemaking process. Pursuant to SFAS No. 71, a corresponding regulatory asset has been recorded which represents the probable future revenue that will result from inclusion in rates charged to customers of taxes which will be paid in the future. The probable future revenue to be recorded takes into consideration the additional future taxes which will be generated by that revenue. Amounts applicable to income taxes due from customers primarily represent differences between the book and tax basis of net utility plant in service and actual removal costs incurred.

Deferred investment tax credits on utility plant additions and leveraged leases, which reduce income taxes payable, are deferred for financial statement purposes and amortized over the life of the related plant or lease. Investment and energy tax credits generated by the non-regulated subsidiary are amortized over a period of one to five years.

Other Income and Expense—Net

Other income and expense—net consists of interest income, gain on sale of investments, investment income of Financial Corporation and other miscellaneous income from merchandise sales, rents, leases and other items.

Thousands	2006	2005
Other Income and Expense - Net		
Gains from company-owned life insurance	$ 2,609	$ 1,856
Interest income	363	403
Earnings from equity investments of Financial Corporation	191	57
Other non-operating expenses	(852)	(1,393)
Net interest on deferred regulatory accounts	(177)	282
Other Income and Expense - Net	$ 2,134	$ 1,205

Earnings Per Share

Basic earnings per share are computed based on the weighted average number of common shares outstanding each year. Diluted earnings per share reflect the potential effects of the conversion of convertible debentures and the exercise of stock options. Diluted earnings per share are calculated as follows:

Thousands, except per share amounts	2006	2005	2004
Net income	$ 63,415	$ 58,149	$ 50,572
Convertible debenture interest less taxes	-	-	200
Net income - diluted	$ 63,415	$ 58,149	$ 50,772
Average common shares outstanding - basic	27,540	27,564	27,016
Stock based compensation	117	57	40
Convertible debentures	-	-	227
Average common shares outstanding - diluted	27,657	27,621	27,283
Earnings per share of common stock - basic	$ 2.30	$ 2.11	$ 1.87
Earnings per share of common stock - diluted	$ 2.29	$ 2.11	$ 1.86

For the years ended December 31, 2006, 2005 and 2004, 105,600 shares, 6,000 shares and 201,800 shares, respectively, represent the number of stock options which were excluded from the calculation of diluted earnings per share because the effect was antidilutive.

Stock-Based Compensation

We periodically provide stock-based compensation to employees in the form of stock options and other incentive awards. As required by SFAS No. 123R, we recognize the fair value of all share-based payments as compensation expense in the financial statements. Prior to January 1, 2006, as permitted by SFAS No. 123, we applied APB Opinion No. 25, "Accounting for Stock Issued to Employees," to account for stock-based compensation. Accordingly, we did not recognize compensation expense for the fair value of our stock option grants. We implemented SFAS 123R effective January 1, 2006 by applying the modified prospective transition method. The impact on net income of this new standard, had it been adopted in 2005, is reflected in the pro forma amounts in Note 4. We have recognized and will continue to recognize compensation

expense for the fair value of stock awards granted under our Long-Term Incentive Plan (LTIP) and the Non-Employee Directors Stock Compensation Plan (NEDSCP) in the period when the shares are earned (see "New Accounting Standards—Adopted Standards—Share Based Payments," above, and Note 4).

_. CONSOLIDATED SUBSIDIARY OPERATIONS AND SEGMENT INFORMATION:

At December 31, 2006, we had one active, direct wholly-owned subsidiary, Financial Corporation.

Our core business segment is the local gas distribution segment, also referred to as the "utility," which involves the distribution and sale of natural gas. Another business segment, "gas storage" (previously referred to as "interstate gas storage") represents natural gas storage services provided to intrastate and interstate customers, and includes asset optimization services under a contract with an independent energy marketing company. The remaining business segment, "other," primarily consists of non-regulated investments in alternative energy projects in California (see "Financial Corporation," below), a Boeing 737-300 aircraft leased to Continental Airlines and low-income housing in Portland, Oregon (see Note 9).

Gas Storage

The gas storage business segment is primarily made up of underground natural gas storage services that we provide to large intra- and inter-state customers using our owned storage capacity that has been developed in advance of core utility customers' requirements. In Oregon, we retain 80 percent of the income before tax from these services and credit the remaining 20 percent to a deferred regulatory account for sharing with core utility customers. For each of the years ended December 31, 2006, 2005 and 2004, this business segment derived a majority of its revenues from five customers. The largest of these customers is served under a long-term contract.

Results for the gas storage segment include revenues, net of amounts shared with core utility customers, from a contract with an independent energy marketing company that optimizes the use of the our assets primarily through the use of commodity transactions and transportation capacity release transactions. In Oregon, we retain 80 percent of the pre-tax income when the costs of the capacity have not been included in utility rates, or 33 percent of the pre-tax income when the costs have been included in core utility rates. The remaining 20 percent and 67 percent, respectively, are credited to a deferred regulatory account for distribution to core utility customers. We have a similar sharing mechanism in Washington for revenue derived from storage and third party optimization.

Other

At December 31, 2006, we reclassified to current assets our net investment of $5.3 million in a Boeing 737-300 airplane leased to Continental Airlines. The original lease term expires in September 2007, and we expect to sell the airplane by the end of 2007. Also in 2006, we sold non-utility real estate investments for $1.8 million, which resulted in a gain on sale of $0.5 million.

Financial Corporation has several financial investments, including investments as a limited partner in windpower electric generating projects and low-income housing projects. Financial Corporation's total assets were $2.6 million and $3.3 million at December 31, 2006 and 2005,

respectively. On January 31, 2005, Financial Corporation sold its limited partnership interests in three solar electric generating systems for approximately $3 million.

gment Information Summary

The following table presents summary financial information about the reportable segments for 2006, 2005 and 2004. Inter-segment transactions are insignificant.

Thousands	Utility	Gas Storage	Other	Total
2006				
Net operating revenues	$ 327,267	$ 12,761	$ 148	$ 340,176
Depreciation and amortization	63,552	883	-	64,435
Income from operations	126,366	9,870	526	136,762
Income from financial investments	2,609	-	191	2,800
Net income	56,653	5,982	780	63,415
Total assets at Dec. 31, 2006	1,912,021	35,970	8,865	1,956,856
2005				
Net operating revenues	$ 315,248	$ 9,609	$ 136	$ 324,993
Depreciation and amortization	60,935	710	-	61,645
Income (loss) from operations	118,794	8,158	(5)	126,947
Income from financial investments	1,856	-	57	1,913
Net income	52,759	4,557	833	58,149
Total assets at Dec. 31, 2005	1,994,868	34,574	12,862	2,042,304
2004				
Net operating revenues	$ 284,904	$ 6,423	$ 168	$ 291,495
Depreciation and amortization	56,899	472	-	57,371
Income (loss) from operations	104,781	5,299	(54)	110,026
Income from financial investments	2,855	-	181	3,036
Net income	47,090	2,880	602	50,572

3. CAPITAL STOCK:

Common Stock

At December 31, 2006, we had reserved 244,406 shares of common stock for issuance under the Employee Stock Purchase Plan, 753,934 shares under our Dividend Reinvestment and Direct Stock Purchase Plan and 1,469,000 shares under our Restated Stock Option Plan (see Note 4).

In connection with the restatement of our Restated Articles of Incorporation, effective May 31, 2006, the par value of our common stock was eliminated. As a result, at December 31, 2006, our "common stock" and "premium on common stock" account balances are reflected on the balance sheet as "common stock."

Expiration of Common Share Purchase Rights

In February 2006, our Board of Directors decided to allow all of the common stock purchase rights (Rights) issued under the Rights Agreement, dated as of February 27, 1996, as amended, to expire in accordance with their terms at the close of business on March 15, 2006.

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Stock Repurchase Program

Our publicly announced stock repurchase program allows us to purchase up to 2.6 million shares, or up to $85.0 million in total, of our common stock in the open market or through privately negotiated transactions. A total of 395,500 and 410,200 shares were repurchased under this program in 2006 and 2005, respectively; however, no shares were repurchased in 2004.

Restated Stock Option Plan

There are 2,400,000 shares authorized for option grants under the Restated Stock Option Plan. At December 31, 2006, options on 1,135,000 shares were available for grant and options on 334,000 shares were outstanding.

Convertible Debentures

In August 2005, we redeemed all of our outstanding Convertible Debentures, 7-1/4% Series due 2012, at 100 percent of their principal amount plus accrued interest to the date of redemption. During 2005, debentures with an aggregate principal amount of $4.0 million were converted into shares of common stock on or prior to the redemption date at the rate of 50.25 shares for each $1,000 principal amount of debentures and $0.5 million of debentures were redeemed.

Summary of Changes in Common Stock

The following table shows the changes in the number of shares of our common stock outstanding and the premium on common stock for the years 2006, 2005 and 2004:

	Shares	Premium on common stock (thousands)
Balance, Dec. 31, 2003	25,938,002	$ 255,871
Sales to public	1,290,000	35,905
Sales to employees	27,541	605
Sales to stockholders	157,124	4,323
Exercise of stock options - net	73,649	2,285
Conversion of convertible debentures to common	64,904	1,086
Lapse of restricted stock award	(4,500)	(41)
Balance, Dec. 31, 2004	27,546,720	$ 300,034
Sales to employees	30,896	741
Sales to stockholders	113,925	3,741
Exercise of stock options - net	97,068	2,241
Conversion of convertible debentures to common	200,887	3,360
Repurchase	(410,200)	(13,646)
Balance, Dec. 31, 2005	27,579,296	$ 296,471
Repurchase	(395,500)	(1,461)
Sales to employees	31,397	-
Exercise of stock options - net	68,548	285
Change to no-par common stock	-	(295,295)
Balance, Dec. 31, 2006	27,283,741	$ -

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4. STOCK-BASED COMPENSATION:

We have the following stock-based compensation plans: the Long-Term Incentive Plan (LTIP); the Restated Stock Option Plan (Restated SOP); the Employee Stock Purchase Plan (ESPP); and the Non-Employee Directors Stock Compensation Plan (NEDSCP). These plans are designed to promote stock ownership in NW Natural by employees and officers and, in the case of the NEDSCP, by non-employee directors.

Long-Term Incentive Plan. The LTIP is intended to provide a flexible, competitive compensation program for eligible officers and key employees. An aggregate of 500,000 shares of common stock was authorized for grants under the LTIP as stock bonus, restricted stock or performance-based stock awards. Shares awarded under the LTIP are purchased on the open market.

At December 31, 2006, 375,060 shares of common stock were available for award under the LTIP, assuming that outstanding performance based grants are awarded at the target level. The LTIP stock awards are compensatory awards for which compensation expense is recognized based on the market value of performance shares earned, or a pro rata amortization over the vesting period for the outstanding restricted stock awards.

Performance-based Stock Awards. Since the LTIP's inception in 2001 through December 31, 2006, performance-based stock awards have been granted annually based on three-year performance periods. At December 31, 2006, certain performance-based stock award measures had been achieved for the 2004-06 award period. Accordingly, participants will receive 40,446 shares of common stock and a dividend equivalent cash payment equal to the number of shares of common stock received on the award payout multiplied by the aggregate cash dividends paid per share during the performance period. For the 12 months ended December 31, 2006, we accrued and expensed $0.9 million related to the 2004-06 performance-based stock award. At December 31, 2006, on a cumulative basis, $1.7 million has been accrued for the 2004-06 performance period.

At December 31, 2006, the aggregate number of performance-based shares granted and outstanding at the threshold, target and maximum levels were as follows:

Year Awarded	Performance Period	Number of Performance Share Awards		
		Threshold	Target	Maximum
2005	2005-07	6,333	33,332	66,664
2006	2006-08	7,536	39,662	79,324
	Total	13,869	72,994	145,988

The threshold level estimates future payout assuming the minimum award payable other than no payout for each component of the formula in the Long-Term Incentive Plan. For each of these performance periods, awards will be based on total shareholder return relative to a peer group of gas distribution companies over the three-year performance period and on performance results achieved relative to specific core and non-core strategies. Compensation expense is recognized in accordance with SFAS No. 123R, based on performance levels achieved and an estimated fair value using a Black-Scholes or binomial model. The weighted-average grant date fair value of unvested shares at December 31, 2006 and 2005 was $30.65 and $42.86, respectively. The

weighted-average grant date fair value of shares vested during the year was $40.15 and granted during the year was $18.63. For the 12 months ended December 31, 2006, the amount accrued and expensed as compensation under these LTIP grants was $1.0 million. At December 31, 2006, on a cumulative basis, $1.5 million has been accrued for the 2005-07 and 2006-08 performance periods.

Restricted Stock Awards. Restricted stock awards also have been granted under the LTIP. A restricted stock award was granted in 2004 consisting of 5,000 shares that will vest ratably over the period 2005-09, and a restricted stock award was granted in 2006 consisting of 6,500 shares that will vest ratably over the period 2007-09. A total of 2,000 restricted stock award shares were vested at December 31, 2006. Compensation expense is recognized ratably over the vesting period.

Restated Stock Option Plan. The Restated SOP authorizes an aggregate of 2,400,000 shares of common stock for issuance as incentive or non-statutory stock options. These options may be granted only to officers and key employees designated by a committee of our Board of Directors. All options are granted at an option price not less than the market value at the date of grant and may be exercised for a period not exceeding 10 years from the date of grant. Option holders may exchange shares they have owned for at least six months, at the current market price, to purchase shares at the option price. We use original issue shares upon exercise of options under the plan (see Note 3.)

Employee Stock Purchase Plan. The ESPP allows employees to purchase common stock at 85 percent of the closing price on the trading day immediately preceding the initial offering date, which is set annually. Each eligible employee may purchase up to $24,000 worth of stock through payroll deductions over a six- to 12-month period. We use original issue shares upon exercise of options under the plan (see Note 3.)

In accordance with APB Opinion No. 25, no compensation expense was recognized for options granted under the Restated SOP or shares issued under the ESPP during 2005 or earlier years (see Note 1, "New Accounting Standards—Adopted Standards—Share Based Payment"). If compensation expense for awards under these two plans had been determined based on fair value at the grant dates using the method prescribed by SFAS No. 123R, net income and earnings per share would have been reduced to the pro forma amounts shown below:

Pro Forma Effect of Stock-Based Options and ESPP:

Thousands, except per share amounts	2005	2004
Net income as reported	$ 58,149	$ 50,572
Add: Stock based compensation expense included in reported net income - net of related tax effects	613	96
Deduct: Pro forma stock-based compensation expense determined under the fair value based method - net of related tax effects	(940)	(519)
Pro forma earnings applicable to common stock - basic	57,822	50,149
Debenture interest less taxes	-	200
Pro forma earnings applicable to common stock—diluted	$ 57,822	$ 50,349
Basic earnings per share		
As reported	$ 2.11	$ 1.87
Pro forma	$ 2.10	$ 1.86
Diluted earnings per share		
As reported	$ 2.11	$ 1.86
Pro forma	$ 2.09	$ 1.85

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The fair value of each stock option is estimated on the grant date using the Black-Scholes option pricing model with the following weighted average assumptions:

	2006	2005	2004
Risk-free interest rate	4.5%	4.2%	3.6%
Expected Life (in years)	6.2	7.0	7.0
Expected market price volatility factor	22.8%	24.6%	25.2%
Expected dividend yield	4.0%	3.6%	4.1%
Present value of options granted	$26.00	$27.87	$24.55

The simplified formula for "plain vanilla" options was utilized to determine the expected life as defined and permitted by Staff Accounting Bulletin No. 107. The risk-free interest rate was based on the implied yield currently available on U.S. Treasury zero-coupon issues with a life equal to the expected life of the options. Historical data was employed in order to estimate the volatility factor, measured on a daily basis, for a period equal to the duration of the expected life of the option awards. The dividend yield was based on management's current estimate for dividend payout at the time of grant. A forfeiture rate of 3 percent was applied to the calculation of compensation expense. We expense the total cost of stock option awards granted to retirement eligible employees at the date of grant in accordance with SFAS No. 123R and the retirement provisions of our plan.

Information regarding the Restated SOP's activity for the three years ended December 31, 2006 is summarized as follows:

		Price per Share	
	Option Shares	Range	Weighted-Average Exercise Price
Balance outstanding, Dec. 31, 2003	322,044	$20.25 - 27.875	$ 25.35
Granted	202,800	31.34 - 32.02	31.40
Exercised	(92,074)	20.25 - 27.875	24.39
Forfeited	(1,300)	26.30 - 31.34	30.18
Balance outstanding, Dec. 31, 2004	431,470	20.25 - 32.02	28.38
Granted	9,000	34.95 - 38.30	37.18
Exercised	(121,170)	20.25 - 31.34	26.59
Forfeited	(10,800)	27.60 - 31.34	30.79
Balance outstanding, Dec. 31, 2005	308,500	20.25 - 38.30	29.26
Granted	97,800	34.29	34.29
Exercised	(69,300)	20.25 - 31.34	27.15
Forfeited	(3,000)	31.34 - 34.29	32.52
Balance outstanding, Dec. 31, 2006	334,000	$20.25 - 38.30	$ 31.14
Shares available for grant Dec. 31, 2004	1,228,000		
Shares available for grant Dec. 31, 2005	1,229,800		
Shares available for grant Dec. 31, 2006	1,135,000		

The weighted average remaining life of outstanding stock options at December 31, 2006 was 7.10 years.

The weighted-average grant-date fair value of equity awards granted during 2005 and 2006 was $7.85 and $6.29, respectively. At December 31, 2006, a total of 179,700 options were exercisable.

During the year ended December 31, 2006, pre-tax compensation expense amounted to $0.6 million relating to options granted under the Restated SOP. This expense was recognized in operations and maintenance expense under the fair value method in accordance with SFAS No. 123R. In addition, $0.2 million of pre-tax compensation expense related to the ESPP was recognized for the year. As of December 31, 2006, there was $0.4 million of unrecognized compensation cost related to the unvested portion of outstanding stock option awards expected to be recognized over a period extending through 2009.

In the year ended December 31, 2006, 69,300 option shares were exercised with a total intrinsic value of $0.8 million. Cash of $2.2 million was received for these exercises and a $0.3 million related tax benefit was realized. The total intrinsic value of options exercised in the years ended December 31, 2005 and 2004 was $1.2 million and $0.7 million, respectively, and the total fair value of options that vested was $0.4 million in both 2006 and 2005 and $0.6 million in 2004.

The following table summarizes additional information about stock options outstanding and exercisable at December 31, 2006:

	Outstanding		Exercisable			
Range of Exercise Prices	Stock Options	(In millions) Aggregate Intrinsic Value	Stock Options	(In millions) Aggregate Intrinsic Value	Weighted-Average Exercise Price	Weighted-Average Remaining Life in Years
$20.25 - 38.30	334,000	$ 3.8	179,700	$ 2.4	$ 29.16	5.9

In accordance with SFAS No. 123R, we capitalize a portion of the expense recognized in relation to stock based compensation. The following table summarizes the effects of stock based compensation resulting from the application of SFAS No. 123R granted under our LTIP, SOP and ESPP:

Thousands, except per share amounts	2006
Operations and maintenance	$ 2,304
Stock-based compensation effect on income before taxes	2,304
Income taxes	(898)
Net stock-based compensation effect on net income	$ 1,406
Effect on basic earnings per share	$ 0.05
Effect on diluted earnings per share	$ 0.05
Effect on cash flow from operations	$ (1,136)
Effect on cash flow from financing activities	$ 1,280

Non-Employee Directors Stock Compensation Plan. In February 2004, the NEDSCP was amended to permit non-employee directors to receive stock awards either in cash or in our stock. As a result of modifications to the directors' compensation arrangements, the NEDSCP was further amended in September 2004 to eliminate any further awards, either in cash or stock, on and after January 1, 2005.

Prior to the latter amendment to the NEDSCP, if non-employee directors elected to receive their awards in stock, approximately $100,000 worth of common stock was awarded upon joining the Board. These stock awards were subject to vesting and to restrictions on sale and transferability. The shares vested in monthly installments over the five calendar years following the award. On January 1 of each year following the initial award, non-employee directors who elected to receive their awards in stock were awarded an additional $20,000 worth of restricted stock, which vested in monthly installments in the fifth year following the award (after the previous award had fully vested). We hold the certificates for the restricted shares until the non-employee director ceases to be a director. Participants receive all dividends and have full voting rights on both vested and unvested shares. All awards vest immediately upon the death of a director or upon a change in control of the Company. Any unvested shares are considered to be unearned compensation, and thus are forfeited if the recipient ceases to be a director. The shares were purchased in the open market by us at the time of the award. During 2006, 7,848 shares vested under the plan and no forfeitures occurred. At December 31, 2006, 11,071 shares remain unvested, all of which are scheduled to vest by December 31, 2008. The weighted-average grant-date fair value of unvested shares at December 31, 2006 and 2005 was $28.92 and $29.02, respectively.

Changes in unearned stock compensation in 2006 resulted from purchases of restricted stock related to the restricted stock grant under the LTIP for $0.2 million, offset by restricted stock amortizations of $0.3 million. In 2005, the change in unearned stock compensation consisted of $0.2 million of restricted stock amortizations.

Under a separate plan, prior to January 1, 2005, non-employee directors could elect to invest their cash fees and retainers for board service in shares of common stock. Under a new deferral plan effective January 1, 2005, such fees and retainers will be deferred to a cash account. Cash account balances may be transferred to and invested in a stock account at the election of the director up to four times per year.

5. LONG-TERM DEBT:

The issuance of first mortgage debt, including secured medium-term notes, under the Mortgage and Deed of Trust (Mortgage), is limited by property additions, adjusted net earnings and other provisions of the Mortgage. The Mortgage constitutes a first mortgage lien on substantially all of our utility property.

The maturities on the long-term debt outstanding, for each of the 12-month periods through December 31, 2011 amount to: $29.5 million in 2007; $5 million in 2008; none in 2009; $35 million in 2010; and $10 million in 2011. Holders of certain long-term debt have put options that, if exercised, would accelerate the maturities by $20 million in each of 2007, 2008 and 2009.

In December 2006, we issued and sold $25 million of 5.15% Series B secured Medium Term Notes (MTNs) due 2016. Proceeds from this sale were used, in part, to repay short-term debt and fund our ongoing utility construction program.

In June 2005, we issued and sold $50 million in principal amount of secured MTNs, consisting of $40 million of the 4.70% Series B due 2015 and $10 million of the 5.25% Series B due 2035. Proceeds from these sales were used, in part, to redeem $15 million of maturing MTNs in July 2005, and the balance was applied to our ongoing utility construction program and the repayment of short-term debt.

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In July 2005, we redeemed three series of maturing MTNs aggregating $15 million in principal amount. The series redeemed were the 6.34% Series B, the 6.38% Series B and the 6.45% Series B, each with a principal balance outstanding of $5 million due in July 2005.

J. NOTES PAYABLE AND LINES OF CREDIT:

Our primary source of short-term funds is from the sale of commercial paper notes payable. In addition to issuing commercial paper to meet seasonal working capital requirements, including the financing of gas purchases, gas inventories and accounts receivable, short-term debt is used temporarily to fund capital requirements. Commercial paper is periodically refinanced through the sale of long-term debt or equity securities. Our commercial paper program is supported by committed bank lines of credit (see below). At December 31, 2006 and 2005, the amounts and average interest rates of commercial paper debt outstanding were $100.1 million and 5.3 percent and $126.7 million and 4.3 percent, respectively. We have not issued commercial paper in an aggregate amount outstanding in excess of our committed lines of credit.

In September 2005, we entered into an agreement for unsecured lines of credit totaling $200 million with five commercial banks, replacing the existing $150 million credit facilities. The bank lines of credit (bank lines) are available and committed for a term of five years, beginning October 1, 2005 and expiring on September 30, 2010. Our bank lines are used primarily as back-up support for the notes payable under our commercial paper borrowing program. Commercial paper borrowing provides the liquidity to meet our working capital and external financing requirements. Under the terms of these bank lines, we pay upfront fees and annual commitment fees but are not required to maintain compensating bank balances. The interest rates on outstanding loans, if any, under these bank lines are based on then-current market interest rates. All principal and unpaid interest under the bank lines is due and payable on September 30, 2010.

The bank lines require that we maintain credit ratings with Standard & Poor's and Moody's Investors Service and notify the banks of any change in our senior unsecured debt ratings by such rating agencies. A change in our credit rating is not an event of default, nor is the maintenance of a specific minimum level of credit rating a condition of drawing upon the bank lines. However, interest rates on any loans outstanding under these bank lines are tied to credit ratings, which would increase or decrease the cost of any loans under the bank lines when ratings are changed.

The bank lines also require us to maintain an indebtedness to total capitalization ratio of 65 percent or less. Failure to comply with this covenant would entitle the banks to terminate their lending commitments and to accelerate the maturity of all amounts outstanding. We were in compliance with this covenant at December 31, 2006, with an indebtedness to total capitalization ratio of 51.9 percent.

7. PENSION AND OTHER POSTRETIREMENT BENEFITS:

We maintain two qualified non-contributory defined benefit pension plans covering all regular employees with more than one year of service, several non-qualified supplemental pension plans for eligible executive officers and certain key employees and other postretirement benefit plans for employees. Only the two qualified defined benefit pension plans have plan assets,

which are held in a qualified trust to fund retirement benefits. Effective January 1, 2007, the Retirement Plan for Non-Bargaining Unit Employees and the Welfare Benefits Plan for Non-Bargaining Unit Employees was closed to anyone hired or rehired after December 31, 2006. Instead, newly hired or rehired non-bargaining unit employees will be provided an enhanced Retirement K Savings Plan (401k) benefit. Benefits provided to bargaining unit employees are not affected by these changes.

The following table provides a reconciliation of the changes in benefit obligations and fair value of plan assets, as applicable, for the pension and other postretirement benefit plans over the three-year period ended December 31, 2006, and a summary of the funded status and amounts recognized in the consolidated balance sheets using measurement dates of December 31, 2006, 2005 and 2004:

	Postretirement Benefits					
	Pension Benefits			Other Benefits		
Thousands	2006	2005	2004	2006	2005	2004
Reconciliation of change in benefit obligation:						
Obligation at January 1	$ 267,854	$ 222,948	$ 205,352	$ 20,398	$ 22,729	$ 23,379
Service cost	7,745	6,322	5,428	555	767	457
Interest cost	14,901	13,203	12,690	1,184	1,248	1,232
Special termination benefits	-	-	237	-	-	-
Expected benefits paid	(13,183)	(12,866)	(10,682)	(1,015)	(1,173)	(1,040)
Plan amendments	-	1,408	-	15	2,384	-
Change in assumptions	(9,208)	31,642	-	133	2,215	-
Net actuarial (gain) or loss	1,301	5,197	9,923	1,166	(7,772)	(1,299)
Obligation at December 31	$ 269,410	$ 267,854	$ 222,948	$ 22,436	$ 20,398	$ 22,729
Reconciliation of change in plan assets:						
Fair value of plan assets at January 1	$ 218,555	$ 186,787	$ 168,324	$ -	$ -	$ -
Actual return on plan assets	30,088	12,558	19,835	-	-	-
Employer contributions	1,058	32,076	9,310	1,015	1,173	1,040
Benefits paid	(13,183)	(12,866)	(10,682)	(1,015)	(1,173)	(1,040)
Fair value of plan assets at December 31	$ 236,518	$ 218,555	$ 186,787	$ -	$ -	$ -
unded status:						
Funded status at December 31	$ (32,892)	$ (49,299)	$ (36,162)	$ (22,436)	$ (20,397)	$ (22,728)
Unrecognized transition obligation	-	-	-	2,469	2,880	3,292
Unrecognized prior-service cost	5,512	6,492	5,146	2,063	2,243	-
Unrecognized net actuarial loss	45,862	69,766	33,897	2,288	988	6,717
Net amount recognized	$ 18,482	$ 26,959	$ 2,881	$ (15,616)	$ (14,286)	$ (12,719)

In September 2006, the FASB issued SFAS No. 158 (see Note 1, "New Accounting Standards—Adopted Standards"). SFAS No. 158 requires balance sheet recognition of the overfunded or underfunded status of pension and other postretirement benefit plans. For pension plans, the liability is based on the projected benefit obligation. Under SFAS No. 158, any actuarial gains and losses, prior service costs and transition assets or obligations that were not recognized under previous accounting standards must be recognized in AOCI under common stock equity, net of tax, until they are amortized as a component of net periodic benefit cost. We consider the recognition of the underfunded status of the qualified defined

benefit plans and postretirement benefit plans to be subject to regulatory deferral under SFAS No. 71. The unrecognized net gains and losses, prior service costs and transition obligations relating to our qualified defined benefit pension and postretirement benefit plans were recognized as regulatory assets at December 31, 2006. An estimated $3.5 million consisting of actuarial gains of $1.9 million, prior service costs of $1.2 million and transition obligations of $0.4 million for the qualified plans will be amortized from the regulatory asset to net periodic benefit cost in 2007. The gains and losses, prior service costs and transition obligations related to our non-qualified supplemental pension plans are recognized in AOCI, net of tax, under common stock equity because these expenses are not the basis for regulatory recovery; however, these amounts are not material. In 2007, an estimated $0.2 million consisting of actuarial gains of $0.2 million and negligible prior service costs for the non-qualified plans will be amortized from AOCI to net periodic benefit cost.

The adoption of SFAS No. 158 did not have a material impact on our results of operations, cash flows or our ability to meet our financial debt covenants. The following table provides a summary of the changes in the statement of financial position at December 31, 2006 due to the application of SFAS No. 158:

Thousands	Before Application of	Adjustments: Adoption of	Adjustments: Regulatory Deferral	After Application of
Minimum pension liability[1]	$ 3,173	$ (3,173)	$ -	$ -
Pension benefit liabilities - current	-	1,134	-	1,134
Pension benefit liabilities - non-current	10,174	21,583	-	31,757
Postretirement benefit liability - current	-	1,503	-	1,503
Postretirement benefit liability - non-current	15,616	5,317	-	20,933
Deferred income taxes and investment tax credits	210,316	(21,442)	21,210	210,084
Regulatory asset	-	-	54,425	54,425
Prepaid pension asset	28,657	(28,657)	-	-
Accumulated other comprehensive income	(1,992)	(33,579)	33,215	(2,356)
Total assets	1,931,088	(28,657)	54,425	1,956,856
Total liabilities	814,179	4,922	21,210	840,311
Total capitalization	1,116,909	(33,579)	33,215	1,116,545

[1] The minimum pension liability before the adoption of SFAS No. 158 includes a current year adjustment of $0.1 million, net of tax.

Our qualified defined benefit pension plans had a projected benefit obligation in excess of plan assets at December 31, 2006. The plans' aggregate projected benefit obligations were $255 million, $254 million and $209 million at December 31, 2006, 2005 and 2004, respectively, and the fair value of plan assets was $236.5 million, $218.6 million and $186.8 million, respectively. The projected benefit obligations at December 31, 2006 decreased by $9.3 million, reflecting the increase in the discount rate assumptions and increased by $0.3 million, reflecting retirement and withdrawal rates updated for actual experience. The projected benefit obligations at December 31, 2005 increased $26.6 million from December 31, 2004 due to the use of updated mortality rates and increased $8.1 million due to a decrease in the discount rate. The combination of investment returns and future cash contributions is expected to provide sufficient funds to cover all future benefit obligations of the plans.

The assumed discount rates were determined independently for each pension and other postretirement benefit plan based on the Citigroup Above Median Curve (Citigroup curve) using high quality bonds (rated AA- or higher by Standard & Poors or Aa3 or higher by Moody's Investor Service). The Citigroup curve was applied to match the estimated cash flows to reflect the timing and amount of future benefit payments for these plans.

The expected long-term rate of return on plan assets was developed as a weighted average of the expected earnings for the target asset portfolio. In developing the expected long-term rate of return assumption, consideration was given to the historical performance of each asset class in which the plans' assets are invested and the target asset allocation for plan assets.

Our Investment Policy and Performance Objectives for the qualified pension plan assets held in the Retirement Trust Fund were approved by the retirement committee which is composed of senior management employees. The policy sets forth the guidelines and objectives governing the investment of plan assets. Plan assets are invested for total return with appropriate consideration for liquidity and portfolio risk. All investments are expected to satisfy the requirements of the rule of prudent investments as set forth under the Employee Retirement Income Security Act of 1974. The approved asset classes are cash and short-term investments, fixed income, common stock and convertible securities, absolute and real return strategies, real estate and investments in our common stock. Plan assets may be invested in separately managed accounts or in commingled or mutual funds. Re-balancing will take place periodically as needed, or when significant cash flows occur, in order to maintain the allocation of assets within the stated target ranges. Our expected long-term rate of return is based upon historical index returns by asset class, adjusted by a factor based on our historical return experience. The Retirement Trust Fund is not currently invested in any NW Natural securities.

Our pension plan asset allocation at December 31, 2006 and 2005, and the target allocation and expected long-term rate of return by asset category, are as follows:

	Percentage of Plan Assets			
	Dec. 31,		Target	Expected Long-term
Asset Category	2006	2005	Allocation	Rate of Return
US Large Cap Equity	19.2%	19.8%	20%	8.50%
US Small/Mid Cap Equity	13.9%	14.2%	15%	9.50%
Non-US Equity	23.5%	19.7%	20%	8.75%
Fixed Income	15.6%	19.3%	15%	5.50%
Real Estate	7.7%	6.2%	8%	7.75%
Absolute Return Strategies	14.3%	14.2%	15%	9.00%
Real Return	5.8%	6.6%	7%	7.75%
Weighted Average				8.25%

Our non-qualified supplemental pension plans' benefit obligations were $13.9 million, $13.5 million and $13.6 million at December 31, 2006, 2005 and 2004, respectively. These plans are not subject to regulatory deferral and the changes in actuarial gains and losses, prior service costs and transition assets or obligations for these plans were recognized in AOCI under common stock equity, net of tax, until they are amortized as a component of net periodic benefit cost. Although the plans are unfunded plans with no plan assets due to their nature as non-qualified plans, we indirectly fund our obligations with trust-owned life insurance.

Our plans for providing postretirement benefits other than pensions also are unfunded plans, but are subject to regulatory deferral. The gains and losses, prior service costs and transition assets or obligations for these plans were recognized as a regulatory asset. The accumulated postretirement benefit obligation for those plans was $22.4 million, $20.4 million and $22.7 million at December 31, 2006, 2005 and 2004, respectively.

Net periodic benefit costs consist of service costs, interest costs, the amortization of actuarial gains and losses, the expected returns on plan assets and, in part, on a market-related valuation of assets. The market-related valuation reflects differences between expected returns and actual investment returns, which are recognized over a three-year period from the year in which they occur, thereby reducing year-to-year net periodic benefit cost volatility.

The following tables provide the components of net periodic benefit cost for the qualified and non-qualified pension and other postretirement benefit plans for the years ended December 31, 2006, 2005 and 2004 and the assumptions used in measuring these costs and benefit obligations:

	Pension Benefits			Other Postretirement Benefits		
Thousands	2006	2005	2004	2006	2005	2004
Service cost	$ 7,745	$ 6,322	$ 5,428	$ 556	$ 767	$ 457
Interest cost	14,901	13,203	12,689	1,184	1,248	1,232
Expected return on plan assets	(17,611)	(14,449)	(13,284)	-	-	-
Amortization of transition obligations	-	-	-	411	411	411
Amortization of prior service costs	979	1,077	1,094	195	142	-
Amortization of net loss	3,520	2,082	1,631	1	173	288
Net periodic benefit cost	$ 9,534	$ 8,235	$ 7,558	$ 2,347	$ 2,741	$ 2,388
Assumptions for net periodic benefit cost:						
Discount rate	5.75%	6.00%	6.25%	5.75%	6.00%	6.25%
Rate of increase in compensation	4.0%-5.0%	4.0%-5.0%	4.0%-5.0%	n/a	n/a	n/a
Expected long-term rate of return	8.25%	8.25%	8.25%	n/a	n/a	n/a
Assumptions for funded status:						
Discount rate	6.0%-6.05%	5.75%	6.00%	5.91%	5.75%	6.00%
Rate of increase in compensation	4.0%-5.0%	4.0%-5.0%	4.0%-5.0%	n/a	n/a	n/a
Expected long-term rate of return	8.25%	8.25%	8.25%	n/a	n/a	n/a

The assumed annual increase in trend rates used in measuring postretirement benefits as of December 31, 2006 were 9 percent for medical and 12 percent for prescription drugs. Medical costs were assumed to decrease gradually each year to a rate of 4.5 percent by 2013, while prescription drug costs were assumed to decrease gradually each year to a rate of 4.5 percent by 2014.

Assumed health care cost trend rates can have a significant effect on the amounts reported for the health care plans. A one-percentage point change in assumed health care cost trend rates would have the following effects:

Thousands	1%	1%
Effect on total of service and interest cost components of net periodic postretirement health care benefit cost	$ 23	$ (21)
Effect on health care cost component of the accumulated postretirement benefit obligation	$ 613	$ (628)

The following table provides information regarding employer contributions and benefit payments for the two qualified pension plans, the non-qualified pension plans and the other postretirement benefit plans for the years ended December 31, 2006 and 2005, and estimated future payments:

Thousands		
Employer Contributions by Plan Year	Pension Benefits	Other Benefits
For 2005	$ 12,497	$ 1,173
For 2006	1,527	1,015
For 2007 (estimated)	1,655	1,571
Benefit Payments		
2004	$ 10,682	$ 1,040
2005	12,866	1,173
2006	13,183	1,015
Estimated Future Payments		
2007	$ 13,139	$ 1,571
2008	13,818	1,596
2009	14,513	1,626
2010	15,615	1,685
2011	16,221	1,753
2012-2016	93,212	9,002

Our Retirement K Savings Plan (RKSP) is a qualified defined contribution plan under Internal Revenue Code Section 401(k). We also have non-qualified deferred compensation plans for eligible officers and senior managers. These plans are designed to enhance the retirement program of employees and to assist them in strengthening their financial security by providing an incentive to save and invest regularly. Our matching contributions to these plans totaled $1.8 million in 2006 and $1.7 million in both 2005 and 2004. The RKSP includes an Employee Stock Ownership Plan.

In addition, in 2005 we began making contributions on behalf of each union employee to the Western States Office and Professional Employees Pension Fund, a multi-employer plan. In both 2006 and 2005, these contributions amounted to $0.5 million.

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8. INCOME TAXES:

A reconciliation between income taxes calculated at the statutory federal tax rate and the tax provision reflected in the consolidated financial statements is as follows:

Thousands, except percentages	2006	2005	2004
Income taxes at federal statutory rate	$ 34,877	$ 31,804	$ 26,986
Increase (decrease):			
Current state income tax, net of federal tax benefit	3,655	2,913	2,554
Federal income tax credits	-	(210)	(210)
Amortization of investment and energy tax credits	(994)	(956)	(920)
Differences required to be flowed-through by regulatory commissions	(704)	(704)	(704)
Gains on Company and trust-owned life insurance	(913)	(650)	(955)
Other - net	155	187	172
Reversal of amounts provided in prior years	158	336	(392)
Total provision for income taxes	$ 36,234	$ 32,720	$ 26,531
Federal statutory tax rate	35.0%	35.0%	35.0%
Increase (decrease):			
Current state income tax, net of federal tax benefit	3.7%	3.2%	3.3%
Federal income tax credits	0.0%	-0.2%	-0.3%
Amortization of investment and energy tax credits	-1.0%	-1.1%	-1.2%
Differences required to be flowed-through by regulatory commissions	-0.7%	-0.8%	-0.9%
Gains on Company and trust-owned life insurance	-0.9%	-0.7%	-1.2%
Other - net	0.2%	0.2%	0.2%
Reversal of amounts provided in prior years	0.1%	0.4%	-0.5%
Effective tax rate	36.4%	36.0%	34.4%

The provision for income taxes consists of the following:

Thousands	2006	2005	2004
Current tax expense (benefit)	$ 52,621	$ 23,034	$ (10,718)
Deferred tax expense (benefit)	(15,393)	10,642	38,170
Deferred investment and energy tax credits	(994)	(956)	(920)
Total provision for income taxes	$ 36,234	$ 32,720	$ 26,531
Total income taxes paid	$ 31,270	$ 28,479	$ 2,500

The amount of income taxes paid in 2006 and 2005 increased significantly as compared to the total income taxes paid in 2004. This was primarily due to the effects of the accelerated bonus depreciation provisions of the Job Creation and Worker Assistance Act of 2002 (Assistance Act) and of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (Reconciliation Act). The Assistance Act provided for an additional depreciation deduction equal to 30 percent of an asset's adjusted basis. The Reconciliation Act increased this first-year additional depreciation deduction to 50 percent of an asset's adjusted basis. The accelerated depreciation provisions provided by the Acts expired December 31, 2004. We realized current tax benefits totaling an estimated $57 million during the effective period, based on plant investments made between September 11, 2001 and December 31, 2004. The accelerated depreciation provisions in 2004 were the primary factors resulting in net operating losses (NOL) for tax purposes.

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The following table summarizes the total provision for income taxes for the regulated utility and other non-regulated business segments for the three years ended December 31:

Thousands	2006	2005	2004
Regulated utility:			
Federal			
Current	$ 40,979	$ 17,848	$ (10,794)
Deferred	(12,472)	8,690	35,213
Deferred investment and energy tax credits	(756)	(784)	(800)
	27,750	25,755	23,618
State			
Current	7,490	1,650	(1,094)
Deferred	(2,338)	2,855	5,027
	5,152	4,504	3,933
Total charged to regulated utility	32,902	30,259	27,551
Non-regulated business segments:			
Federal			
Current	3,807	3,581	1,187
Deferred	(714)	(1,189)	(1,610)
Deferred investment and energy tax credits	(238)	(172)	(120)
	2,855	2,220	(543)
State			
Current	346	(44)	(17)
Deferred	131	285	(460)
	477	241	(478)
Total charged to non-regulated business segments	3,331	2,461	(1,020)
Total provision for income taxes	$ 36,234	$ 32,720	$ 26,531

The following table summarizes the tax effect of significant items comprising our deferred income tax accounts for the two years ended December 31:

Thousands	2006	2005
Deferred tax liabilities (assets)		
Utility plant and equipment	$ 150,648	$ 146,681
Utility regulatory balances	-	3,045
Utility other deferred tax differences	-	1,769
Non-regulated deferred tax differences	3,893	6,121
Deferred tax liabilities	154,540	157,616
Utility regulatory balances	(10,039)	-
Utility other deferred tax differences	(4,053)	-
Deferred tax assets	(14,092)	-
	140,448	157,616
Regulatory income tax assets	67,141	65,843
Minimum pension liability	(1,413)	(1,128)
Deferred income taxes	206,177	222,331
Deferred investment tax credits	3,907	5,069
Deferred income taxes and investment tax credits	$ 210,084	$ 227,400

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We have determined that the utility is more likely than not to realize all recorded deferred tax assets as of December 31, 2006.

The following is a reconciliation of the change in our deferred tax balance for the year ended December 31:

Thousands	2006
Deferred tax expense (benefit), above	$ (15,393)
Increase in differences required to be flowed-through	1,298
Decrease in minimum pension liability included in OCI	(285)
Decrease in deferred taxes associated with asset held for sale	(1,942)
Decrease in deferred investment tax credits	(994)
Change in deferred income tax accounts	$ (17,316)

We calculate our deferred tax assets and liabilities under SFAS No. 109, which requires recording deferred tax balances, at the currently enacted tax rate, on assets and liabilities that are reported differently for income tax purposes than for financial reporting purposes. Deferred tax provisions are not recorded in the income statement for certain temporary differences where regulators require that we flow through deferred income tax benefits or expenses in the ratemaking process of the regulated utility.

A deferred income tax charge associated with accruals of minimum pension liability was included in AOCI.

The Internal Revenue Service (IRS) completed its audit of our consolidated income tax returns for the years 2002-2004 in the second quarter of 2006. The focus of the examination was the $35.8 million NOL generated in 2004 and carried back to 2002. This loss was primarily due to the deductions claimed for a pension contribution and accelerated depreciation provided by both the Assistance Act and the Reconciliation Act discussed above. A federal refund of $8.3 million was received in October 2005. In conjunction with recording the refund, we recorded additional federal and state income tax credits of $4.2 million. In addition to the NOL, the IRS examined income tax positions taken with respect to various other ordinary business transactions. We reached agreement with the IRS for certain income tax positions such that a notice of proposed adjustment was issued. As a result of this agreement, we recorded an immaterial income tax benefit of $0.1 million.

9. PROPERTY AND INVESTMENTS:

The following table sets forth the major classifications of our utility plant and accumulated depreciation at December 31:

	2006		2005	
Thousands, except percentages	Amount	Weighted Average Depreciation Rate	Amount	Weighted Average Depreciation Rate
Transmission and distribution	$ 1,657,466	3.3%	$ 1,575,545	3.2%
Utility storage	110,721	2.6%	109,908	2.6%
General	92,946	2.6%	90,780	3.1%
Intangible and other	68,088	8.6%	66,354	8.4%
Gas stored long-term	12,850	0.0%	13,078	0.0%
Utility plant in service	1,942,071	3.4%	1,855,665	3.4%
Assets held for future use	-		1,833	
Construction work in progress	21,427		17,946	
Total utility plant	1,963,498		1,875,444	
Accumulated depreciation	(574,093)		(536,867)	
Utility plant-net	$ 1,389,405		$ 1,338,577	

Accumulated depreciation does not include $187.4 million and $169.9 million at December 31, 2006 and 2005, respectively, which represent accrued asset removal costs reflected on the balance sheets as regulatory liabilities (see Note 1., "Plant and Property and Accrued Asset Removal Costs").

The following table summarizes our investments in non-utility plant at December 31:

	2006		2005	
Thousands, except percentages	Amount	Weighted Average Depreciation Rate	Amount	Weighted Average Depreciation Rate
Non-utility storage	$ 34,652		$ 34,486	
Other	4,820		4,953	
Non-utility plant in service	39,472	2.5%	39,439	2.6%
Construction work in progress	3,180		1,397	
Total non-utility plant	42,652		40,836	
Less accumulated depreciation	(6,916)		(5,990)	
Non-utility plant – net	$ 35,736		$ 34,846	

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The following table summarizes our other long-term investments, including financial investments in life insurance policies accounted for at fair value based on cash surrender values, equity investments in certain partnerships and joint ventures accounted for under the equity or cost methods, and a leveraged lease investment in an aircraft, at December 31:

Thousands	2006	2005
Life insurance cash surrender value	$ 45,234	$ 46,555
Aircraft leveraged lease	-	6,884
Real estate partnership	-	1,502
Note receivable	526	1,237
Gas pipeline and other	1,369	1,434
Electric generation	856	839
Total other investments	$ 47,985	$ 58,451

Aircraft Leveraged Lease. In 1987, we invested in a Boeing 737-300 aircraft, which is leased to Continental Airlines for 20 years under a leveraged lease agreement, which expires in March 2007. We have reclassified these amounts into current assets due to our expectation of selling the asset in 2007.

Real Estate Partnership. In 2006, we sold our investment in a real estate partnership and received $1.8 million in cash, realizing a gain of $0.3 million on the sale.

Gas Pipeline. A wholly-owned subsidiary of Financial Corporation, KB Pipeline Company, owns a 10 percent interest in an 18-mile interstate natural gas pipeline.

Electric Generation. At December 31, 2006, Financial Corporation held ownership interests ranging from 25 to 41 percent in wind power electric generation projects located in California. The wind-generated power is sold to Pacific Gas and Electric Company and Southern California Edison Company under long-term contracts. In January 2005, Financial Corporation sold its limited partnership interests in three electric generating systems (see Note 2).

FASB Interpretation No. 46(R), "Consolidation of Variable Interest Entities," provides guidance for determining whether consolidation is required for entities over which control is achieved through means other than voting rights, know as "variable interest entities." We do not have any significant interests in variable interest entities. See Note 1, "New Accounting Standards—Adopted Standards—Variable Interest Entities."

10. FAIR VALUE OF FINANCIAL INSTRUMENTS:

The estimated fair value of NW Natural's financial instruments has been determined using available market information and appropriate valuation methodologies. The following are financial instruments whose carrying values are sensitive to market conditions:

	Dec. 31, 2006		Dec. 31, 2005	
Thousands	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Long-term debt including amount due within one year	$ 546,500	$ 595,564	$ 529,500	$ 579,382

Fair value of the long-term debt was estimated using market prices in effect on the valuation date. Interest rates for debt with similar terms and remaining maturities were used to estimate fair value for long-term debt issues.

.1. USE OF FINANCIAL DERIVATIVES:

We enter into forward contracts and other related financial transactions for the purchase of natural gas that qualify as derivative instruments under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS No. 138 and SFAS No. 149 (collectively referred to as SFAS No. 133). We primarily utilize derivative financial instruments to manage commodity prices related to natural gas supply requirements.

In the normal course of business, we generally enter into index-price physical forward natural gas commodity purchase (gas supply) contracts to meet the requirements of core utility customers. We also enter into financial derivatives, up to prescribed limits, to hedge price variability related to the physical contracts. Derivatives entered into prudently for future gas years prior to the PGA filing receive SFAS No. 71 regulatory deferral treatment. Derivatives contracts entered into for core utility customer requirements after the annual PGA rate has been set are subject to the PGA incentive sharing mechanism, whereby 67 percent of the changes in fair value are deferred as regulatory assets or liabilities and the remaining 33 percent is recorded to the income statement. During the fourth quarter of 2006, we entered into a number of financial derivatives after our PGA filing. The unrealized mark-to-market losses on these hedges totaled $9.5 million, of which $2.9 million was subject to sharing and was recorded as a loss, with the remainder deferred.

The mark-to-market adjustment at December 31, 2006 for all derivatives was a total unrealized loss of $43.2 million consisting of the following: unrealized losses of $40.3 million on swap contracts, $0.7 million on option contracts, $2.1 million on indexed-price physical supply contracts and $0.1 million on foreign exchange forwards.

Certain natural gas purchases from Canadian suppliers are payable in Canadian dollars, including both commodity and demand charges, which exposes us to adverse changes in foreign currency rates. Foreign currency forward contracts are used to hedge the fluctuation in foreign currency exchange rates for our commodity and commodity-related demand charges paid in Canadian dollars. Foreign currency contracts for commodity costs are purchased on a month-to-month basis because the Canadian cost is priced at the average noon-day exchange rate for each month. Foreign currency contracts for demand costs have terms ranging up to 12 months. The gains and losses on the shorter-term currency contracts for commodity costs are recognized immediately in cost of gas. The gains and losses on the currency contracts for demand charges are not recognized in current income but are subject to a regulatory deferral tariff and, as such, are recorded as a derivative asset or liability. These forward contracts qualify for cash flow hedge accounting treatment under SFAS No. 133. The mark-to-market adjustment at December 31, 2006 was an unrealized loss of $0.1 million. These unrealized gains and losses were subject to regulatory deferral and, as such, were recorded as a derivative asset or liability which is offset by recording a corresponding amount to a regulatory asset or regulatory liability account resulting in a nominal loss which was deferred to a regulatory account.

We did not use any derivative instruments to hedge oil or propane prices or interest rates during 2006, 2005 or 2004.

At December 31, 2006 and 2005, unrealized gains or losses from mark-to-market valuations of our derivative instruments were primarily reported as regulatory liabilities or regulatory assets because the realized gains or losses at settlement are included in utility gas costs, pursuant to regulatory deferral mechanisms. The estimated fair values of unrealized gains and losses on derivative instruments outstanding, determined using a discounted cash flow model for swaps and indexed-price contracts and a Black-Scholes model for options, were as follows:

	Fair Value Gains (Losses)			
	Dec. 31, 2006		Dec. 31, 2005	
Thousands	Current	Non-Current	Current	Non-Current
Natural gas commodity-based derivative instruments:				
Fixed-price financial swaps	$ (33,965)	$ (6,313)	$ 159,373	$ 14,417
Fixed-price financial options	(678)	-	1,871	-
Indexed-price physical supply	1,115	(3,271)	846	(6,300)
Fixed-price physical supply	-	-	820	-
Physical options	-	-	567	-
Foreign currency forwards	(135)	-	183	-
Total	$ (33,663)	$ (9,584)	$ 163,660	$ 8,117

In 2006, we realized a net loss of $20.0 million from the settlement of fixed-price financial swap contracts which were recorded as increases to the cost of gas. Net realized gains from the settlement of such contracts in 2005 and 2004 were $88.9 million and $42.4 million, respectively, and were recorded as decreases to the cost of gas. Realized losses in 2006 were offset by lower gas purchase costs from the underlying hedged floating rate physical supply contracts. The currency exchange rate in all foreign currency forward purchase contracts is included in our cost of gas at settlement; therefore, no gain or loss was recorded from the settlement of those contracts. Any change in value of cash flow hedge contracts that is not included in regulatory recovery is included in other comprehensive income.

As of December 31, 2006, all of the natural gas commodity price swap contracts mature by October 31, 2008 and all of the natural gas commodity call option contracts mature by April 30, 2007.

12. COMMITMENTS AND CONTINGENCIES:

Lease Commitments

We lease land, buildings and equipment under agreements that expire in various years through 2045. Rental expense under operating leases was $4.4 million, $4.1 million and $4.5 million for the years ended December 31, 2006, 2005 and 2004, respectively. The table below reflects the future minimum lease payments due under non-cancelable leases at December 31, 2006. Such payments total $55.9 million for operating leases. The net present value of payments on capital leases less imputed interest was $0.6 million. These commitments relate principally to the lease of our office headquarters, underground gas storage facilities, vehicles and computer equipment.

Millions	2007	2008	2009	2010	2011	Later years
Operating leases	$ 4.2	$ 4.1	$ 4.1	$ 4.1	$ 4.1	$ 35.3
Capital leases	0.3	0.2	0.1	-	-	-
Minimum lease payments	$ 4.5	$ 4.3	$ 4.2	$ 4.1	$ 4.1	$ 35.3

Gas Purchase and Pipeline Capacity Purchase and Release Commitments

We have signed agreements providing for the reservation of firm pipeline capacity under which we are required to make fixed monthly payments for contracted capacity. The pricing component of the monthly payment is established, subject to change, by U.S. or Canadian regulatory bodies. In addition, we have entered into long-term sale agreements to release firm pipeline capacity. We also enter into gas purchase agreements. The aggregate amounts of these agreements were as follows at December 31, 2006:

Thousands	Gas Purchase Agreements	Pipeline Capacity Purchase Agreements	Pipeline Capacity Release Agreements
2007	$ 283,180	$ 86,129	$ 5,105
2008	177,943	75,953	5,105
2009	98,807	70,093	5,105
2010	47,263	70,339	4,254
2011	25,828	70,059	-
2012 through 2026	73,179	198,863	-
Total	706,200	571,436	19,569
Less: Amount representing interest	59,737	100,411	1,663
Total at present value	$ 646,463	$ 471,025	$ 17,906

Our total payments of fixed charges under capacity purchase agreements in 2006, 2005 and 2004 were $69.2 million, $83.1 million and $89.3 million, respectively. Included in the amounts for 2006, 2005 and 2004 were reductions for capacity release sales of $3.7 million in each year. In addition, per-unit charges are required to be paid based on the actual quantities shipped under the agreements. In certain take-or-pay purchase commitments, annual deficiencies may be offset by prepayments subject to recovery over a longer term if future purchases exceed the minimum annual requirements.

Environmental Matters

We own, or have previously owned, properties that may require environmental remediation or action. We accrue all material loss contingencies relating to these properties that we believe to be probable of assertion and reasonably estimable. We continue to study the extent of our potential environmental liabilities, but due to the numerous uncertainties surrounding the course of environmental remediation and the preliminary nature of several environmental site investigations, the range of potential loss beyond the amounts currently accrued, and the probabilities thereof, cannot be reasonably estimated. We regularly review our remediation liability for each site where we may be exposed to remediation responsibilities. The costs of environmental remediation are difficult to estimate. A number of steps are involved in each environmental remediation effort, including site investigations, remediation, operations and maintenance, monitoring and site closure. Each of these steps may, over time, involve a number of alternative actions, each of which can change the course of the effort. In certain cases, in addition to ourselves, there are a number of other potentially responsible parties, each of which, in proceedings and negotiations with other potentially responsible parties and regulators, may influence the course of the remediation effort. The allocation of liabilities among the potentially

responsible parties is often subject to dispute and can be highly uncertain. The events giving rise to environmental liabilities often occurred many decades ago, which complicates the determination of allocating liabilities among potentially responsible parties. Site investigations and remediation efforts often develop slowly over many years. To the extent reasonably estimable, we estimate the costs of environmental liabilities using current technology, enacted laws and regulations, industry experience gained at similar sites and an assessment of the probable level of involvement and financial condition of other potentially responsible parties. Unless there is a better estimate within this range of probable cost, we record the liability at the lower end of this range. It is likely that changes in these estimates will occur throughout the remediation process for each of these sites due to uncertainty concerning our responsibility, the complexity of environmental laws and regulations and the selection of compliance alternatives. The status of each of the sites currently under investigation is provided below.

Gasco site. We own property in Multnomah County, Oregon that is the site of a former gas manufacturing plant that was closed in 1956 (the Gasco site). The Gasco site has been under investigation by us for environmental contamination under the Oregon Department of Environmental Quality's (ODEQ) Voluntary Clean-Up Program. In June 2003, we filed a Feasibility Scoping Plan and an Ecological and Human Health Risk Assessment with the ODEQ, which outlined a range of remedial alternatives for the most contaminated portion of the Gasco site. In 2006, the estimated liability for this site increased $7.2 million due to updated estimates for the completion of the Feasibility Study and Work Plan, the design and treatment system for pilot wells and the construction of a containment wall for source control. We have accrued a liability of $6.4 million for the Gasco site, which is at the low end of the range because no amount within the range is considered to be more likely than another and the high end of the range cannot be estimated.

Siltronic (formerly Wacker) site. We previously owned property adjacent to the Gasco site that now is the location of a manufacturing plant owned by Siltronic Corporation (formerly Wacker Siltronic Corporation) (the Siltronic site). We are currently working with the ODEQ to develop a study of manufactured gas plant wastes on the uplands at this site. The amount of the additional accrual was deferred to a regulatory asset account pursuant to an order of the OPUC (see "Regulatory and Insurance Recovery for Environmental Matters," below).

Portland Harbor site. In 1998, the ODEQ and the U.S. Environmental Protection Agency (EPA) completed a study of sediments in a 5.5-mile segment of the Willamette River (Portland Harbor) that includes the area adjacent to the Gasco site and the Siltronic site. The Portland Harbor was listed by the EPA as a Superfund site in 2000 and we were notified that we are a potentially responsible party. Subsequently, the EPA approved a Programmatic Work Plan, Field Sampling Plan and Quality Assurance Project Plan for the Portland Harbor Remedial Investigation/Feasibility Study (RI/FS). As a result of the EPA's requests for additional data after reviewing the data collected to date at the site, an additional accrual of $1.3 million was recorded in 2006 for the additional studies, regulatory oversight and related legal costs. Current information is not sufficient to reasonably estimate additional liabilities, if any, or the range of potential liabilities, for environmental remediation and monitoring after the RI/FS work plan is completed, except for the early action removal of a tar deposit in the river sediments discussed below.

In April 2004, we entered into an Administrative Order on Consent providing for early action removal of a deposit of tar in the river sediments adjacent to the Gasco site. We completed the

removal of the tar deposit in the Portland Harbor in October 2005 and on November 5, 2005, the EPA approved the completed project. The estimated cost for the removal, including technical work, oversight, consultants, legal fees and ongoing monitoring, is $10.3 million. To date we have spent $9.8 million on work related to the removal of the tar deposit with a remaining liability of $0.5 million.

Central Gas Storage Tanks. On September 22, 2006, we received notice from the ODEQ that our Central Service Center has been assigned a high priority for further environmental investigation. Previously there were three manufactured gas storage tanks on the premises. The ODEQ believes there could be site contamination associated with releases of condensate from stored manufactured gas, or through historic gas handling practices. In the early 1990s, we excavated waste piles and much of the contaminated surface soils and removed accessible waste from some of the abandoned piping. A negligible accrual was recorded in September 2006 for the ODEQ site assessment and legal and technical costs to investigate and determine the appropriate action, if any. In February 2007, we received notice that the site has been added to the ODEQ's list of sites where releases of hazardous substances have been confirmed and its list where it has been determined that additional investigation or cleanup is necessary. Possible costs are not currently estimable; however, we intend to seek regulatory authorization for the deferral of environmental costs related to this site (see "Regulatory and Insurance Recovery for Environmental Matters," below).

Oregon Steel Mills site. See "Legal Proceedings," below.

Regulatory and Insurance Recovery for Environmental Matters. In May 2003, the OPUC approved our request for deferral of environmental costs associated with specific sites, including the Gasco, Siltronic and Portland Harbor sites. The authorization, which was extended through January 2007 and expanded to include the Oregon Steel Mills site, allows us to defer and seek recovery of unreimbursed environmental costs in a future general rate case. In April 2006, the OPUC authorized us to accrue interest on deferred balances effective January 27, 2006, subject to an annual demonstration that we have maximized our insurance recovery or made substantial progress in securing insurance recovery for unrecovered environmental expenses. An application for extension of the regulatory approval to defer environmental costs and accrued interest is pending. As of December 31, 2006, we have paid a cumulative total of $19.1 million relating to the named sites since the effective date of the deferral authorization.

On a cumulative basis, we have recognized a total of $32.7 million for environmental costs, including legal, investigation, monitoring and remediation costs. Of this total, $24.0 million has been spent to-date and $8.7 million is reported as an outstanding liability. At December 31, 2006, we had a regulatory asset of $27.8 million which includes $19.1 million of total expenditures to date and accruals for an additional estimated cost of $8.7 million. We believe the recovery of these costs is probable through the regulatory process. We also have an insurance receivable of $1.1 million, which is not included in the regulatory asset amount. We intend to pursue recovery of these environmental costs from our general liability insurance policies, and the regulatory asset will be reduced by the amount of any corresponding insurance recoveries. We consider insurance recovery of some portion of our environmental costs probable based on a combination of factors, including a review of the terms of our insurance policies, the financial condition of the insurance companies providing coverage, a review of

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successful claims filed by other utilities with similar gas manufacturing facilities, and Oregon legislation that allows an insured party to seek recovery of "all sums" from one insurance company. As of January 2007, we have entered into settlement discussions with six of our major insurers, and expect to add another four insurers within the next several months. We anticipate that our overall insurance recovery effort will extend over several years.

The following table summarizes the regulatory assets and accrued liabilities relating to environmental matters at December 31, 2006 and 2005:

	Regulatory Asset		Accrued Liability	
Millions	2006	2005	2006	2005
Gasco site	$ 10.3	$ 3.2	$ 6.4	$ 1.4
Siltronic site	0.5	0.3	-	-
Portland Harbor site	16.8	15.1	2.1	4.9
Oregon Steel Mills site	0.2	0.2	0.2	0.1
Total	$ 27.8	$ 18.8	$ 8.7	$ 6.4

Legal Proceedings

We are subject to claims and litigation arising in the ordinary course of business. Although the final outcome of any of these legal proceedings, including the matters described below, cannot be predicted with certainty, we do not expect that the ultimate disposition of these matters will have a material adverse effect on our financial condition, results of operations or cash flows.

Georgia-Pacific Corporation vs. Northwest Natural Gas Company. On February 3, 2006, Georgia-Pacific Corporation (Georgia-Pacific) filed suit against NW Natural (Georgia-Pacific Corporation v. Northwest Natural Gas Company, Case No. CV06-151-PK, United States District Court, District of Oregon), alleging that we offered to sell natural gas to Georgia-Pacific under the interruptible sales service provisions of Rate Schedule 32 at a commodity rate set at our Weighted Average Cost of Gas. Georgia-Pacific further alleged that it accepted this offer and that we failed to perform as promised when, in October 2005, we notified Georgia-Pacific that we would have to charge Georgia-Pacific the incremental costs of acquiring gas on the open market. Georgia-Pacific also alleged breach of contract, promissory estoppel, fraudulent misrepresentation and breach of the duty of good faith and fair dealing.

On February 23, 2006, we filed a motion for summary judgment on all claims. On June 30, 2006, an order was issued by the U.S. District Court for the District of Oregon dismissing the lawsuit with prejudice and denying all pending motions, if any, as moot. On July 27, 2006, Georgia-Pacific appealed this ruling to the Ninth Circuit Court of Appeals. We have reached agreement with Georgia-Pacific on settlement terms and the lawsuit has been dismissed.

Independent Backhoe Operator Action. Since May 2004, five lawsuits have been filed against NW Natural by independent backhoe operators who performed backhoe services for NW Natural under contract. These five lawsuits have been consolidated into one case, in which 10 plaintiffs remain (*Law and Zuehlke, et. al. v. Northwest Natural Gas Co.,* CV-04-728-KI, United States District Court, District of Oregon). Plaintiffs allege violation of the Fair Labor Standards Act for failure to pay overtime and also assert state wage and hour claims. Plaintiffs claim that they should have been considered "employees," and seek overtime wages and

interest in amounts to be determined, liquidated damages equal to the overtime award, civil penalties and attorneys' fees and costs. Additionally, plaintiffs allege that the failure to classify them as employees constituted a breach of contract under and with respect to certain employee benefits plans, programs and agreements. Plaintiffs seek an unspecified amount of damages for the value of what they would have received under these employee benefit plans if they had been classified as employees. There is insufficient information at this time to reasonably estimate the range of liability, if any, from these claims. We will vigorously contest these claims and do not expect the outcome of this litigation to have a material adverse effect on our results of operations or financial condition.

Oregon Steel Mills site. In 2004, NW Natural was served with a third-party complaint by the Port of Portland (Port) in a Multnomah County Circuit Court case, *Oregon Steel Mills, Inc. v. The Port of Portland*. The Port alleges that in the 1940s and 1950s petroleum wastes generated by our predecessor, Portland Gas & Coke Company, and 10 other third-party defendants were disposed of in a waste oil disposal facility operated by the United States or Shaver Transportation Company on property then owned by the Port and now owned by Oregon Steel Mills. The Port's complaint seeks contribution for unspecified past remedial action costs incurred by the Port regarding the former waste oil disposal facility as well as a declaratory judgment allocating liability for future remedial action costs. In March 2005, motions to dismiss by ourselves and other third-party defendants were denied on the basis that the failure of the Port to plead and prove that we were in violation of law was an affirmative defense that may be asserted at trial, but did not provide a sufficient basis for dismissal of the Port's claim. No date has been set for trial and discovery is ongoing. We do not expect that the ultimate disposition of this matter will have a material adverse effect on our financial condition, results of operations or cash flows.

NORTHWEST NATURAL GAS COMPANY

QUARTERLY FINANCIAL INFORMATION (UNAUDITED)

Thousands, except per share amounts	Quarter ended March 31	June 30	Sept. 30	Dec. 31	Total
2006					
Operating revenues	$ 390,391	$ 170,979	$ 114,914	$ 336,888	$ 1,013,172
Net operating revenues	125,464	61,747	41,341	111,624	340,176
Net income (loss)	41,033	1,994	(9,724)	30,112	63,415
Basic earnings (loss) per share	1.49	0.07	(0.35)	1.10	2.30*
Diluted earnings (loss) per share	1.48	0.07	(0.35)	1.09	2.29*
2005					
Operating revenues	$ 308,777	$ 153,667	$ 106,667	$ 341,375	$ 910,486
Net operating revenues	120,986	57,649	41,940	104,418	324,993
Net income (loss)	39,887	1,140	(8,671)	25,793	58,149
Basic earnings (loss) per share	1.45	0.04	(0.31)	0.94	2.11*
Diluted earnings (loss) per share	1.43	0.04	(0.31)	0.93	2.11*

* Quarterly earnings (loss) per share are based upon the average number of common shares outstanding during each quarter. Because the average number of shares outstanding has changed in each quarter shown, the sum of quarterly earnings (loss) per share may not equal earnings per share for the year. Variations in earnings between quarterly periods are due primarily to the seasonal nature of our business.

NORTHWEST NATURAL GAS COMPANY

SCHEDULE II – VALUATION AND QUALIFYING ACCOUNTS AND RESERVES

COLUMN A	COLUMN	COLUMN C		COLUMN	COLUMN
		Additions		Deductions	
'housands (year ended Dec. 31)	Balance at beginning of period	Charge d to costs and ex penses	Charged to other accounts	Net Write-offs	Balance at end of period
06					
Reserves deducted in balance sheet from assets to which they apply:					
Allowance for uncollectible accounts	$ 3,067	$ 3,036	$ 0	$ 3,070	$ 3,033
2005					
Reserves deducted in balance sheet from assets to which they apply:					
Allowance for uncollectible accounts	$ 2,434	$ 3,034	$ 0	$ 2,401	$ 3,067
2004					
Reserves deducted in balance sheet from assets to which they apply:					
Allowance for uncollectible accounts	$ 1,763	$ 3,312	$ 0	$ 2,641	$ 2,434

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

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ITEM 9A. CONTROLS AND PROCEDURES

(a) Evaluation of Disclosure Controls and Procedures

As of December 31, 2006, the principal executive officer and principal financial officer of the Company have evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended (Exchange Act)). Based upon that evaluation, the principal executive officer and principal financial officer of NW Natural have concluded that such disclosure controls and procedures are effective to ensure that information required to be disclosed by us and included in our reports filed with or furnished to the Securities and Exchange Commission under the Exchange Act is accumulated and communicated to our management as appropriate to allow timely decision regarding required disclosure.

(b) Changes in Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in the Exchange Act Rule 13a-15(f). There have been no changes in our internal control over financial reporting that occurred during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

The statements contained in Exhibit 31.1 and Exhibit 31.2 should be considered in light of, and read together with, the information set forth in this Item 9A.

Management's Report on Internal Control Over Financial Reporting and The Report of Independent Registered Public Accounting Firm appear under Item 8.

ITEM 9B. OTHER INFORMATION

None.

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PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS OF THE REGISTRANT AND CORPORATE GOVERNANCE

Information concerning our Board of Directors, its Committees and the Audit Committee financial expert contained in NW Natural's definitive Proxy Statement for the May 24, 2007 Annual Meeting of Shareholders is hereby incorporated by reference. The information concerning "Section 16(a) Beneficial Ownership Reporting Compliance" and "Corporate Governance" contained in our definitive Proxy Statement for the May 24, 2007 Annual Meeting of Shareholders is hereby incorporated by reference.

Name	Age at Dec. 31, 2006	Positions held during last five years
Mark S. Dodson	61	President and Chief Executive Officer (2003-); President, Chief Operating Officer and General Counsel (2001-2002).
Michael S. McCoy	63	Executive Vice President, Customer and Utility Operations (2000-2006).
Gregg S. Kantor	49	Executive Vice President (2006 -); Senior Vice President, Public and Regulatory Affairs (2003-2006); Vice President, Public Affairs and Communications (1998-2002).
David H. Anderson	45	Senior Vice President and Chief Financial Officer (2004-); Chief Financial Officer, TXU Gas Company (2004); Senior Vice President, Principal Accounting Officer and Controller (2003-2004); Vice President of Investor Relations and Shareholder Services, TXU Corp. (1997-2003).
Margaret D. Kirkpatrick	52	Vice President and General Counsel (2005-); Partner, Stoel Rives LLP (1991-2005).
Lea Anne Doolittle	51	Vice President, Human Resources (2000-).
J. Keith White	53	Vice President, Business Development and Energy Supply (2007-); Managing Director, Gas Operations and Wholesale Services (2005-2006); Managing Director and Chief Strategic Officer (2003-2005); Director, Strategic Development (2003); Director, Corporate and Business Development (2001-2003); Director, Business Development (1998-2001).
David R. Williams	53	Vice President, Utility Services (2007-); Director, Acquire Customers (2006); Director, Gas Operations (2005-2006); General Manager, Utility Operations (1999-2004)
·ant M. Yoshihara	51	Vice President, Utility Operations (2007-); Managing Director, Utility Services (2005-2006); General Manager, Consumer Services (2003-2004); General Manager, Marketing, Development and Utility Operations (2000-2002).
Stephen P. Feltz	51	Treasurer and Controller (1999-).
C. J. Rue	61	Secretary (1982-); Assistant Treasurer (1987-).
Richelle T. Luther	38	Assistant Secretary (2002-); Associate, Stoel Rives LLP (1997-2002).

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Each executive officer serves successive annual terms; present terms end on May 24, 2007. There are no family relationships among our executive officers.

NW Natural has adopted a Code of Ethics for all employees, including our chief executive officer, chief financial officer and principal accounting officer, and a Financial Code of Ethics that applies to senior financial employees, both of which are available on our website at www.nwnatural.com.

ITEM 11. EXECUTIVE COMPENSATION

The information concerning "Executive Compensation" and "Report of the Organization and Executive Compensation Committee on Executive Management Compensation" contained in our definitive Proxy Statement for the May 24, 2007 Annual Meeting of Shareholders is hereby incorporated by reference. Information related to Executive Officers as of December 31, 2006 is reflected in Part III, Item 10, above.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The following table sets forth information regarding compensation plans under which equity securities of NW Natural are authorized for issuance as of December 31, 2006 (see Note 4 to the Consolidated Financial Statements):

	(a) Number of securities to be issued upon exercise of outstanding options, warrants and rights	(b) Weighted-average exercise price of outstanding options, warrants and rights	(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by security holders:			
Long-Term Incentive Plan (LTIP)			
(Target Award)[1]	84,494	n/a	375,060
Restated Stock Option Plan	334,000	$ 31.14	1,135,000
Employee Stock Purchase Plan	23,303	$ 35.17	221,103
Equity compensation plans not approved by security holders:			
Executive Deferred Compensation Plan (EDCP)[2]	7,700	n/a	n/a
Directors Deferred Compensation Plan (DDCP)[2]	77,751	n/a	n/a
Deferred Compensation Plan for Directors and Executives (DCP)[3]	17,510	n/a	n/a
Non-Employee Directors Stock Compensation Plan[4]	n/a	n/a	n/a
Total	544,758		1,731,163

The information captioned "Beneficial Ownership of Common Stock by Directors and Executive Officers" contained in the our definitive Proxy Statement for the May 24, 2007 Annual Meeting of Shareholders is incorporated herein by reference.

[1] Shares issued pursuant to the LTIP do not include an exercise price, but are payable by us when the award criteria are satisfied. If the maximum awards were paid pursuant to the performance-based awards outstanding at December 31, 2006, the number of shares shown in column (a) would increase by 72,994 shares and the number of shares shown in column (c) would decrease by 72,994 shares.

Prior to January 1, 2005, deferred amounts were credited, at the participant's election, to either a "cash account" or a "stock account." If deferred amounts were credited to stock accounts, such accounts were credited with a number of shares of NW Natural common stock based on the purchase price of the common stock on the next purchase date under our Dividend Reinvestment and Direct Stock Purchase Plan, and such accounts were credited with additional shares based on the deemed reinvestment of dividends. At the election of the participant, deferred balances in the stock accounts are payable after termination of Board service or employment in a lump sum, in installments over a period not to exceed 10 years in the case of the DDCP, or 15 years in the case of the EDCP, or in a combination of lump sum and installments. We have contributed common stock to the trustee of the Umbrella Trusts such that the Umbrella Trusts hold approximately the number of shares of common stock equal to the number of shares credited to all participants' stock accounts.

[3] Effective January 1, 2005, the EDCP and DDCP were replaced by the Deferred Compensation Plan for Directors and Executives (DCP). The DCP continues the basic provisions of the EDCP and DDCP under which deferred amounts are credited to either a "cash account" or a "stock account." Stock accounts represent a right to receive shares of NW Natural common stock on a deferred basis, and such accounts are credited with additional shares based on the deemed reinvestment of dividends. Effective January 1, 2007, cash accounts are credited quarterly with interest at a rate equal to Moody's Average Corporate Bond Yield, while EDCP and DDCP cash accounts continue to be credited quarterly with interest at a rate equal to Moody's Average Corporate Bond Yield plus two percentage points. For the EDCP and the DDCP only, the crediting rate is subject to a six percent minimum rate. Our obligation to pay deferred compensation in accordance with the terms of the DCP will generally become due on retirement, death, or other termination of service, and will be paid in a lump sum or in installments of five or ten years as elected by the participant in accordance with the terms of the DCP. The right of each participant in the DCP is that of a general, unsecured creditor of the Company.

[4] The material features of this plan are more particularly described in Note 4 to the Consolidated Financial Statements included in this report.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information captioned "Transactions with Related Persons" and "Corporate Governance" in the Company's definitive Proxy Statement for the May 24, 2007 Annual Meeting of Shareholders is hereby incorporated by reference.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information captioned "2006 and 2005 Audit Firm Fees" in the Company's definitive Proxy Statement for the May 24, 2007 Annual Meeting of Shareholders is hereby incorporated by reference.

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PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) The following documents are filed as part of this report:

1. A list of all Financial Statements and Supplemental Schedules is incorporated by reference to Item 8.

2. List of Exhibits filed:

Reference is made to the Exhibit Index commencing on page 118.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its ,ehalf by the undersigned, thereunto duly authorized.

Date: February 28, 2007

NORTHWEST NATURAL GAS COMPANY
By: /s/ Mark S. Dodson
Mark S. Dodson, President
and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the date indicated.

SIGNATURE	TITLE	DATE
/s/ Mark S. Dodson Mark S. Dodson, President and Chief Executive Officer	Principal Executive Officer and Director	February 28, 2007
/s/ David H. Anderson David H. Anderson Senior Vice President and Chief Financial Officer	Principal Financial Officer	February 28, 2007
/s/ Stephen P. Feltz Stephen P. Feltz Treasurer and Controller	Principal Accounting Officer	February 28, 2007
/s/ Timothy P. Boyle Timothy P. Boyle	Director	)
'artha L. Byorum	Director	)
/s/ John D. Carter John D. Carter	Director	)
/s/ C. Scott Gibson C. Scott Gibson	Director	)
/s/ Tod R. Hamachek Tod R. Hamachek	Director	)
/s/ Randall C. Papé Randall C. Papé	Director	) February 28, 2007
/s/ Richard G. Reiten Richard G. Reiten	Director	)
/s/ Kenneth Thrasher Kenneth Thrasher	Director	)
/s/ Russell F. Tromley Russell F. Tromley	Director	)

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EXHIBIT INDEX

To

Annual Report on Form 10-K

For Fiscal Year Ended

December 31, 2006

Exhibit Number	Document
3a.	Restated Articles of Incorporation, as filed and effective May 31, 2006 and amended May 31, 2006.
*3b.	Bylaws as amended July 22, 2004 (incorporated herein by reference to Exhibit 3 to Form 10-Q for quarter ended June 30, 2004, File No. 1-15973.
*4a.	Copy of Mortgage and Deed of Trust, dated as of July 1, 1946, to Bankers Trust and R. G. Page (to whom Stanley Burg is now successor), Trustees (incorporated herein by reference to Exhibit 7(j) in File No. 2-6494); and copies of Supplemental Indentures Nos. 1 through 14 to the Mortgage and Deed of Trust, dated respectively, as of June 1, 1949, March 1, 1954, April 1, 1956, February 1, 1959, July 1, 1961, January 1, 1964, March 1, 1966, December 1, 1969, April 1, 1971, January 1, 1975, December 1, 1975, July 1, 1981, June 1, 1985 and November 1, 1985 (incorporated herein by reference to Exhibit 4(d) in File No. 33-1929); Supplemental Indenture No. 15 to the Mortgage and Deed of Trust, dated as of July 1, 1986 (filed as Exhibit 4(c) in File No. 33-24168); Supplemental Indentures Nos. 16, 17 and 18 to the Mortgage and Deed of Trust, dated, respectively, as of November 1, 1988, October 1, 1989 and July 1, 1990 (incorporated herein by reference to Exhibit 4(c) in File No. 33-40482); Supplemental Indenture No. 19 to the Mortgage and Deed of Trust, dated as of June 1, 1991 (incorporated herein by reference to Exhibit 4(c) in File No. 33-64014); and Supplemental Indenture No. 20 to the Mortgage and Deed of Trust, dated as of June 1, 1993 (incorporated herein by reference to Exhibit 4(c) in File No. 33-53795).
*4d.	Copy of Indenture, dated as of June 1, 1991, between the Company and Bankers Trust Company, Trustee, relating to the Company's Unsecured Medium-Term Notes (incorporated herein by reference to Exhibit 4(e) in File No. 33-64014).
*4e.	Officers' Certificate dated June 12, 1991 creating Series A of the Company's Unsecured Medium-Term Notes (incorporated herein by reference to Exhibit 4e. to Form 10-K for 1993, File No. 0-994).
*4f.	Officers' Certificate dated June 18, 1993 creating Series B of the Company's Unsecured Medium-Term Notes (incorporated herein by reference to Exhibit 4f. to Form 10-K for 1993, File No. 0-994).
*4f.(1)	Officers' Certificate dated January 17, 2003 relating to Series B of the Company's Unsecured Medium-Term Notes and supplementing the Officers' Certificate dated June 18, 1993 (incorporated herein by reference to Exhibit 4f.(1) to Form 10-K for 2002, File No. 0-994).

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*4i.	Form of Credit Agreement between Northwest Natural Gas Company and each of JPMorgan Chase Bank, NA, U.S. Bank National Association, Bank of America, NA, Wells Fargo Bank, NA and Wachovia Bank, National Association, dated as of October 1, 2005, including Form of Note (incorporated herein by reference to Exhibit 10.1 to Form 10-Q dated November 3, 2005, File No. 1-15973).
4j.	Distribution Agreement, dated September 28, 2004 as amended and restated on December 7, 2006, among the Company, Merrill Lynch, Pierce Fenner & Smith Incorporated, UBS Securities LLC, J.P. Morgan Securities Inc. and Piper Jaffray & Co.
*4k.	Form of Secured Medium-Term Notes, Series B (incorporated herein by reference to Exhibit 4.1 to Form 8-K dated October 4, 2004, File No. 1-15973).
*4l.	Form of Unsecured Medium-Term Notes, Series B (incorporated herein by reference to Exhibit 4.2 to Form 8-K dated October 4, 2004, File No. 1-15973).
*10j.	Transportation Agreement, dated June 29, 1990, between the Company and Northwest Pipeline Corporation (incorporated herein by reference to Exhibit 10j. to Form 10-K for 1993, File No. 0-994).
*10j.(1)	Replacement Firm Transportation Agreement, dated July 31, 1991, between the Company and Northwest Pipeline Corporation (incorporated herein by reference to Exhibit 10j.(2) to Form 10-K for 1992, File No. 0-994).
*10j.(2)	Firm Transportation Service Agreement, dated November 10, 1993, between the Company and Pacific Gas Transmission Company (incorporated herein by reference to Exhibit 10j.(2) to Form 10-K for 1993, File No. 0-994).
*10j.(3)	Service Agreement, dated June 17, 1993, between Northwest Pipeline Corporation and the Company (incorporated herein by reference to Exhibit 10j.(3) to Form 10-K for 1994, File No. 0-994).
*10j.(5)	Firm Transportation Service Agreement, dated June 22, 1994, between Pacific Gas Transmission Company and the Company (incorporated herein by reference to Exhibit 10j.(5) to Form 10-K for 1995, File No. 0-994).
*10j.(6)	Firm Service Agreement between the Company and Westcoast Energy Inc., dated as of April 1, 2003 (incorporated herein by reference to Exhibit 10 to Form 10-Q for quarter ended March 31, 2003, File No. 0-994).
11	Statement re computation of per share earnings.
12	Statement re computation of ratios of earnings to fixed charges.
23	Consent of PricewaterhouseCoopers LLP.
31.1	Certification of Principal Executive Officer Pursuant to Rule 13a-14(a)/15-d-14(a), Section 302 of the Sarbanes-Oxley Act of 2002.

31.2	Certification of Principal Financial Officer Pursuant to Rule 13a-14(a)/15-d-14(a), Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Principal Executive Officer and Principal Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
Executive Compensation Plans and Arrangements:	
*10b.	Executive Supplemental Retirement Income Plan (2004 Restatement) (incorporated herein by reference to Exhibit 10.2 to Form 8-K dated September 28, 2004, File No. 1-15973).
*10b.(1)	Supplemental Executive Retirement Plan, effective September 1, 2004 restated December 1, 2006 (incorporated herein by reference to Exhibit 10.1 to Form 8-K dated December 20, 2004, File No. 1-15973).
*10b.(2)	Northwest Natural Gas Company Supplemental Trust, effective January 1, 2005, restated as of December 15, 2005 (incorporated herein by reference to Exhibit 10.7 to Form 8-K dated December 16, 2005, File No. 1-15973).
*10b.(3)	Northwest Natural Gas Company Umbrella Trust for Directors, effective January 1, 1991, restated as of December 15, 2005 (incorporated herein by reference to Exhibit 10.5 to Form 8-K dated December 16, 2005, File No. 1-15973).
*10b.(4)	Northwest Natural Gas Company Umbrella Trust for Executives, effective January 1, 1988, restated as of December 15, 2005 (incorporated herein by reference to Exhibit 10.6 to Form 8-K dated December 16, 2005, File No. 1-15973).
*10b.(5)	Amended and Restated ESRIP Change in Control Appendix to the Executive Supplemental Retirement Income Plan, as amended and effective December 14, 2006 (incorporated herein by reference to Exhibit 10.4 to Form 8-K dated December 19, 2006, File No. 1-15973).
10c.	Restated Stock Option Plan, as amended effective December 14, 2006.
*10c.(1)	Form of Restated Stock Option Plan Agreement (incorporated herein by reference to Exhibit 10.3 to Form 10-Q dated November 3, 2005, File No. 1-15973).
*10e.	Executive Deferred Compensation Plan, effective as of January 1, 1987, restated as of January 1, 2007 (incorporated herein by reference to Exhibit 10.6 to Form 8-K dated December 19, 2006, File No. 1-15973).
*10f.	Directors Deferred Compensation Plan, effective June 1, 1981, restated as of January 1, 2007 (incorporated herein by reference to Exhibit 10.7 to Form 8-K dated December 19, 2006, File No. 1-15973).
*10f.(1)	Deferred Compensation Plan for Directors and Executives effective January 1, 2005, restated as of January 1, 2007 (incorporated herein by reference to Exhibit 10.2 to Form 10-Q dated November 2, 2006, File No. 1-15973).

*10g.	Form of Indemnity Agreement as entered into between the Company and each director and executive officer (incorporated herein by reference to Exhibit 10g. to Form 10-K for 1988, File No. 0-994).
*10i.	Non-Employee Directors Stock Compensation Plan, as amended effective December 15, 2005 (incorporated herein by reference to Exhibit 10.2 to Form 8-K dated December 16, 2005, File No. 1-15973).
*10k.	Executive Annual Incentive Plan, effective January 1, 2003 (incorporated herein by reference to Exhibit 10 k. to Form 10-K for 2002, File No. 0-994)
*10o.	Form of amended and restated executive change in control severance agreement between the Company and each executive officer other than Mark S. Dodson (incorporated herein by reference to Exhibit 10.2 to Form 8-K dated December 19, 2006, File No. 1-15973).
*10o.-1	Amended and restated executive change in control severance agreement dated December 14, 2006 between the Company and Mark S. Dodson (incorporated herein by reference to Exhibit 10.3 to Form 8-K dated December 19, 2006, File No. 1-15973).
*10p.	Employment Agreement dated July 2, 1997, between the Company and an executive officer (incorporated herein by reference to Exhibit 10(a) for Form 10-Q for the quarter ended September 30, 1997, File No. 0-994).
*10p.-1	Amendment dated December 18, 1997 to employment agreement dated July 2, 1997, between the Company and an executive officer (incorporated herein by reference to Exhibit 10p.-1 to Form 10-K for 1997, File No. 0-994).
*10p.-2	Amendment dated September 24, 1998 to employment agreement dated July 2, 1997, as previously amended, between the Company and an executive officer (incorporated herein by reference to Exhibit 10(g) to Form 10-Q for the quarter ended September 30, 1998, File No. 0-994).
*10p.-3	Employment Agreement dated December 20, 2002, between the Company and an executive officer (incorporated herein by reference to Exhibit 10p.-3 to Form 10-K for 2002, File No. 0-994).
*10p.-4	Amendment dated December 14, 2006 to employment agreement dated December 20, 2002 between the Company and Mark S. Dodson (incorporated herein by reference to Exhibit 10.8 to Form 8-K dated December 19, 2006, File No. 1-15973).
*10v.	Northwest Natural Gas Company Long-Term Incentive Plan, as amended and restated effective July 26, 2001 (incorporated herein by reference to Exhibit 10(c) to Form 10-Q for the quarter ended June 30, 2001, File No. 0-994).
*10w.	Form of Long-Term Incentive Award Agreement under the Long-Term Incentive Plan (incorporated herein by reference to Exhibit 10.8 to Form 8-K dated December 16, 2005, File No. 1-15973).

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*10w.(1)	Form of Long-Term Incentive Award Agreement under the Long-Term Incentive Plan (incorporated herein by reference to Exhibit 10.1 to Form 8-K dated February 21, 2007, File No. 1-15973).
*10x.	Form of Restricted Stock Bonus Agreement under the Long-Term Incentive Plan (incorporated herein by reference to Exhibit 10.9 to Form 8-K dated December 16, 2005, File No. 1-15973).
*10x.(1)	Restricted Stock Bonus Agreement with an executive officer dated July 26, 2006 (incorporated by reference to Exhibit 10.1 to Form 8-K dated July 28, 2006, File No. 1-15973).
*10z.(1)	Summary of non-employee director compensation, effective January 1, 2005 (incorporated herein by reference to Form 8-K dated October 3, 2006, File No. 1-15973).
*10aa.	Form of Consent dated December 14, 2006 entered into by each executive officer (incorporated herein by reference to Exhibit 10.1 to Form 8-K dated December 19, 2006, File No. 1-15973).

* Incorporated herein by reference as indicated

Exhibit 3A

RESTATED ARTICLES OF INCORPORATION

OF

NORTHWEST NATURAL GAS COMPANY

(These Restated Articles of Incorporation of Northwest Natural Gas Company supersede its theretofore existing Restated Articles of Incorporation and all amendments thereto.)

ARTICLE I

The name of this corporation is NORTHWEST NATURAL GAS COMPANY, and its duration shall be perpetual.

ARTICLE II

The purposes of the corporation are to engage in any lawful activity for which corporations may be organized under the Oregon Business Corporation Act.

ARTICLE III

A. The aggregate number of shares of capital stock which the corporation shall have authority to issue is 63,500,000 shares, divided into 3,500,000 shares of Preferred Stock, issuable in series as hereinafter provided, and 60,000,000 shares of Common Stock.

B. A statement of the preferences, limitations and relative rights of each class of capital stock of the corporation, namely, the Preferred Stock and the Common Stock, of the variations in the relative rights and preferences as between series of the Preferred Stock, insofar as the same are fixed by these Restated Articles of Incorporation, and of the authority vested in the board of directors of the corporation to establish series of Preferred Stock and to fix and determine the variations in the relative rights and preferences as between series insofar as the same are not fixed by these Restated Articles of Incorporation, is as follows:

Preferred Stock

1. The shares of the Preferred Stock may be divided into and issued in series. Each series shall be so designated as to distinguish the shares thereof from the shares of all other series of the Preferred Stock and all other classes of capital stock of the corporation. To the extent that these Restated Articles of Incorporation shall not have established series of the Preferred Stock and fixed and determined the variations in the relative rights and preferences as between series, the board of directors shall have authority, and is hereby expressly vested with authority, to divide the Preferred Stock into series and, within the limitations set forth in these Restated Articles of Incorporation and such limitations as may be provided by law, to fix and determine the relative rights and preferences of any series of the Preferred Stock so established. Such action by the board of directors shall be expressed in a resolution or resolutions adopted by it prior to the issuance of shares of each series, which resolution or resolutions shall also set forth the distinguishing designation of the particular series of the Preferred Stock established thereby. Without limiting the generality of the foregoing, authority is hereby expressly vested in the board of directors so to fix and determine with respect to any series of the Preferred Stock:

   (a) The rate of dividend and the relative preference of each series in the payment of dividends;

   (b) The price at which and the terms and conditions on which shares may be redeemed;

   (c) The amount payable upon shares in the event of voluntary and involuntary liquidation and the relative preference of each series on liquidation;

   (d) Sinking fund provisions, if any, for the redemption or purchase of shares;

   (e) The terms and conditions, if any, on which shares may be converted if the shares of any series are issued with the privilege of conversion; and

(f) Any other relative right or preference as permitted by law.

All shares of the Preferred Stock of the same series shall be identical except that shares of the same series issued at different times may vary as to the dates from which dividends thereon shall be cumulative; and all shares of the Preferred Stock, irrespective of series, shall constitute one and the same class of stock and shall be identical except as to the designation thereof, the date or dates from which dividends on shares thereof shall be cumulative, and the relative rights and preferences set forth above in clauses (a) through (f) of this subdivision, as to which there may be variations between different series. Except as otherwise may be provided by law or by the resolutions establishing any series of Preferred Stock in accordance with the foregoing provisions of this subdivision, whenever the written consent, affirmative vote, or other action on the part of the holders of the Preferred Stock may be required for any purpose, such consent, vote or other action shall be taken by the holders of the Preferred Stock as a single class irrespective of series and not by different series.

2. The holders of shares of the Preferred Stock of each series shall be entitled to receive dividends, when and as declared by the board of directors, out of any funds legally available for the payment of dividends, at the annual rate fixed and determined with respect to each series either by these Restated Articles of Incorporation or in accordance with subdivision III. B. 1., and no more, payable quarterly on the 15th day of February, May, August and November in each year or on such other date or dates as the board of directors shall determine in the resolutions establishing such series. Such dividends shall be cumulative in the case of shares of each series either from the date of issuance of shares of such series or from the first day of the current dividend period within which shares of such series shall be issued, as the board of directors shall determine, so that if dividends on all outstanding shares of each particular series of the Preferred Stock, at the annual dividend rates fixed and determined either by these Restated Articles of Incorporation or in accordance with subdivision III. B. 1., shall not have been paid or declared and set apart for payment for all past dividend periods and for the then current dividend periods, the deficiency shall be fully paid or dividends equal thereto declared and set apart for payment at said rates before any dividends on the Common Stock shall be paid or declared and set apart for payment. No interest, or sum of money in lieu of interest, shall be payable in respect of any dividend payment or payments which may be in arrears.

3. In the event of any dissolution, liquidation or winding up of the corporation, before any distribution or payment shall be made to the holders of the Common Stock, the holders of the Preferred Stock of each series then outstanding shall be entitled to be paid out of the net assets of the corporation available for distribution to its shareholders the respective amounts per share fixed and determined with respect to each series either by these Restated Articles of Incorporation or in accordance with subdivision III. B. 1., and no more. If upon dissolution, liquidation or winding up of the corporation, whether voluntary or involuntary, the net assets of the corporation available for distribution to its shareholders shall be insufficient to pay the holders of all outstanding shares of Preferred Stock of all series the full amounts to which they shall be respectively entitled as aforesaid, the net assets of the corporation so available for distribution shall be distributed to the holders of Preferred Stock in accordance with the relative preferences of each series of Preferred Stock established either by these Restated Articles of Incorporation or in accordance with subdivision III. B. 1. For the purposes of this subdivision, any dissolution, liquidation or winding up which may arise out of or result from the condemnation or purchase of all or a major portion of the properties of the corporation by (i) the United States Government or any authority, agency or instrumentality thereof (ii) a State of the United States or any political subdivision, authority, agency or instrumentality thereof, or (iii) a district, cooperative or other association or entity not organized for profit, shall be deemed to be an involuntary dissolution, liquidation or winding up; and a consolidation, merger or amalgamation of the corporation with or into any other corporation or corporations shall not be deemed to be a dissolution, liquidation or winding up of the corporation, whether voluntary or involuntary.

4. The holders of shares of the Preferred Stock shall have no right to vote in the election of directors or for any other purpose, except as may be otherwise provided by law or by resolutions establishing any series of Preferred Stock in accordance with subdivision III. B. 1. Holders of Preferred Stock shall be entitled to notice of each meeting of shareholders at which they shall have any right to vote, but shall not be entitled to notice of any other meeting of shareholders.

Common Stock

5. Subject to the limitations set forth in subdivisions III. B. 2. (and subject to the rights of any class of stock hereafter authorized), dividends may be paid upon the Common Stock when and as declared by the board of directors of the corporation out of any funds legally available for the payment of dividends.

6. Subject to the limitations set forth in subdivisions III. B. 3. (and subject to the rights of any other class of stock hereafter authorized), upon any dissolution, liquidation or winding up of the corporation, whether voluntary or involuntary, the net assets of the corporation shall be distributed ratably to the holders of the Common Stock.

7. Except as may be otherwise provided by law or by the resolutions establishing any series of Preferred Stock in accordance with subdivision III. B. 1., the holders of the Common Stock shall have the exclusive right to vote for the election of directors and for all other purposes. In the election of directors of the corporation, every holder of record of any share or shares of the Common Stock of the corporation shall have the right to cast as many votes for one candidate as shall equal the number of such shares multiplied by the number of directors to be elected, or to distribute such number of votes among any two or more candidates for such election.

8. Upon the issuance for money or other consideration of any shares of capital stock of the corporation, or of any security convertible into capital stock of the corporation, no holder of shares of the capital stock, irrespective of the class or kind thereof, shall have any preemptive or other right to subscribe for, purchase or receive any proportionate or other amount of such shares of capital stock, or such security convertible into capital stock, proposed to be issued; and the board of directors may cause the corporation to dispose of all or any of such shares of capital stock, or of any such security convertible into capital stock, as and when said board may determine, free of any such right, either by offering the same to the corporation's then shareholders or by otherwise selling or disposing of such shares of other securities, as the board of directors may deem advisable.

ARTICLE IV

A. The business and affairs of the corporation shall be managed by a board of directors. Except as provided in subdivision B. below, the number of members of the board, their classifications and terms of office, and the manner of their election and removal shall be as follows:

1. The number of directors shall be that number, not less than nine or more than thirteen, determined from time to time by resolution adopted by affirmative vote of a majority of the entire board of directors. The directors shall be divided into three classes, designated Class I, Class II, and Class III. Each class shall consist, as nearly as possible, of one-third of the total number of directors. At the 1984 annual meeting of shareholders, Class I directors shall be elected for a one-year term, Class II directors for a two-year term, and Class III directors for a three-year term. At each succeeding annual meeting of shareholders, successors to directors whose terms expire at that annual meeting shall be of the same class as the directors they succeed, and shall be elected for three-year terms. If the number of directors should be changed by resolution of the board of directors, any increase or decrease shall be apportioned among the classes so as to maintain the number of directors in each class as nearly equal as possible, but in no case shall a decrease in the number of directors shorten the term of any incumbent director.

2. A director shall hold office until the annual meeting for the year in which his or her term shall expire and until his or her successor shall have been elected and qualified, subject, however, to prior death, resignation, retirement or removal from office. Any newly created directorship resulting from an increase in the number of directors and any other vacancy on the board of directors, however caused, may be filled by the affirmative vote of a majority of the directors then in office, although less than a quorum, or by a sole remaining director.

3. One or more of the directors may be removed with or without cause by the affirmative vote of the holders of not less than two-thirds of the shares entitled to vote thereon at a meeting of the shareholders called

expressly for that purpose; provided, however, that for as long as the corporation shall have cumulative voting, if fewer than all the directors should be candidates for removal, no one of them shall be removed if the votes cast against his or her removal would be sufficient to elect him or her if then cumulatively voted at an election of the class of directors of which he or she shall be a part.

4. No person, except those persons nominated by the board, shall be eligible for election as a director at any annual or special meeting of shareholders unless a written request that his or her name be placed in nomination shall be received from a shareholder of record entitled to vote at such election by the secretary of the corporation not later than the latter of (a) the thirtieth day prior to the date fixed for the meeting, or (b) the tenth day after the mailing of notice of that meeting, together with the written consent of the nominee to serve as a director.

B. Notwithstanding the provisions of subdivision A. above, whenever the holders of any one or more classes of the capital stock of the corporation shall have the right, voting separately as a class or classes, to elect directors at an annual or special meeting of shareholders, the election, term of office, filling of vacancies and other features of such directorships shall be governed by the provisions of these Restated Articles of Incorporation applicable thereto. Directors so elected shall not be divided into classes unless expressly provided by such provisions, and during their prescribed terms of office, the board of directors shall consist of such directors in addition to the directors determined as provided in subdivision A. above.

C. This Article IV may not be repealed or amended in any respect unless such action shall be approved by the affirmative vote of the holders of not less than two-thirds of the shares entitled to vote at an election of directors determined as provided in subdivision A. above, at a meeting of the shareholders called expressly for that purpose.

ARTICLE V

A. For purposes of this Article V:

1. The term "Affiliate", as used to indicate a relationship with a specified "Persons" (as hereinafter defined), shall mean a Person that directly or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the Person specified.

2. The term "Associate", as used to indicate a relationship with a specified Person, shall mean (a) any Person (other than the corporation) of which such specified Person is a director, officer, partner, trustee, guardian, fiduciary or official or is, directly or indirectly, the beneficial owner of 10% or more of any class of equity securities or any beneficial interest, (b) any Person who is a director, officer, partner, trustee, guardian, fiduciary or official or is, directly or indirectly, the beneficial owner of 10% or more of any class of equity securities or any beneficial interest of or in such specified Person (other than the corporation), and (c) any relative or spouse of such specified Person, or any relative of such spouse who has the same home as such specified Person.

3. The term "Beneficial Owner" shall have the meaning set forth in Rule 13d-3 of the General Rules and Regulations under the Securities Exchange Act of 1934 as in effect on April 9, 1984; provided, however, that, notwithstanding the provisions of such Rule, a Person shall be deemed to be the Beneficial Owner of any share of the capital stock of the corporation that such Person shall have the right to acquire at any time pursuant to any agreement, contract, arrangement or understanding, or upon exercise of conversion rights, warrants or options, or otherwise, and any such share of capital stock shall be deemed to be outstanding for purposes of subdivision V.A.9.

4. The term "Business Transaction" shall include, without limitation, (a) any merger, consolidation or plan of exchange of the corporation, or any Person controlled by or under common control with the corporation, with or into any "Related Person" (as hereinafter defined), (b) any merger, consolidation or plan of exchange of a Related Person with or into the corporation or any Person controlled by or under common control with the corporation, (c) any sale, lease, exchange, transfer or other disposition (in one transaction or a series of transactions) including without limitation a mortgage or any other security device, of all or

any "Substantial Part" (as hereinafter defined) of the property and assets of the corporation, or any Person controlled by or under common control with the corporation, to or with a Related Person, (d) any purchase, lease, exchange, transfer or other acquisition (in one transaction or a series of transactions), including without limitation a mortgage or any other security device, of all or any Substantial Part of the property and assets of a Related Person, by or with the corporation or any Person controlled by or under common control with the corporation, (e) any recapitalization of the corporation that would have the effect of increasing the voting power of a Related Person, (f) the issuance, sale, exchange or other disposition of any securities of the corporation, or of any Person controlled by or under common control with the corporation, by the corporation or by any Person controlled by or under common control with the corporation, (g) any liquidation, spinoff, splitoff, splitup or dissolution of the corporation, and (h) any agreement, contract or other arrangement providing for any of the transactions described in this subdivision.

5. The term "Continuing Director" shall mean a director who was a director of the corporation on April 9, 1984 and a director who shall become a director subsequent thereto whose election, or whose nomination for election by the shareholders, shall have been approved by a vote of a majority of the then Continuing Directors.

6. The term "Highest Purchase Price" shall mean, with respect to the shares of any class or series of the capital stock of the corporation, the highest amount of consideration paid by a Related Person for a share of the same class and series at any time regardless of whether the share was acquired before or after such Related Person became a Related Person; provided, however, that the Highest Purchase Price shall be appropriately adjusted to reflect the occurrence of any reclassification, recapitalization, stock split, reverse stock split or other readjustment in the number of outstanding shares of that class or series, or the declaration of a stock dividend thereon. The Highest Purchase Price shall include any brokerage commissions, transfer taxes and soliciting dealers' fees paid by such Related Person with respect to any shares of the capital stock acquired by such Related Person.

7. The term "Other Consideration" shall include, without limitation, capital stock to be retained by the shareholders of the corporation in a Business Transaction in which the corporation shall be the survivor.

8. The term "Person" shall mean any natural person, corporation, partnership, trust, firm, association, government, governmental. agency or any other entity whether acting in an individual, fiduciary or other capacity.

9. The term "Related Person" shall mean (a) any Person which, together with its Affiliates and Associates, shall be the Beneficial Owner in the aggregate of 10 percent or more of the capital stock of the corporation, and (b) any Affiliate or Associate (other than the corporation or a wholly owned subsidiary of the corporation) of any such Person. Two or more Persons acting in concert for the purpose of acquiring, holding or disposing of the capital stock of the corporation shall be deemed to be a "Related Person". A Related Person shall be deemed to have acquired a share of capital stock at the time when such Related Person became the Beneficial Owner thereof. With respect to the shares of the capital stock of the corporation owned by any Related Person, if the price paid for such shares cannot be determined by a majority of the Continuing Directors, the price so paid shall be deemed to be the market price of the shares in question at the time when such Related Person became the Beneficial Owner thereof.

10. The term "Substantial Part" shall mean 10% or more of the fair market value of the total assets of a Person, as reflected on the most recent balance sheet of such Person available to the Continuing Directors on the date of mailing of the notice of the meeting of shareholders called for the purpose of voting with respect to a Business Transaction involving the assets constituting any such Substantial Part.

B. The corporation shall not enter into any Business Transaction with a Related Person or in which a Related Person shall have an interest (except proportionately as a shareholder of the corporation) without first obtaining both (1) the affirmative vote of the holders of not less than two-thirds of the outstanding shares of the capital stock of the corporation not held by such Related Person, and (2) the determination of a majority of the Continuing Directors that the cash or fair market value of the property, securities or Other Consideration to be received per share by the holders, other than such Related Person, of the shares of each class or series of the

capital stock of the corporation in such Business Transaction shall not be less than the Highest Purchase Price paid by such Related Person in acquiring any of its holdings of shares of the same class or series, unless the Continuing Directors by a majority vote shall either (a) have expressly approved the acquisition of the shares of the capital stock of the corporation that caused such Related Person to become a Related Person, or (b) have expressly approved such Business Transaction.

For the purposes of this Article V, a majority of the Continuing Directors shall have the power to make a good faith determination, on the basis of information known to them, of: (1) the number of shares of capital stock of the corporation of which any Person shall be the Beneficial Owner, (2) whether a Person is an Affiliate or Associate of another Person, (3) whether a Person has an agreement, contract, arrangement or understanding with another Person as to the matters referred to in subdivision V.A.3. or clause (h) of subdivision V.A.4., (4) the Highest Purchase Price paid by a Related Person for shares of any class or series of the capital stock, (5) whether the assets subject to any Business Transaction constitute a Substantial Part, (6) whether any Business Transaction is one in which a Related Person has an interest (except proportionately as a shareholder of the corporation), and (7) such other matters with respect to which a determination may be required under this Article V.

D. In determining whether to give their approval as provided in subdivision V.B., the Continuing Directors shall give due consideration to all relevant factors involved, including, without limitation, (1) the value of the corporation in a freely negotiated transaction and its future value as an independent entity, (2) the recognition of gain or loss to the corporation for tax purposes or the postponement of such recognition in a tax-free transaction, (3) the anticipated developments of the business of the corporation not yet reflected in the price of its shares, and (4) the impact on employees, customers, suppliers and the public generally within the geographical area it serves.

E. This Article V may not be repealed or amended in any respect unless such action shall be approved by the affirmative vote of the holders of not less than two-thirds of the capital stock of the corporation not held by a Related Person at a meeting of the shareholders called expressly for that purpose.

ARTICLE VI

No director of the corporation shall be personally liable to the corporation or its shareholders for monetary damages for conduct as a director; provided that this Article VI shall not eliminate the liability of a director for any act or omission for which such elimination of liability is not permitted under the Oregon Business Corporation Act. No amendment to the Oregon Business Corporation Act that further limits the acts or omissions for which elimination of liability is permitted shall affect the liability of a director for any act or omission which occurs prior to the effective date of such amendment.

ARTICLE VII

The corporation shall indemnify to the fullest extent then permitted by law any person who is made, or threatened to be made, a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative, investigative or otherwise (including an action, suit or proceeding by or in the right of the corporation) by reason of the fact that the person is or was a director or officer of the corporation or is or was serving at the request of the corporation as a director or officer of another corporation, partnership, joint venture, trust or other enterprise against all judgments, amounts paid in settlement, fines and such expenses (including attorneys' fees), actually and reasonably incurred in connection therewith. This Article shall not be deemed exclusive of any other provisions for indemnification of directors and officers that may be included in any statute, bylaw, agreement, vote of shareholders or directors or otherwise, both as to action in any official capacity and as to action in another capacity while holding an office.

As amended May 31, 2006.

Exhibit 4J

Northwest Natural Gas Company

$160,000,000

Medium-Term Notes, Series B

<u>Distribution Agreement</u>

September 28, 2004, amended and

restated on December 7, 2006

Merrill Lynch, Pierce, Fenner & Smith

Incorporated

4 World Financial Center

15th Floor

New York, New York 10080

UBS Securities LLC

677 Washington Blvd.

Stamford, Connecticut 06901

J.P. Morgan Securities Inc.

270 Park Avenue

New York, New York 10017

Piper Jaffray & Co.

)0 Nicollet Mall

Minneapolis, Minnesota 55402

Ladies and Gentlemen:

Northwest Natural Gas Company, an Oregon corporation (the "**Company**"), proposes to issue and sell from time-to-time not to exceed $160,000,000 of its First Mortgage Bonds, designated Secured Medium-Term Notes, Series B (the " **Secured Notes** "), and its Unsecured Medium-Term Notes, Series B (the " **Unsecured Notes** ", and, together with the Secured Notes, the " **Securities** "). Prior to December 7, 2006, $50,000,000 of the Securities have been previously offered and sold. The Secured Notes will be issued under the Company's Mortgage and Deed of Trust, dated as of July 1, 1946, to Deutsche Bank Trust Company Americas (formerly known as Bankers Trust Company) (the " **Mortgage Trustee** " or the " **Trustee** ") and R.G. Page (Stanley Burg, successor), as trustees, as supplemented (such Mortgage and Deed of Trust as supplemented being hereinafter referred to as the " **Mortgage** " or the " **Indenture** "). The Unsecured Notes will be issued under an indenture, dated as of June 1, 1991 (the " **Note Indenture** " or the " **Indenture** "), between the Company and Deutsche Bank Trust Company Americas, as trustee (the " **Indenture Trustee** " or the " **Trustee** ").

The Securities shall have the maturities, interest rates, if any, redemption provisions and other terms set forth in the Prospectus referred to below, as it may be amended or supplemented from time-to-time, and any final term sheet relating to an offering of a particular issuance of securities, containing information that describes the final terms of such Securities or such offering ("the " **Term Sheet** "). The Securities will be issued, and the terms thereof established, from time-to-time, by the Company in accordance with the respective Indentures.

The Company represents, warrants, covenants and agrees with each of you and with each other person which shall become a party to this agreement individually, an " **Agent** ," and collectively, the " **Agents** ") and each Agent, severally and not jointly, covenants and agrees with the Company as follows:

1. Representations and Warranties of the Company. The Company represents and warrants to each Agent that:

(a) The Company is a corporation duly organized and validly existing under the laws of the State of Oregon, and is qualified to do business as a foreign corporation in the State of Washington, with power (corporate and other) to own its properties and conduct its business as described in the Prospectus and the Pricing Disclosure Package (as defined below) (if applicable), each referred to below;

(b) A registration statement on Form S-3 (Registration No. 333-112604) (the "**Registration Statement**"), in respect of $200,000,000 of the Company's securities (which may include the Company's First Mortgage Bonds designated Secured Medium-Term Notes Series B, and Unsecured Medium-Term Notes Series B) has been filed with the Securities and Exchange Commission (the " **Commission** ") under the Securities Act of 1933, as amended (the " **Act** "), in the form heretofore delivered or to be delivered (excluding the exhibits thereto but including the documents incorporated by reference in the prospectus included therein) to such Agent, and such Registration Statement in such form has been declared effective by the Commission and no stop order suspending its effectiveness has been issued and no proceeding for that purpose has been initiated or threatened by the Commission (any preliminary prospectus included in the Registration Statement being hereinafter called a " **Preliminary Prospectus** "). The Registration Statement, including all exhibits thereto and including the documents incorporated by reference in the prospectus included therein, and including any prospectus supplement relating to the Securities that is filed with the Commission and deemed by virtue of Rule 430B to be part of the registration statement at the applicable time of effectiveness or deemed effectiveness, but excluding Forms T-1 and T-2, each as amended at the time such part of the registration statement or any post-effective amendment became effective, each is hereinafter called the " **Registration Statement** "; the prospectus included as a part of the Registration Statement (including the Prospectus Supplement, dated September 28, 2004, and any other prospectus supplement relating to the Securities), in the form in which it most recently has been filed with the Commission on or prior to the date of this Agreement, is hereinafter called the " **Prospectus** "; any reference herein to any Preliminary Prospectus or the

Prospectus shall be deemed to refer to and include the documents filed by the Company under the Securities Exchange Act of 1934, as amended (the " **Exchange Act** "), and incorporated therein by reference as of the date of such Preliminary Prospectus or the Prospectus, as the case may be; any reference to any amendment or supplement to any Preliminary Prospectus or the Prospectus, including any supplement to the Prospectus that sets forth only the terms of a particular issue of the Securities (a " **Pricing Supplement** "), shall be deemed to refer to and include the documents filed by the Company under the Exchange Act and incorporated therein by reference as of the date of such amendment or Pricing Supplement; any reference to the Prospectus as amended or supplemented shall be deemed to refer to and include the Prospectus as then amended or supplemented (including the applicable Pricing Supplement) in relation to a particular issue of Securities to be sold pursuant to this Agreement, in the form filed with the Commission pursuant to Rule 424(b) under the Act, including any documents filed by the Company under the Exchange Act and incorporated therein by reference as of the date of such amendment or supplement; " **Pricing Disclosure Package** " means the Prospectus, including all amendments and supplements thereto and any preliminary Pricing Supplement as of the Applicable Time (as defined below), and each Term Sheet prepared pursuant to Section 5(p) and any other free-writing prospectus (as defined in Rule 405 under the Act) that has been prepared by or on behalf of the Company relating to such Securities as of such Applicable Time; and " **Applicable Time** " means the time and date set forth in the Terms Agreement (as defined below) for an issue of Securities, or if the Company does not enter into a Terms Agreement with respect to a sale of Securities, the time and date of each acceptance by the Company of any offer to purchase Securities hereunder (whether through an Agent as agent or to an Agent as principal);

(c) The documents incorporated by reference in the Prospectus and in the Pricing Disclosure Package (if applicable), when filed with the Commission or, if later, when they became effective, conformed in all material respects with the requirements of the Act or the Exchange Act, as applicable, and the applicable rules and regulations of the Commission thereunder; none of such documents when so filed or when such documents became effective, as the case may be, included an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein, in the light of the circumstances under which they were made, not misleading; any future documents so filed or incorporated by reference in the Prospectus or any Pricing Disclosure Package, or any amendment or supplement to either thereof, when filed with the Commission or, if later, when effective, will conform in all material respects with the applicable requirements of the Act or the Exchange Act, as applicable, and the rules and regulations of the Commission thereunder, and when such documents are filed or become effective, as the case may be, they will not contain an untrue statement of a material fact or omit to state a material fact required to be stated therein or necessary to make the statements therein, in the light of the circumstances under which they were made, not misleading; provided , however , that the Company makes no representations or warranties as

to information contained in or omitted from the Prospectus as amended or supplemented or any Pricing Disclosure Package in reliance upon and in conformity with information furnished in writing to the Company by any Agent specifically for use therein;

(d) The Registration Statement when it became effective conformed, and the Prospectus conforms, and any amendment or supplement thereto will conform, in all material respects, with the provisions of the Act and the Trust Indenture Act of 1939, as amended (the " **Trust Indenture Act"),** and the rules and regulations of the Commission thereunder; and the Registration Statement when it became effective did not (and as of the applicable effective date and on each of the dates and times referred to in clause (a) of Section 6 will not), the Prospectus, the Prospectus (including any preliminary Pricing Supplement) together with the Term Sheet, and the Pricing Disclosure Package (if applicable) does not (and on each of the dates and times referred to in clause (a) of Section 6 will not) and any amendment or supplement to the Prospectus, as of its date and on each of the dates referred to in clause (a) of Section 6, will not, contain an untrue statement of a material fact or omit to state a material fact required to be stated therein or necessary to make the statements therein not misleading; provided , however , that the Company makes no representations or warranties as to information contained in or omitted from any such document in reliance upon and in conformity with information furnished in writing to the Company by any Agent specifically for use therein;

(e) The Company is not an "ineligible issuer" in connection with the offering pursuant to Rules 164, 405 and 433 under the Act. Any free writing prospectus that the Company is required to file pursuant to Rule 433(d) under the Act has been, or will be, filed with the Commission in accordance with the requirements of the Act and the applicable rules and regulations of the Commission thereunder. Each free writing prospectus that the Company has filed, or is required to file, pursuant to Rule 433(d) under the Act or that was prepared by or on behalf of or used or referred to by the Company complies or will comply in all material respects with the requirements of the Act and the applicable rules and regulations of the Commission thereunder. Any such free writing prospectus did not or will not, as of its issue date and through the time the Securities are sold by the Agents, include any information that conflicts with the information contained in the Registration Statement and the Prospectus; and any such free writing prospectus, when taken together with the information contained in the Registration Statement and the Prospectus, did not, when issued or filed pursuant to Rule 433, and does not contain an untrue statement of a material fact or omit to state a material fact necessary to make the statements therein, in the light of the circumstances under which they were made, not misleading; provided , however , that the Company makes no representations or warranties as to information contained in or omitted from the free writing prospectus in reliance upon and in conformity with information furnished in writing to the Company by any Agent specifically for use therein; except for any free writing prospectuses each furnished to the applicable Agent before first use, the Company has not prepared, used or referred to, and will not, without such Agent's consent, prepare, use or refer to any free writing prospectus.

(f) Except as set forth in or contemplated by the Prospectus, since the date as of which information is given in the Prospectus (if applicable) (i) there has not been any material adverse change in the condition of the Company and its subsidiaries taken as a whole, financial or otherwise, (ii) there has not been any transaction entered into by the Company or any of its subsidiaries which is material to the Company and its subsidiaries taken as a whole, other than transactions in the ordinary course of business, and (iii) neither the Company nor any of its subsidiaries has incurred any contingent obligation which is material to the Company and its subsidiaries taken as a whole;

(g) The Securities have been duly authorized, and, when issued and authenticated pursuant to their respective Indentures and delivered pursuant to this Agreement and any Terms Agreement (as defined in Section 3 hereof), will have been duly executed, authenticated, issued and delivered, will constitute valid and legally binding obligations of the Company, enforceable in accordance with their terms, except as their enforceability may be limited by laws and principles of equity relating to or affecting generally the enforcement of creditors' rights, including without limitation, bankruptcy and insolvency laws, and will be entitled to the benefits provided by their respective Indentures (which will be substantially in the form filed as exhibits to the Registration Statement); the Indentures have been duly authorized and qualified under the Trust Indenture Act, constitute valid and legally binding instruments, enforceable in accordance with their terms, except as their enforceability may be limited by laws and principles of equity relating to or affecting generally the enforcement of creditors' rights, including without limitation, bankruptcy and insolvency laws; and the Indentures conform, and the Securities of each issue, when issued, will conform, in all material respects, to the descriptions thereof in the Prospectus, as amended or supplemented, and the Pricing Disclosure Package (if applicable) with respect to such issue;

(h) The issue and sale of the Securities, the compliance by the Company with all of the provisions of the Securities, the Indentures, this Agreement and any Terms Agreement, and the consummation by the Company of the transactions herein and therein contemplated will not result in a breach or violation of any of the terms or provisions of, or constitute a default under, any indenture, mortgage, deed of trust, loan agreement or other agreement or instrument to which the Company is a party or by which the Company is bound or to which any of the property of the Company is subject, nor will such action result in any violation of the provisions of any statute or the Restated Articles of Incorporation, as amended, or the Bylaws, as amended, of the Company or any order, rule or regulation of any court or any regulatory authority or other governmental agency or body having jurisdiction over the Company or any of its properties; and no consent, approval, authorization, order, registration or qualification of or with any court or governmental agency or body is required by the Company for the solicitation of offers to purchase Securities and the issue and sale of the Securities or the

consummation by the Company of the other transactions contemplated by the Indentures, this Agreement or any Terms Agreement, except such as have been obtained at or prior to the Commencement Date (as defined in Section 4 hereof), will have been obtained under the Act, the Trust Indenture Act and the public utility laws of the State of Oregon and such as may be required to be obtained under the public utility laws of the State of Washington and such as may be required under state securities or Blue Sky laws in connection with the solicitation by such Agent of offers to purchase Securities from the Company and with purchases of Securities by such Agent as principal, as the case may be, in each case in the manner contemplated hereby; and

(i) Other than as set forth or contemplated in the Prospectus, there are no legal or governmental proceedings pending to which the Company is a party or to which any property of the Company is subject, which, if determined adversely to the Company, would individually or in the aggregate have a material adverse effect on the consolidated financial position, stockholders' equity or consolidated results of operations of the Company, and, to the best of the Company's knowledge, no such proceedings are threatened.

(j) The Company's internal control over financial reporting includes policies and procedures that are designed to (1) provide for the maintenance of records that, in reasonable detail, accurately and fairly reflect transactions concerning the assets of the Company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles in the United States of America; (3) provide reasonable assurance that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (4) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

(k) The Company employs disclosure controls and procedures that are designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms, and is accumulated and communicated to the Company's management, including its principal executive and principal financial officer, as appropriate, to allow timely decisions regarding disclosure.

2. Obligations of the Agents and the Company.

(a) Subject to the terms and conditions hereof and to the reservation by the Company of the right to sell Securities directly on its own behalf, the Company hereby (i) appoints each of Merrill Lynch, Pierce, Fenner & Smith Incorporated, UBS Securities LLC, J.P. Morgan Securities Inc. and Piper Jaffray & Co. as an agent of the Company for the purpose of soliciting and receiving offers to purchase Securities from the Company and (ii) reserves the right, from time to

time, to appoint additional agents for the purpose of soliciting and receiving offers to purchase Securities from the Company; provided that each such additional agent shall be required to become a party to this Agreement and undertake the obligations of an Agent hereunder pursuant to an Additional Agent Appointment Agreement (" **Additional Agent Appointment Agreement** ") substantially in the form of Exhibit 1 hereto.

(b) On the basis of the representations and warranties herein, and subject to the terms and conditions hereof, each of the Agents, as agent of the Company, severally and not jointly, agrees to use its reasonable best efforts to solicit and receive offers to purchase particular issues of the Securities from the Company upon the terms and conditions set forth in the Prospectus as amended or supplemented with respect thereto and in any applicable Pricing Disclosure Package. Each Agent will promptly advise the Company by telephone or other appropriate means of all reasonable offers to purchase Securities, other than those rejected by such Agent. The Company shall not, without the consent of each Agent, which consent shall not unreasonably be withheld, solicit or accept offers to purchase, or sell, any debt securities with a maturity, at the time of original issuance, of from nine months to 30 years, except (i) pursuant to this Agreement, (ii) pursuant to a private placement not constituting a public offering under the Act, or (iii) in connection with a firm commitment underwriting pursuant to an underwriting agreement that does not provide for a continuous offering. However, the Company, subject to Section 5(f) hereof, reserves the right to sell, and may solicit and accept offers to purchase, Securities directly on its own behalf, and, in the case of any such sale not resulting from a solicitation made by an Agent, no commission will be payable with respect to such sale.

(c) Procedural details relating to the issue and delivery of Securities, the solicitation of offers to purchase Securities and the payment therefor, unless an Agent and the Company shall otherwise agree, shall be as set forth in the Administrative Procedure attached hereto as Annex I (the " **Administrative Procedure** "). The provisions of the Administrative Procedure shall apply to all transactions contemplated hereunder other than those made pursuant to a Terms Agreement. Each Agent and the Company shall perform the respective duties and obligations specifically provided to be performed by each of them in the Administrative Procedure. The Company will furnish to the Trustees a copy of the Administrative Procedure as from time to time in effect.

(d) The Company reserves the right, in its sole discretion, to instruct the Agents to suspend, at any time, for any period of time or permanently, the solicitation of offers to purchase the Securities. As soon as practicable, but in any event not later than one business day after receipt of instructions from the Company, the Agents will suspend solicitation of offers to purchase Securities from the Company until such time as the Company has advised the Agents that such solicitation may be resumed.

(e) The Company agrees to pay each Agent a commission, at the time of settlement (each a "**Settlement Date**") of any sale of a Security by the Company as a result of a solicitation made by such Agent, in an amount, unless otherwise agreed, equal to the following applicable percentage of the principal amount of such Security sold:

Range of Maturities	Commission (percentage of aggregate principal amount of Securities sold)
From 9 months to less than 1 year	.125%
From 1 year to less than 18 months	.150%
From 18 months to less than 2 years	.200%
From 2 years to less than 3 years	.250%
From 3 years to less than 4 years	.350%
From 4 years to less than 5 years	.450%
From 5 years to less than 6 years	.500%
From 6 years to less than 7 years	.550%
From 7 years to less than 10 years	.600%
From 10 years to less than 15 years	.625%
From 15 years to less than 20 years	.675%
From 20 years to 30 years	.750%

(f) Each of the several Agents represents and agrees that it will make no offer that would constitute a Free Writing Prospectus (as defined in Rule 405 under the Securities Act) that is required to be filed by the Company pursuant to Rule 433 under the Securities Act other than a Term Sheet in accordance with Section 5(p), unless the Company and such Agents otherwise agree in connection with a particular offering of Securities.

3. Sales to Agents as Principal. Each sale of Securities to an Agent, as principal, shall be made in accordance with the terms of this Agreement and (unless the Company and such Agent shall otherwise agree) a separate agreement (each a " **Terms Agreement** "), which will provide for the sale of such Securities to, and the purchase thereof by, such Agent, as principal. A Terms Agreement may be either (i) a written agreement substantially in the form of Annex II hereto, or (ii) an oral agreement between any Agent and the Company confirmed in writing by such Agent. A Terms Agreement may also specify certain provisions relating to the reoffering of such Securities by such Agent. Each Terms Agreement shall specify the principal amount of Securities to be purchased by an Agent pursuant thereto, the price to be paid to the Company for such Securities, any provisions relating to the rights of, and defaults by, any underwriters acting together with such Agent in the reoffering of the Securities, the time and date of delivery of and payment for such Securities (each, a " **Time of Delivery** ") and place of delivery of such Securities, and any requirements for opinions of counsel, accountants' letters and officers' certificates pursuant to Section 5 hereof. Each purchase of Securities, unless otherwise agreed shall be at a discount equivalent to the commission payable

to an Agent, acting as agent, with respect to a sale of Securities of identical maturity, as set forth in Section 2(e) hereof). The Agent may engage the services of any other broker or dealer in connection with the resale of the Securities purchased as principal and may allow any portion of the discount received in connection with such purchase from the Company to be paid to such brokers and dealers. The commitment of an Agent to purchase Securities as principal, whether pursuant to a Terms Agreement or otherwise, shall be deemed to have been made on the basis of the representations and warranties of the Company herein contained and, to the extent not otherwise agreed upon in a Terms Agreement or otherwise, shall be subject to the terms and conditions herein set forth.

4. Commencement. At 11:00 a.m., New York City time, on September 28, 2004, the Distribution Agreement, dated September 28, 2004 ("Original Distribution Agreement"), among the Company and the Agents was executed (such time and date being referred to herein as the " **Commencement Date** "), the Agents were furnished at the offices of Thelen Reid & Priest LLP, 875 Third Avenue, New York, New York, with the following:

(a) An opinion of Simpson Thacher & Bartlett LLP, counsel to the Agents, dated the Commencement Date, with respect to such matters as such Agents reasonably requested, which opinion relied as to all matters governed by Oregon law, upon the opinion of Beth A. Ugoretz, Esq., General Counsel for the Company, referred to in Section 4(b) hereof and, as to all matters governed by Washington law, upon the opinion of Stoel Rives LLP referred to in Section 4(d) hereof;

(b) An opinion of Beth A. Ugoretz, Esq., dated the Commencement Date, in form and substance reasonably satisfactory to such Agents, to the effect set forth in Annex III to the Original Distribution Agreement, which opinion relied, as to all matters governed by New York law, the Act, the Exchange Act and the Trust Indenture Act, upon the opinion of Thelen Reid & Priest LLP referred to in Section 4(c) hereof and, as to certain matters governed by Washington law, upon the opinion of Stoel Rives LLP referred to in Section 4(d) hereof;

(c) An opinion of Thelen Reid & Priest LLP, dated the Commencement Date, in form and substance reasonably satisfactory to such Agents, to the effect set forth in Annex IV to the Original Distribution Agreement, which opinion relied as to all matters governed by Oregon law, upon the opinion of Beth A. Ugoretz, Esq., referred to in Section 4(b) hereof and, as to all matters governed by Washington law, upon the opinion of Stoel Rives LLP referred to in Section 4(d) hereof;

(d) An opinion of Stoel Rives LLP, dated the Commencement Date, in form and substance reasonably satisfactory to such Agents, to the effect set forth in Annex V to the Original Distribution Agreement;

(e) A letter from PricewaterhouseCoopers LLP, the Company's independent registered public accounting firm, dated the Commencement Date, in form and substance reasonably satisfactory to such Agents and subject to compliance with the requirements of Statements on Auditing Standards issued by the American Institute of Certified Public Accountants (" **SAS** "), to the effect set forth in Annex VI to the Original Distribution Agreement; and

(f) A certificate of the President or any Vice President of the Company, dated the Commencement Date, in form reasonably satisfactory to such Agents, (i) as to the accuracy of the representations and warranties of the Company herein at and as of the Commencement Date, (ii) as to the performance by the Company in all material respects of all of its obligations hereunder to be performed at or prior to the Commencement Date, (iii) as to the matters set forth in Section 1(e) hereof, (iv) as to the absence of any stop order of the Commission suspending the effectiveness of the Registration Statement or any pending or contemplated proceedings for such purpose, (v) as to the full force and effect of the authorizing order of the Oregon Public Utility Commission (the " **OPUC** ") referred to in Section 7(a) hereof, and (vi) as to such other matters as such Agents reasonably requested.

5. Covenants of the Company. The Company covenants and agrees with each Agent:

(a) (i) To make no amendment or supplement to the Registration Statement, the Prospectus or the Pricing Disclosure Package (other than a Pricing Supplement or a free-writing prospectus consisting of a Term Sheet) (A) prior to the Commencement Date, which any Agent shall reasonably disapprove by notice to the Company promptly after receipt of the proposed form thereof or (B) after the date of any agreement by an Agent, pursuant to a Terms Agreement or otherwise, to purchase Securities as principal and prior to the related Time of Delivery which such Agent shall reasonably disapprove by notice to the Company promptly after receipt of the proposed form thereof; (ii) to prepare, with respect to each particular issue of Securities to be sold through or to such Agent pursuant to this Agreement, a Terms Agreement or otherwise, a Pricing Supplement with respect to such Securities in a form reasonably satisfactory to such Agent and to file such Pricing Supplement in accordance with Rule 424(b) under the Act; (iii) to make no amendment or supplement to the Registration Statement, the Prospectus or the Pricing Disclosure Package, other than a Pricing Supplement or a free writing prospectus consisting of a Term Sheet, without affording such Agent a reasonable opportunity for review thereof and comment thereon; (iv) to timely file all reports and any definitive proxy or information statements required to be filed by the Company with the Commission pursuant to Section 13(a), 13(c), 14 or 15(d) of the Exchange Act for so long as the delivery of a prospectus is required (or in lieu thereof the notice referred to in Rule 173(a) under the Act) in connection with the offering or sale of the Securities, and during such same period to advise such Agent, promptly after the Company receives notice thereof, of the time when any amendment to the Registration Statement has been filed or has become effective or any supplement to the Prospectus or the Pricing Disclosure Package or any amended Prospectus or Pricing Disclosure Package (other than any Pricing Supplement that relates to Securities not purchased through or by such Agent) has been filed with the Commission, of the issuance by the Commission of any stop

order or of any order preventing or suspending the use of any prospectus relating to the Securities, of the suspension of the qualification of the Securities for offering or sale in any jurisdiction, of the initiation or threatening of any proceeding for any such purpose, or of any request by the Commission for the amendment or supplement of the Registration Statement or Prospectus or for additional information; (v) to promptly make every reasonable effort to comply with all requests of the Commission for additional information; and (vi) in the event of the issuance of any such stop order or of any such order preventing or suspending the use of any such prospectus or suspending any such qualification, to use its best efforts to obtain its withdrawal;

(b) From time-to-time, to take such action as such Agent reasonably may request to qualify the Securities for offering and sale under the securities laws of such jurisdictions as may be approved by the Company and to comply with such laws so as to permit the continuance of sales and dealings therein for as long as may be necessary to complete the distribution or sale of the Securities; provided , however , that in connection therewith the Company shall not be required to qualify as a foreign corporation or to file a general consent to service of process in any jurisdiction, or to comply with any other requirement reasonably deemed by the Company to be unduly burdensome; provided , further , that the provisions of this subsection (b) shall not apply so long as the Securities are "covered securities" within the meaning of Section 18 of the Act and any rules and regulations thereunder;

(c) To furnish such Agent with copies of the Registration Statement and each amendment thereto, the Prospectus and each amendment or supplement thereto, other than any Pricing Supplement (except as provided in the Administrative Procedure), in the form in which it is filed with the Commission pursuant to Rule 424(b) under the Act, and with copies of the documents incorporated by reference therein (other than exhibits incorporated by reference in the Registration Statement), each in such quantities as such Agent may reasonably request from time-to-time; and, if the delivery of a prospectus (or in lieu thereof the notice referred to in Rule 173(a) under the Act) is required at any time in connection with the offering or sale of the Securities to or through an Agent pursuant to this Agreement and if, at such time, any event shall have occurred as a result of which the Prospectus as then amended or supplemented or the Pricing Disclosure Package as then amended or supplemented, as the case may be, would include an untrue statement of a material fact or omit to state any material fact necessary in order to make the statements therein, in the light of the circumstances under which they were made, not misleading, or, if for any other reason it shall be necessary during such period to amend or supplement the Prospectus or the Pricing Disclosure Package or to file under the Exchange Act any document incorporated by reference in the Prospectus in order to comply with the Act, the Exchange Act or the Trust Indenture Act or to ensure that the information included in any free writing prospectus does not conflict with information contained in the Registration Statement or the Prospectus, to notify such Agent and request such Agent, in its capacity as agent of the Company, to suspend

solicitation of offers to purchase Securities from the Company (and, if so notified, such Agent shall cease such solicitations as soon as practicable, but in any event not later than one business day later); and if the Company shall decide to amend or supplement the Registration Statement, the Prospectus or the Pricing Disclosure Package, to so advise such Agent promptly by telephone (confirmed in writing) and to prepare and cause to be filed promptly with the Commission an amendment or supplement to the Registration Statement, the Prospectus or the Pricing Disclosure Package or to file any document incorporated by reference in the Prospectus or the Pricing Disclosure Package that will correct such statement or omission or conflict or effect such compliance; provided that , (i) should such event relate solely to activities of any Agent (except any termination of any Agent's services hereunder), such Agent shall assume the expense of preparing and furnishing any such amendment or supplement; (ii) if, during such period, such Agent shall continue to own Securities purchased from the Company as principal or such Agent otherwise shall be required to deliver a prospectus (or the notice referred to in Section 173(a) of the Act) in respect of transactions in the Securities, the Company shall promptly prepare and file with the Commission such an amendment or supplement; and (iii) if such Agent shall be required to deliver a prospectus (or the notice referred to in Section 173(a) of the Act) in connection with sales of any Securities purchased by it as principal at any time nine months or more after the date of such purchase and (A) there shall be, as a result of such purchase, no Securities remaining to be sold under the Registration Statement or (B) the Company, pursuant to Section 2(d) hereof, shall have instructed the Agents, during such nine month period, to suspend permanently the solicitation of offers to purchase the Securities, such Agent shall assume the expense of preparing and furnishing any such amendment or supplement in connection with the sales of any Securities purchased by such Agent as principal. (For the purposes of this Section 5(c), the Company shall be entitled to assume that a Prospectus shall no longer be required to be delivered under the Act from and after the date six months from the date of the purchase by an Agent as principal of the particular issuance of Securities to which it relates, unless it shall have received notice from such Agent to the contrary);

(d) To make generally available to its security holders as soon as practicable, but in any event not later than eighteen months after (i) the effective date of the Registration Statement, (ii) the effective date of each post-effective amendment to the Registration Statement, and (iii) the date of each filing by the Company with the Commission of an Annual Report on Form 10-K that is incorporated by reference in the Registration Statement, an earning statement of the Company and its subsidiaries (which need not be audited) in accordance with Section 11(a) of the Act and the rules and regulations of the Commission thereunder (including, at the option of the Company, Rule 158);

(e) For the period ending five years from the date any Securities are sold by the Company pursuant to an offer solicited by such Agent under this Agreement, to furnish to such Agent copies of all reports or other communications (financial or other) furnished to stockholders, and deliver to such Agent (i) as soon as they are

available, copies of any reports and financial statements furnished to or filed with the Commission pursuant to Section 13(a), 13(c), 14 or 15(d) of the Exchange Act, (ii) copies of all registration statements filed under the Act (other than those in respect of shareholder or employee plans), and (iii) such additional information concerning the business and financial condition of the Company as such Agent may from time to time reasonably request (such financial statements to be on a consolidated basis to the extent the accounts of the Company and its subsidiaries are consolidated in reports furnished to its stockholders generally or to the Commission);

(f) That, from the date of any Terms Agreement or other agreement with such Agent to purchase Securities as principal and to and including the earlier of (i) the termination of the trading restrictions for the Securities purchased thereunder, as notified to the Company by such Agent and (ii) the related Time of Delivery, the Company, without the prior written consent of such Agent, will not offer, sell, contract to sell or otherwise dispose of any debt securities of the Company in a public offering which both have a maturity of from nine months to 30 years and are substantially similar to the Securities;

(g) That each acceptance by the Company of an offer to purchase Securities procured by such Agent, as agent, and each agreement by the Company, pursuant to a Terms Agreement or otherwise, to sell Securities to such Agent, as principal, shall be deemed to be an affirmation to such Agent that the representations and warranties of the Company contained in or made pursuant to this Agreement are true and correct as of the date of such acceptance or agreement, as the case may be, as though made as of such date, and an undertaking that such representations and warranties will be true and correct as of the Settlement Date for the Securities relating to such acceptance or as of the Time of Delivery relating to such sale, as the case may be, as though made as of such date (except that such representations and warranties shall be deemed to relate to the Registration Statement and the Prospectus as amended and supplemented relating to such Securities);

(h) That, reasonably in advance of (i) each date as of which an Agent reasonably requests an opinion or opinions of Simpson Thacher & Bartlett LLP, counsel to the Agents, or other counsel to the Agents reasonably satisfactory to the Company, or (ii) each time that the Company sells Securities to such Agent as principal pursuant to a Terms Agreement or other agreement and such Agent requests an opinion or opinions by Simpson Thacher & Bartlett LLP, counsel to the Agents, or other counsel to the Agents reasonably satisfactory to the Company, the Company shall furnish to such counsel such papers and information as they may reasonably request to enable them to furnish to such Agent a letter in form reasonably satisfactory to such Agent, to the effect that such Agent may rely on the opinion of such counsel referred to in Section 4(a) hereof, to the same extent as though it was dated the date of such letter (except that the statements in such opinion shall be deemed to relate to the Registration Statement and the Prospectus as amended and supplemented to the date of such letter and, if such letter is being furnished in connection with clause (ii) above, the applicable

Pricing Disclosure Package), or in lieu of such a letter, an opinion of the same tenor as the opinion of such counsel referred to in Section 4(a) hereof, but modified to relate to the Registration Statement and the Prospectus as amended and supplemented to such date and the Pricing Disclosure Package, if applicable;

(i) That each time that (x) the Registration Statement, the Prospectus or the Pricing Disclosure Package shall be amended or supplemented (other than by a Term Sheet, other free writing prospectus or Pricing Supplement related to the Securities or by an amendment or supplement providing solely for a change in the interest rates of the Securities or similar changes and, unless the Agents shall otherwise specify, other than by an amendment or supplement which relates exclusively to an offering of debt securities other than the Securities), (y) a document incorporated by reference in the Prospectus as amended or supplemented (other than a Current Report on Form 8-K, unless the Agents shall otherwise specify) shall be filed under the Act or Exchange Act (unless waived by the Agents), or (z) the Company sells Securities to such Agent, as principal, pursuant to a Terms Agreement or other agreement and such Terms Agreement or other agreement specifies the delivery of an opinion, letter or certificate under this Section 5(i) as a condition to the purchase of Securities pursuant to such Terms Agreement or other agreement, the Company shall furnish or cause to be furnished to such Agent:

(i) a letter from C.J. Rue, Esq., counsel for the Company, or other counsel for the Company reasonably satisfactory to such Agent, dated the date of such amendment, supplement, incorporation or Time of Delivery relating to such sale, as the case may be, in form reasonably satisfactory to such Agent, to the effect that such Agent may rely on the opinion of such counsel referred to in Section 4(b) hereof (which letter shall reflect any modifications to the opinion delivered at the Commencement Date which are reflected in the opinion attached as Annex III hereto) to the same extent as though it were dated the date of such letter (except that the statements in such opinion shall be deemed to relate to the Registration Statement and the Prospectus as amended and supplemented to the date of such letter, excluding, in the case of the statements in the paragraph next following paragraph 14 of such opinion, all documents filed by the Company under the Exchange Act and incorporated by reference into the Registration Statement and Prospectus during or prior to the fiscal year which is the subject of the Company's most recent Annual Report on Form 10-K) or, in lieu of such a letter, an opinion of the same tenor as the opinion of such counsel referred to in Section 4(b) hereof (which opinion shall reflect any modifications to the opinion delivered at the Commencement Date which are reflected in the opinion attached as Annex III hereto), but modified to relate to the Registration Statement and the Prospectus as so amended and supplemented to such date (provided that if such letter or opinion is being furnished pursuant to clause (z) above, it shall also address the applicable Pricing Disclosure Package);

(ii) a letter of Thelen Reid Brown Raysman & Steiner LLP, New York, New York, counsel for the Company, or other counsel for the Company reasonably satisfactory to such Agent, dated the date of such amendment, supplement, incorporation or Time of Delivery relating to such sale, as the case may be, in form reasonably satisfactory to such Agent, to the effect that such Agent may rely on the opinion of such counsel referred to in Section 4(c) hereof (which letter shall reflect any modifications to the opinion delivered at the Commencement Date which are reflected in the opinion attached as Annex IV hereto) to the same extent as though it were dated the date of such letter (except that the statements in such opinion shall be deemed to relate to the Registration Statement and the Prospectus as amended and supplemented to the date of such letter, excluding, in the case of the statements in the paragraph next following paragraph 10 of such opinion, all documents filed by the Company under the Exchange Act and incorporated by reference into the Registration Statement and the Prospectus during or prior to the fiscal year which is the subject of the Company's most recent Annual Report on Form 10-K) or, in lieu of such letter, an opinion of the same tenor as the opinion of such counsel referred to in Section 4(c) hereof (which opinion shall reflect any modifications to the opinion delivered at the Commencement Date which are reflected in the opinion attached as Annex IV hereto), but modified to relate to the Registration Statement and the Prospectus as so amended and supplemented to such date (provided that if such letter or opinion is being furnished pursuant to clause (z) above, it shall also address the applicable Pricing Disclosure Package);

(iii) a letter of Stoel Rives LLP, Portland, Oregon, special Washington counsel for the Company, or other special Washington counsel for the Company reasonably satisfactory to such Agent, dated the date of such amendment, supplement, incorporation or Time of Delivery relating to such sale, as the case may be, in form reasonably satisfactory to such Agent, to the effect that such Agent may rely on the opinions of such counsel referred to in Sections 4(d) (which letter shall reflect any modifications to the opinion delivered at the Commencement Date which are reflected in the opinion attached as Annex V hereto) and 5(n) hereof to the same extent as though they were dated the date of such letter or, in lieu of such letter, an opinion of the same tenor as the opinions of such counsel referred to in Sections 4(d) (which opinion shall reflect any modifications to the opinion delivered at the Commencement Date which are reflected in the opinion attached as Annex V hereto) and 5(n) hereof; and

(iv) a certificate executed by the President or any Vice President of the Company, dated the date of such supplement, amendment, incorporation or Time of Delivery relating to such sale, as the case may be, in such form as shall be reasonably satisfactory to such Agent, to the effect that the statements contained in the certificate referred to in Section 4(f) hereof are true and correct at such date as though made as of such date (except that

such statements shall be deemed to relate to the Registration Statement and the Prospectus as amended and supplemented to such date and, if such certificate is being furnished pursuant to clause (z) above, the applicable Pricing Disclosure Package) or, in lieu of such certificate, a certificate of the same tenor as the certificate referred to in Section 4(f) hereof, but modified to relate to the Registration Statement and the Prospectus as amended and supplemented to such date and the Pricing Disclosure Package, if applicable;

(j) That each time that (x) the Registration Statement, the Prospectus or the Pricing Disclosure Package shall be amended or supplemented to include additional financial information (unless waived by the Agents), or (y) the Company sells Securities to such Agent as principal pursuant to a Terms Agreement or other agreement and such Terms Agreement or other agreement specifies the delivery of a letter under this Section 5(j) as a condition to the purchase of Securities pursuant to such Terms Agreement or other agreement, and subject to compliance with the requirements of SAS issued by the American Institute of Certified Public Accountants, the Company shall furnish or cause to be furnished to such Agent a letter of PricewaterhouseCoopers LLP or other independent registered public accounting firm for the Company reasonably satisfactory to the Agent, dated the date of such amendment, supplement, incorporation or Time of Delivery relating to such sale, as the case may be, in form reasonably satisfactory to such Agent, to the effect that such Agent may rely upon the letter of such accountants referred to in Section 4(e) hereof to the same extent as though it were dated the date of such subsequent letter (except the statements in such former letter shall be deemed to relate to the financial statements included or incorporated in the Registration Statement and Prospectus as amended and supplemented to the date of such latter letter and the Pricing Disclosure Package, if applicable), or, in lieu of such latter letter, a letter of the same tenor as the letter referred to in Section 4(e) hereof, but modified to relate to the Registration Statement and the Prospectus as amended or supplemented to the date of such letter and the Pricing Disclosure Package, if applicable, with such changes as may be necessary to reflect changes in the financial statements and other information derived from the accounting records of the Company, to the extent such financial statements and other information are available as of a date not more than five business days prior to the date of such letter;

(k) To offer to any person who has agreed to purchase Securities as the result of an offer to purchase solicited by such Agent, as agent, the right to refuse to purchase and pay for such Securities if, at the Settlement Date for such Securities, any condition set forth in Section 6 hereof shall not have been satisfied (it being understood that the judgment of such person with respect to the impracticability or inadvisability of such purchase of Securities shall be substituted, for purposes of this Section 5(k), for the judgment of such Agent with respect thereto);

(l) To pay or cause to be paid the following: (i) the fees and expenses of the Company's counsel and accountants in connection with the registration of the

Securities under the Act and all other expenses in connection with the preparation, printing and filing of the Registration Statement, any Preliminary Prospectus, the Prospectus, each Pricing Disclosure Package, any free writing prospectus prepared by or on behalf of, used by, or referred to by the Company and any Pricing Supplements and all other amendments and supplements thereto and the mailing and delivering of copies thereof to such Agent; (ii) the fees and expenses of counsel for the Agents in connection with the establishment and update of the program contemplated hereby, any opinions to be rendered by such counsel hereunder and the transactions contemplated hereunder; (iii) the cost of preparing this Agreement, any Terms Agreement and any other documents approved by the Company in connection with the offering, purchase, sale and delivery of the Securities; (iv) the fees, not to exceed $5,000, and expenses of counsel for the Agents in connection with the qualification of the Securities for offering and sale under state securities laws as provided in Section 5(b) hereof and the preparation of any blue sky and legal investment memoranda; (v) any fees charged by securities rating services for rating the Securities; (vi) any filing fees incident to any required review by the National Association of Securities Dealers, Inc. of the terms of the sale of the Securities; (vii) the cost of preparing the Securities; (viii) the fees and expenses of the Trustees and any agent of any Trustee and any transfer or paying agent of the Company and the fees and disbursements of counsel for any Trustee or any such agent in connection with any Indenture and the Securities; (ix) any advertising expenses connected with the solicitation of offers to purchase and the sale of Securities so long as such advertising expenses have been approved by the Company; and (x) all other costs and expenses incident to the performance of the Company's obligations hereunder which are not otherwise specifically provided for in this Section; provided, however, that, except as provided in Sections 8 and 9 hereof, such Agent shall pay all other expenses it incurs, including any expenses that may be incurred by it or for its account pursuant to the proviso of Section 5(c) hereof;

(m) To advise each Agent, promptly after the Company receives notice thereof, of the downgrading, or the issuance of a notice of any intended or potential downgrading, of the ratings of the Securities by either Moody's Investors Service or Standard & Poor's Rating Services;

(n) That prior to the solicitation of offers to purchase any Securities, and the issuance and sale of such Securities, the Company will obtain from the Washington Utilities and Transportation Commission (the " **WUTC** ") one or more orders establishing compliance with the public utility laws of the State of Washington in respect of the issuance and sale of all such Securities in accordance with the terms and conditions of this Agreement, and the Company shall furnish or cause to be furnished to each Agent and Agents' counsel:

(i) a copy of such order or orders;

(ii) a certificate of the President or any Vice President of the Company dated on or after the date of each such order, as to the full force and effect of

each such order and representing and warranting that, in respect of the portion of the Securities to which such order or orders pertain, no further consent, approval, authorization or order of the WUTC is required for the solicitation of offers to purchase Securities and the issuance and sale of the Securities or the consummation by the Company of the other transactions contemplated by the Indentures, this Agreement or any Terms Agreement in the manner contemplated by such order or orders; and

(iii) a letter of Stoel Rives LLP, Portland, Oregon, special Washington counsel for the Company, or other special Washington counsel for the Company reasonably satisfactory to such Agent, dated on or after the date of each such order, in form and substance reasonably satisfactory to such Agent, to the effect set forth in Annex VII hereto;

(o) If all of the Securities registered pursuant to the Registration Statement being offered pursuant to this Agreement have not been sold prior to December 1, 2008, prior to such date the Company will file a new shelf registration statement and take any other action necessary to permit the public offering of the Securities to continue without interruption. If such new registration statement is an automatic shelf registration statement as defined in Rule 405 under the Act, the Company will be a well-known seasoned issuer (as defined in Rule 405 under the Act) eligible to use the registration statement as an automatic shelf registration statement and the Company will not have received notice that the Commission objects to the use of the registration statement as an automatic shelf registration statement. References in this Agreement to the Registration Statement shall include any such new registration statement after it becomes effective;

(p) Unless otherwise agreed to by the Company and such Agent, to prepare a Term Sheet relating to each offering of the Securities hereunder containing information that describes the final terms of the Securities being offered, in the form attached hereto as Annex VIII or as otherwise agreed to by the Company and such Agent and to file such Term Sheet within the period required by Rule 433(d)(5)(ii) under the Act following the date the final terms have been established; and

(q) To file promptly all material required to be filed by the Company with the Commission pursuant to Rule 433(d) under the Act.

6. Conditions to Agents' Obligations. The obligation of an Agent, as agent of the Company, at any time (each a "**Solicitation Time**"), to solicit offers to purchase the Securities and the obligation of an Agent to purchase Securities as principal, pursuant to a Terms Agreement or otherwise, shall be subject, in such Agent's discretion, to the conditions that:

(a) all of the representations and warranties of the Company herein (and, in the case of an obligation of an Agent under a Terms Agreement or other agreement with an Agent to purchase Securities as principal, in or incorporated in such agreement by reference) were true and correct (i) on the Commencement Date; (ii) each time that the Registration Statement or the Prospectus shall be amended or

supplemented, (iii) each time a document incorporated by reference in the Prospectus as amended or supplemented shall be filed by the Company under the Act or Exchange Act, (iv) at each Applicable Time, (v) at each Settlement Date, and (vi) at each Time of Delivery of Securities so to be purchased by such Agent, as principal, as the case may be,

(b) prior to such Solicitation Time or such Time of Delivery, as the case may be, the Company shall have performed all of its obligations hereunder theretofore to be performed,

(c) all requests for additional information on the part of the Commission shall have been complied with to the reasonable satisfaction of such Agent,

(d) there shall be in full force and effect orders of the OPUC and the WUTC which permit the issuance and sale of the Securities in accordance with the terms and conditions of this Agreement,

(e) no stop order suspending the effectiveness of the Registration Statement shall have been issued and no proceedings for that purpose shall be pending before, or to the knowledge of the Company contemplated by, the Commission, and

(f) there shall not have occurred: (i) a suspension or material limitation of trading in securities generally on the New York Stock Exchange or in any securities of the Company on the New York Stock Exchange or any relevant exchange or a material disruption in securities settlement or clearance services in the United States; (ii) a general moratorium on commercial banking activities in New York declared by either Federal or New York State authorities; (iii) any material adverse change in the financial markets in the United States, any outbreak of hostilities or escalation thereof or other calamity or crisis or material adverse change in national financial or economic conditions, in each case, the effect of which, in the reasonable judgment of such Agent, makes it impracticable or inadvisable to proceed with the solicitation of offers to purchase Securities or the purchase of Securities from the Company as principal on the terms and in the manner contemplated by this Agreement and, if applicable, any Terms Agreement or other agreement; or (iv) unless known to such Agent prior to such Solicitation Time, any downgrading, or any notice shall have been given of any intended or potential downgrading, of the Securities by either Moody's Investors Service or Standard & Poor's Rating Services.

In addition to the foregoing, the obligation of an Agent to purchase Securities as principal, pursuant to a Terms Agreement or other agreement, shall be subject, in such Agent's discretion, to the further condition that there shall not have been, since the date of such Terms Agreement or other agreement or since the respective dates as of which information is given in the Registration Statement, any material adverse change in the condition, financial or otherwise, or in the earnings, business affairs or business prospects of the Company and its subsidiaries considered as one enterprise, whether or not arising in the ordinary course of business.

7. Conditions to Company's Obligations.

(a) The obligation of the Company to sell and deliver any Security pursuant hereto, to a Terms Agreement or otherwise shall be subject to the condition that, after the acceptance by the Company of an offer to purchase such Security procured by an Agent, as agent, or the agreement by the Company, pursuant to a Terms Agreement or otherwise, to sell such Security to an Agent, as principal, and prior to the Time of Delivery or the Settlement Date, as the case may be, with respect to such purchase or sale, neither the OPUC nor the WUTC shall have issued an order revoking its then existing order or orders permitting the issuance and sale of the Securities through each Agent, as agent, on the terms set forth herein or to each Agent, as principal, pursuant to a Terms Agreement or other agreement.

(b) If the condition specified in Section 7(a) hereof shall not have been fulfilled, the obligation of the Company to sell Securities hereunder or under a Terms Agreement or other agreement may be terminated by the Company; and neither the Company nor any Agent shall have any liability to the other, except for (i) the obligation of the Company to pay certain expenses to the extent provided for in Section 5(l) hereof, (ii) the obligation of the Company to pay commissions and hold the Agents harmless as provided in Section 9 hereof (and, for purposes of said Section 9, such a failure of such condition to be fulfilled shall be considered a default by the Company on its obligation to deliver such Securities), and (iii) any liability under Section 8 hereof.

8. Indemnification.

(a) The Company will indemnify and hold harmless each Agent against any losses, claims, damages or liabilities, joint or several, to which such Agent may become subject, under the Act or otherwise, insofar as such losses, claims, damages or liabilities or actions in respect thereof arise out of or are based upon an untrue statement or alleged untrue statement of a material fact contained in the Registration Statement, any Preliminary Prospectus, the Prospectus, the Prospectus as amended or supplemented, any Pricing Disclosure Package, any Issuer Free Writing Prospectus (as defined in Rule 433(h)) or arise out of or are based upon the omission or alleged omission to state therein a material fact required to be stated therein or necessary to make the statements therein not misleading, and will reimburse such Agent for any legal or other expenses reasonably incurred by it, as incurred, in connection with investigating or defending any such loss, claim, damage, liability or action; provided, however, that the Company shall not be liable in any such case to the extent that any such loss, claim, damage or liability or action in respect thereof arises out of or is based upon an untrue statement or alleged untrue statement or omission or alleged omission made in the Registration Statement, any Preliminary Prospectus, the Prospectus, the Prospectus as amended or supplemented, any Pricing Disclosure Package or any Issuer Free Writing Prospectus in reliance upon and in conformity with written information furnished to the Company by such Agent specifically for use therein.

(b) Each Agent will indemnify and hold harmless the Company against any losses, claims, damages or liabilities to which the Company may become subject, under the Act or otherwise, insofar as such losses, claims, damages or liabilities or actions in respect thereof arise out of or are based upon an untrue statement or alleged untrue statement of a material fact contained in the Registration Statement, any Preliminary Prospectus, the Prospectus, the Prospectus as amended or supplemented, any Pricing Disclosure Package or any Issuer Free Writing Prospectus, or arise out of or are based upon the omission or alleged omission to state therein a material fact required to be stated therein or necessary to make the statements therein not misleading, in each case to the extent, but only to the extent, that such untrue statement or alleged untrue statement or omission or alleged omission was made in the Registration Statement, any Preliminary Prospectus, the Prospectus, the Prospectus as amended or supplemented, any Pricing Disclosure Package or any Issuer Free Writing Prospectus in reliance upon and in conformity with written information furnished to the Company by such Agent specifically for use therein, and will reimburse the Company for any legal or other expenses incurred by the Company, as incurred, in connection with investigating or defending any such loss, claim, damage or liability or action. Each Agent hereby furnishes to the Company in writing expressly for use in the Registration Statement, any Preliminary Prospectus, the Prospectus and the Prospectus as amended or supplemented (i) the first sentence in the fifth paragraph on the cover page of the Prospectus relating to the offerings of Medium-Term Notes by the Agents, as principal, and (ii) under "Plan of Distribution," the second and third paragraphs, the third and last sentences of the seventh paragraph, the eighth, ninth, tenth and eleventh paragraphs and the statements relating to the Agents in the twelfth paragraph.

(c) Promptly after receipt by an indemnified party under Section 8(a) or Section 8(b) of notice of the commencement of any action, such indemnified party shall, if a claim in respect thereof is to be made against the indemnifying party under such Section, notify the indemnifying party in writing of the commencement thereof; but the omission so to notify the indemnifying party shall not relieve it from any liability which it may have to any indemnified party otherwise than under such Section. In case any such action shall be brought against any indemnified party and it shall notify the indemnifying party of the commencement thereof, the indemnifying party shall be entitled to participate therein and, to the extent that it shall wish, jointly with any other indemnifying party similarly notified, to assume the defense thereof, with counsel satisfactory to such indemnified party (who shall not, except with the consent of the indemnified party, be counsel to the indemnifying party); provided, however, in no event shall such indemnifying parties be obligated to retain more than one counsel (and necessary local counsel), in addition to counsel for such indemnifying parties, to represent the indemnified parties, and after notice from the indemnifying party to such indemnified party of its election so to assume the defense thereof, the indemnifying party shall not be liable to such indemnified party under such Section for any legal expenses of other counsel or any other expenses, in each case subsequently incurred by such indemnified party, in connection with the defense thereof other than reasonable

costs of investigation. Each indemnified party may also participate at its own expense in the defense of any such action. No indemnifying party shall, without the prior written consent of the indemnified party, effect any settlement of any pending or threatened proceeding in respect of which any indemnified party is or could have been a party and indemnity could have been sought hereunder by such indemnified party, unless such settlement includes (i) an unconditional release of such indemnified party from all liability on claims that are the subject matter of such proceeding and (ii) no statement as to or an admission of fault, culpability or failure to act by or on behalf of an indemnified party.

(d) If the indemnification provided for in Section 8(a) or Section 8(b) hereof is unavailable or insufficient to hold harmless an indemnified party in respect of any losses, claims, damages or liabilities (or actions in respect thereof) referred to therein, then each indemnifying party shall contribute to the amount paid or payable by such indemnified party as a result of such losses, claims, damages or liabilities (or actions in respect thereof) in such proportion as is appropriate to reflect any relevant equitable considerations including the relative fault of the Company on the one hand and each Agent on the other in connection with the statements or omissions which resulted in such losses, claims, damages or liabilities (or actions in respect thereof), and relative benefit of the Company on the one hand and each Agent on the other. Relative fault shall be determined by reference to, among other things, whether the untrue or alleged untrue statement of a material fact or the omission or alleged omission to state a material fact required to be stated therein or necessary in order to make the statements therein not misleading relates to information supplied by the Company on the one hand or by any Agent on the other and the parties' relative intent, knowledge, access to information and opportunity to correct or prevent such statement or omission. The relative benefits received by the Company on the one hand and each Agent on the other shall be deemed to be in the same proportion as the total net proceeds from the sale of Securities (before deducting expenses) received by the Company bear to the total commissions or discounts received by such Agent in respect thereof. The Company and each Agent agree that it would not be just and equitable if contribution pursuant to this Section 8(d) were determined (i) with respect only to any losses, claims, damages or liabilities referred to in Section 8(a) hereof, by per capita allocation (even if all Agents were treated as one entity for such purpose) or (ii) by any method of allocation which does not take account of the equitable considerations referred to above in this Section 8(d). The amount paid or payable by an indemnified party as a result of the losses, claims, damages or liabilities (or actions in respect thereof) referred to above in this Section 8(d) shall be deemed to include any legal or other expenses reasonably incurred by such indemnified party in connection with investigating or defending any such action or claim. Notwithstanding the provisions of this Section 8(d), no Agent shall be required to contribute any amount which exceeds the total price at which the Securities purchased by or through it were offered by it to the public less the amount of any damages which it shall have otherwise paid or become liable to pay by reason or any untrue or alleged untrue statement or omission or alleged omission. No person guilty of fraudulent misrepresentation (within the meaning

of Section 11(f) of the Act) shall be entitled to contribution from any person who was not guilty of such fraudulent misrepresentation. The obligations of each of the Agents under this Section 8(d) to contribute are several and are not joint.

(e) The obligations of the Company under this Section 8 shall be in addition to any liability which the Company may otherwise have and shall extend, upon the same terms and conditions, to each person, if any, who controls any Agent within the meaning of the Act. The obligations of each Agent under this Section 8 shall be in addition to any liability which such Agent may otherwise have and shall extend, upon the same terms and conditions, to each director of the Company, to each officer of the Company who has signed the Registration Statement and to each person, if any, who controls the Company within the meaning of the Act.

9. Nonperformance. Each Agent, in soliciting offers to purchase Securities from the Company and in performing the other obligations of such Agent hereunder (other than in respect of any purchase by an Agent as principal pursuant to a Terms Agreement or otherwise), is acting solely as agent for the Company and not as principal. Each Agent will make reasonable efforts to assist the Company in obtaining performance by each purchaser whose offer to purchase Securities from the Company was solicited by such Agent and has been accepted by the Company, but such Agent shall not have any liability to the Company in the event such purchase is not consummated for any reason. If the Company shall default on its obligation to deliver Securities to a purchaser whose offer it has accepted, the Company shall (i) hold each Agent harmless against any loss, claim or damage arising from or as a result of such default by the Company and (ii) notwithstanding such default, pay to the Agent that solicited such offer any commission to which it would be entitled in connection with such sale.

10. Survival of Agreement. The respective indemnities, agreements, representations, warranties and other statements by any Agent and the Company set forth in or made pursuant to this Agreement shall remain in full force and effect regardless of any investigation (or any statement as to the results thereof) made by or on behalf of any Agent or any controlling person of any Agent or the Company, or any officer or director or any controlling person of the Company, and shall survive each delivery of and payment for any of the Securities.

11. Suspension or Termination. The provisions of this Agreement relating to the solicitation of offers to purchase Securities from the Company may be suspended or terminated at any time by the Company as to any Agent or by any Agent as to such Agent upon the giving of written notice of such suspension or termination to such Agent or the Company, as the case may be. In the event of such suspension or termination with respect to any Agent, this Agreement shall remain in full force and effect with respect to (i) any Agent as to which such suspension or termination has not occurred, (ii) the rights and obligations of any party which have previously accrued or which relate to Securities which are already issued, agreed to be issued or the subject of a pending offer at the time of such suspension or termination, (iii) Sections 2(e), 5(d), 5(e), 5(l), 8, 9 and 10 hereof, and (iv) the obligations of the Company to amend or supplement the Prospectus, so long as any Agent continues to hold Securities as principal.

12. Notices. Except as otherwise specifically provided herein or in the Administrative Procedure, all statements, requests, notices and advices hereunder shall be in writing or by telephone, if promptly confirmed in writing, and if to Merrill Lynch, Pierce, Fenner & Smith Incorporated, shall be sufficient in all respects when delivered or sent by facsimile transmission or registered mail to 4 World Financial Center, 15th Floor, New York, New York 10080, Attention: MTN Product Management, Facsimile Transmission No. 212-449-2234, Telephone No. 212-449-7476, if to UBS Securities LLC, shall be sufficient in all respects when delivered or sent by facsimile transmission or registered mail to 677 Washington Blvd., Stamford, Connecticut 06901, Facsimile Transmission No. 203-719-0495, Attention: Fixed Income Syndicate, if to J.P. Morgan Securities Inc., shall be sufficient in all respects when delivered or sent by facsimile transmission or registered mail to 270 Park Avenue, 8th Floor, New York, New York 10017, Facsimile Transmission No. 212-834-6081, Attention: Medium Term Notes Desk and if to Piper Jaffray & Co., shall be sufficient in all respects when delivered or sent by facsimile transmission or registered mail to 800 Nicollet Mall, Minneapolis, Minnesota 55402, Facsimile Transmission No. 612-313-3117, Telephone No: 612-303-1824, Attention: Debt Capital Markets; if to the Company, shall be sufficient in all respects when delivered or sent by facsimile transmission or registered mail to One Pacific Square, 220 N.W. Second Avenue, Portland, Oregon 97209, Attention: Chief Financial Officer, with a copy to the General Counsel, Facsimile Transmission No. 503-220-2584, Telephone No. 503-220-2406; and if to any additional Agent, as set forth in the Additional Agent Appointment Agreement relating to such Agent.

13. Benefit of Agreement. This Agreement, any Additional Agent Appointment Agreement and any Terms Agreement shall be binding upon, and inure solely to the benefit of, each Agent which is a party hereto and thereto and the Company, and to the extent provided in Section 8 and Section 10 hereof, the officers and directors of the Company and any person who controls any Agent or the Company, and their respective personal representatives, successors and assigns, and no other person shall acquire or have any right under or by virtue of this Agreement, any Additional Agent Appointment Agreement or any Terms Agreement. No purchaser of any of the Securities through or from any Agent hereunder shall be deemed a successor or assign by reason of such purchase.

14. Timing. Time shall be of the essence in this Agreement, any Additional Agent Appointment Agreement and any Terms Agreement. As used herein, the term "business day" shall mean any day when banks in New York City are not authorized or obligated by law or executive order to remain closed.

15. Governing Law. This Agreement, any Additional Agent Appointment Agreement and any Terms Agreement shall be governed by and construed in accordance with the laws of the State of New York.

16. Descriptive Headings. The descriptive headings of the several paragraphs of this Agreement are inserted for convenience only and do not constitute a part of this Agreement.

17. Relationship. The Company acknowledges and agrees that the Agents are acting solely in the capacity of arm's length contractual counterparties to the Company with

respect to the offering of the Securities as contemplated by this Agreement and not as financial advisors or fiduciaries to the Company in connection herewith. Additionally, none of the Agents is advising the Company as to any legal, tax, investment, accounting or regulatory matters in any jurisdiction in connection with the offering of the Securities as contemplated by this Agreement. Any review by the Agents of the Company in connection with the offering of the Securities contemplated by this Agreement and the transactions contemplated by this Agreement will not be performed on behalf of the Company.

18. Execution in Counterparts. This Agreement, any Additional Agent Appointment Agreement and any Terms Agreement may be executed by any one or more of the parties hereto and thereto in any number of counterparts, each of which shall be an original, but all of such respective counterparts shall together constitute one and the same instrument.

If the foregoing is in accordance with your understanding, please sign and return to us three counterparts hereof, whereupon this letter and the acceptance by each of you hereof shall constitute a binding agreement between the Company and each of you in accordance with its terms.

Very truly yours,
NORTHWEST NATURAL GAS COMPANY
By:
Title:

Accepted as of the date hereof:

MERRILL LYNCH, PIERCE, FENNER & SMITH

INCORPORATED

By:
Title:
UBS SECURITIES LLC
By:
Title:
By:
Title:
J.P. MORGAN SECURITIES INC.
By:
Title:
PIPER JAFFRAY & CO.
By:
Title:

Northwest Natural Gas Company

Administrative Procedure

This Administrative Procedure relates to the Securities defined in the Distribution Agreement, dated September 28, 2004, amended and restated on December 7, 2006 (the " **Distribution Agreement** "), amongst Northwest Natural Gas Company (the " **Company** "), on the one hand, and Merrill Lynch, Pierce, Fenner & Smith Incorporated, UBS Securities LLC, J.P. Morgan Securities Inc., Piper Jaffray & Co. and each other person which shall become a party thereto (each, an " **Agent** " and, together, the " **Agents** "), on the other. Defined terms used herein and not defined herein shall have the meanings given such terms in the Distribution Agreement or the Indentures. An Agent, in relation to a purchase of a Security by a purchaser solicited by such Agent, is referred to herein as the " **Selling Agent** " and, in relation to a purchase of a Security by such Agent as principal other than pursuant to a Terms Agreement, as the " **Purchasing Agent** ". As used herein, the term " **business day** " shall mean any day when banks in New York City are not authorized or obligated by law or executive order to remain closed.

The procedures to be followed with respect to the settlement of sales of Securities directly by the Company to purchasers solicited by an Agent, as agent, are set forth below. The terms and settlement details related to a purchase of Securities by an Agent, as principal, from the Company will be set forth in a Terms Agreement, pursuant to the Distribution Agreement, unless the Company and such Agent otherwise shall agree.

The Company will advise each Agent in writing of those persons with whom such Agent is to communicate regarding offers to purchase Securities and the related settlement details.

Order No. 04 248 dated May 11, 2004, of the Oregon Public Utility Commission (the "**OPUC**") authorizes the issuance and sale of the Securities, subject to the conditions set forth in such order. In addition, such order of the OPUC authorizes the issuance and sale by the Company (i) only of Securities bearing interest at fixed rates, established within the maximum all-in spreads over Benchmark Treasury Yields for various maturities (determined in accordance with said orders as of the time the commitment to purchase any Securities is received by the Company and the Agent) and (ii) of Securities to Agents, as principal, at 100% of the principal amount thereof less a percentage not to exceed the commission applicable to an agency sale of Securities of the same maturity. Prior to the solicitation of offers to purchase any Securities, and the issuance and sale of such Securities, the Company will obtain one or more orders of the Washington Utilities and Transportation Commission (the " **WUTC** ") establishing compliance with applicable statutory provisions with respect to the issuance and sale of such Securities and establishing conditions with respect thereto.

As stated in the Company's Prospectus Supplement dated September 28, 2004 and the accompanying Prospectus dated February 18, 2004, if the terms of any Security, as determined by the Company, provide that such Security will be redeemable at the option of the Company, such Security will be made redeemable in whole or in part.

Procedure for Rate Changes:

When a decision has been reached to change the interest rate on or other variable terms with respect to any Securities being offered for sale, the Company will promptly advise the Agents and the Agents will forthwith suspend solicitation of offers to purchase such Securities. The Agent will telephone the Company with recommendations as to the changed interest rates or other variable terms. At such time as the Company advises the Agents of the new interest rates or other variable terms, the Agent may resume solicitation of offers to purchase such Securities. Until such time only "indications of interest" may be recorded.

Acceptance or Rejection of Offers by Company:

Each Agent will promptly advise the Company by telephone or other appropriate means of all reasonable offers to purchase Securities, other than those rejected by such Agent. Each Agent, in its discretion reasonably exercised, may reject any offer received by it, in whole or in part. Each Agent also may make offers to the Company to purchase Securities as a Purchasing Agent. The Company, in its sole discretion, may accept any offer to purchase Securities and may reject any such offer, in whole or in part.

The Company will promptly notify the Selling Agent or Purchasing Agent, as the case may be, of its acceptance or rejection of an offer to purchase Securities. If the Company accepts an offer to purchase Securities, it will confirm such acceptance in writing to the Selling Agent or Purchasing Agent, as the case may be.

Settlement:

The receipt of immediately available funds by the Company in payment for a Security and the authentication and delivery of such Security will, with respect to such Security, constitute "Settlement."

All offers solicited by a Selling Agent or made by a Purchasing Agent and accepted by the Company will be settled on a date (the " **Settlement Date** ") which shall be the third business day after the date of acceptance of such offer, unless the Company and the purchaser shall agree to settle (a) on any other business day after the acceptance of such offer or (b) with respect to an offer accepted by the Company prior to 10:00 a.m., New York City time, on the date of such acceptance.

Settlement Procedures:

A. After the acceptance of an offer by the Company, the Selling Agent or Purchasing Agent, as the case may be, will communicate the following details of the terms of such offer (the " ***Sale Information*** ") to the Company by telephone (confirmed in writing) or by facsimile transmission or other acceptable written means:

(1) Principal amount of Securities to be purchased;

(2) Issue Price ("**Issue Price**" shall mean (i) in the case of a sale in which an Agent shall act as a Selling Agent, the price to the purchaser or (ii) in the case of a sale to an Agent as Purchasing Agent, that Purchasing Agent's reoffering price);

(3) Selling Agent's commission or, if applicable, Purchasing Agent's discount (spread between the reoffering price and Purchasing Agent's purchase price);

(4) Net proceeds to the Company: (2) minus (3);

(5) Method of and specified funds for payment of purchase price;

(6) (a) Fixed Rate Securities:
- (i) interest rate
- (ii) interest payment dates
- (iii) regular record dates;

(b) Floating Rate Securities:
- (i) interest rate basis
- (ii) initial interest rate
- (iii) spread or spread multiplier, if any
- (iv) interest rate reset dates
- (v) interest rate reset period
- (vi) interest payment dates
- (vii) initial interest payment date
- (viii) interest payment period
- (ix) regular record dates
- (x) index maturity
- (xi) calculation agent
- (xii) maximum and minimum interest rates, if any
- (xiii) calculation date
- (xiv) interest determination dates;

(7) (a) Trade Date;

(b) Interest Commencement Date (Settlement Date unless otherwise noted; "Issue Date" on Secured Notes);

(c) Time of delivery;

(8) Closing location;

(9) Maturity date;

(10) If redeemable at the Company's option:

(a) whether redeemable (i) in whole or (ii) in whole or in part;

(b) whether redeemable at (i) fixed redemption prices or (ii) a make-whole redemption price;
(c) if redeemable at fixed redemption prices:
(i) initial redemption date
(ii) redemption limitation date
(iii) each redemption price and period;
(d) if redeemable at a make-whole redemption price, the make-whole spread;
(11) Sinking fund or other retirement provisions;
(12) If repayable at the holder's option:
(a) repayment date;
(b) repayment price;
(c) election period;
(13) The name of the Selling Agent or Purchasing Agent, as the case may be;
(14) Exact name, address and taxpayer identification number of party to be the registered owner;
(15) Party to whom Securities are to be delivered;
(16) Denominations of certificates to be delivered at settlement;
(17) The name of the Company's bank and the account number for payment of the purchase price;
(18) Whether the Securities to be purchased are Secured Notes or Unsecured Notes;
(19) Any other significant terms of the Securities or their offer or sale.

B. After receiving such settlement information from the Agent, the Company will advise the Trustee of the above settlement information. The Company will prepare a Pricing Supplement to the Prospectus and deliver copies to the Agent and will cause the Trustee to issue, authenticate and deliver Securities.

If an identical Pricing Supplement has not been previously filed with the Securities and Exchange Commission (the "**SEC**"), the Company will arrange to have transmitted promptly via EDGAR one copy of the Pricing Supplement (with the appropriate paragraph under Rule 424(b) and the Registration No. inscribed in the upper right corner) to the SEC, within the applicable time period provided in Rule 424(b).

One copy of the Pricing Supplement (with a copy of the cover letter sent to the SEC if a filing with the SEC is required) will be sent by facsimile to the Agents involved in such issue as soon as practicable but in no event later than 12:00 noon on the second day after the Trade Date at each of the following numbers:

ADP IDS

1155 Long Island Ave.

Edgewood, New York 11717

Attn: Charmany Hill

Telephone No: 631-254-7118

Facsimile No: 631-254-7132

and

Merrill Lynch, Pierce, Fenner & Smith

Incorporated

Merrill Lynch World Headquarters

4 World Financial Center

15th Floor

New York, New York 10080

Attn: MTN Product Management

Facsimile No: 212-449-2234

Telephone No: 212-449-7476

and

UBS Securities LLC

677 Washington Blvd.

Stamford, Connecticut 06901

Attn: Fixed Income Syndicate

Facsimile No: 203-719-0495

Telephone No: 203-719-1088

and

J.P. Morgan Securities Inc.

270 Park Avenue, 8th Floor

New York, New York 10017

Attn: Medium Term Notes Desk

Facsimile No: 212-834-6081

and

Piper Jaffray & Co.

800 Nicollet Mall

Minneapolis, Minnesota 55402

Attention: Debt Capital Markets

Facsimile No. 612-313-3117

Telephone No: 612-303-1824

The Company shall supply the Agents as soon as practicable but in no event later than the Settlement Date with an adequate supply of Prospectus Supplements and the accompanying Prospectuses and Pricing Supplements at the above addresses.

In addition, the Company will make any required filings with the OPUC and WUTC in respect of the Securities that are issued.

Suspension of Solicitation; Amendment or Settlement:

Subject to its representations, warranties and covenants contained in the Distribution Agreement, the Company may instruct the Agents to suspend solicitation of purchases at any time. Upon receipt of such instructions, the Agents will forthwith suspend solicitation of offers to purchase from the Company until such time as the Company has advised them that solicitation of offers to purchase may be resumed. If the Company decides to amend or supplement the Prospectus (other than to change interest rates or other variable terms with respect to the offering of the Securities), it will promptly advise the Agents and will furnish the Agents and their counsel with copies of the proposed amendment or supplement.

In the event that at the time the solicitation of offers to purchase from the Company is suspended (other than to change interest rates or other variable terms) there shall be any orders outstanding which have not been settled, the Company will promptly advise the Agents and the Trustee whether such orders may be settled and whether copies of the Prospectus as theretofore amended and/or supplemented as in effect at the time of the suspension may be delivered in connection with the settlement of such orders. The Company will have the sole responsibility for such decision and for any arrangements which may be made in the event that the Company determines that such orders may not be settled or that copies of such Prospectus may not be so delivered.

Delivery of Confirmation and Prospectus to Purchaser by Selling Agent:

The Selling Agent will deliver to the purchaser of a Security a written confirmation of the sale and delivery and payment instructions. In addition, the Selling Agent will deliver or convey to such purchaser or its agent the Prospectus as amended or supplemented (including the Pricing Supplement) relating to such Security prior to delivery to such purchaser or its agent of, or together with, the earlier to be delivered of (a) the confirmation of sale or (b) the Security.

Instruction from Company to Trustee for Preparation of Securities:

After receiving the Sale Information from the Selling Agent or Purchasing Agent, as the case may be, the Company will communicate such Sale Information to the Mortgage Trustee or the Indenture Trustee, as the case may be, by telephone (confirmed in writing, by facsimile transmission or by other acceptable 'ritten means).

The Company will instruct such Trustee by telephone (confirmed in writing, by facsimile transmission or by other acceptable written means) to authenticate and deliver the Securities no later than 2:15 p.m., New York City time, on the Settlement Date. Such instruction will be given by the Company prior to 3:00 p.m., New York City time, on the business day prior to the Settlement Date, unless the Settlement Date is the date of acceptance by the Company of the offer to purchase Securities, in which case such instruction will be given by the Company to the Trustee by 10:00 a.m., New York City time, on the Settlement Date.

Procedures for Book-Entry Securities:

In connection with Securities issued in book-entry form and maintained in the book-entry system of The Depository Trust Company (" **DTC** "), (i) the Company and the Trustee shall act in accordance with the letters of representation (relating to the Secured Notes and the Unsecured Notes, respectively) from the Company and the Trustee to DTC, as the same may be amended, supplemented or otherwise modified from time to time, and (ii) the Trustee shall act in accordance with one or more Medium-Term Note Certificate Agreements, relating to the Securities, between the Trustee and DTC, as the same may be amended, supplemented or otherwise modified from time to time, and in accordance with its obligations as a participant in DTC.

The beneficial owner of a Security issued in book-entry form (or one or more indirect participants in DTC designated by such owner) will designate one or more participants in DTC (with respect to such Security issued in book-entry form, the " **Participants** ") to act as agent for such beneficial owner in connection with the book-entry system maintained by DTC, and DTC will record in book-entry form, in accordance with instructions provided by such Participants, a credit balance with respect to such Security issued in book-entry form in the account of such Participants. The ownership interest of such beneficial owner in such Security issued in book-entry form will be recorded through the records of such Participants or through the separate records of such Participants and one or more indirect participants in DTC.

Transfers of a Book-Entry Security will be accomplished by book entries made by DTC and, in turn, by Participants (and in certain cases, one or more indirect participants in DTC) acting on behalf of beneficial transferors and transferees of such Book-Entry Security.

Beneficial interests in the Securities may be purchased, owned and transferred only in denominations of $1,000 or any integral multiple of $1,000.

Preparation and Delivery of Securities by Trustee and Receipt of Payment Therefor:

Certificated Securities

The Company will instruct the Mortgage Trustee or the Indenture Trustee, as the case may be, to:

(i) Prepare each Security and appropriate receipts that will serve as the documentary control of the transaction.

(ii) In the case of a sale of Securities to a purchaser solicited by a Selling Agent, by 2:15 p.m., New York City time, on the Settlement Date, deliver the Securities to such Selling Agent, at the address listed below, for the benefit of the purchaser of such Securities against delivery by such Selling Agent of a receipt therefor. (On the Settlement Date, such Selling Agent will deliver payment for such Securities in immediately available funds to the Company's account at a bank designated by the Company and included as a part of the Sale Information provided by the Selling Agent in an amount equal to the net proceeds to the Company; provided that the Selling Agent reserves the right to withhold payment for which it shall not have received funds from the purchaser.)

(iii) In the case of a sale of Securities to a Purchasing Agent, by 2:15 p.m., New York City time, on the Settlement Date, deliver the Securities to such Purchasing Agent, at the address listed below, against delivery of payment therefor. (On the Settlement Date, such Purchasing Agent will deliver payment for such Securities in immediately available funds to the Company's account at a bank designated by the Company and included as a part of the Sale Information provided by the Purchasing Agent in an amount equal to the net proceeds to the Company.)

(iv) Complete the 4-ply Security and deliver three copies thereof as follows:

1. Security with Agent's customer confirmation.
2. Copy 1 - for Trustee.
3. Copy 2 - for Agent.
4. Copy 3 - for Company.

(v) With respect to each sale, deliver the Securities and Copies 1 and 2 thereof to the appropriate Agent at the following address:

Merrill Lynch, Pierce, Fenner & Smith

Incorporated

55 Water Street

3rd Floor Plaza Level, DTC New York Window

New York, New York 10041

Attn: Morna Noel

Facsimile No: 212-855-2457

or

UBS Securities LLC

677 Washington Blvd.

Stamford, Connecticut 06901

Attn: Fixed Income Syndicate

Facsimile No: 203-719-0495

or

J.P. Morgan Securities Inc.

270 Park Avenue, 8th Floor

New York, New York 10017

Attn: Medium Term Notes Desk

Facsimile No: 212-834-6081

or

Piper Jaffray & Co.

800 Nicollet Mall

Minneapolis, Minnesota 55402

Attention: Debt Capital Markets

Facsimile No. 612-313-3117

Telephone No: 612-303-1824

as the case may be, or to any other Agent as directed by such Agent. (The Agent will acknowledge receipt of the Security, will keep Copy 2 and will return Copy 1 to the Trustee. Delivery of the Security by the Trustee will be made only against such acknowledgment of receipt. Prior to the first settlement date, the Trustee or the Company shall have sent a letter to Merrill Lynch Clearance Operations, UBS Securities LLC, J.P. Morgan Securities Inc., Piper Jaffray & Co. or any other Agent, as the case may be, containing standard wire instructions for the net proceeds of each Security, addressed as follows:

Merrill Lynch, Pierce, Fenner & Smith

Incorporated

4 World Financial Center

15th Floor

New York, New York 10080

Facsimile No: 212-449-2234

or

UBS Securities LLC

677 Washington Blvd.

Stamford, Connecticut 06901

Attn: Fixed Income Syndicate

Facsimile No: 203-719-0495

or

J.P. Morgan Securities Inc.

270 Park Avenue, 8th Floor

New York, New York 10017

Attn: Medium Term Notes Desk

Facsimile No: 212-834-6081

or

Piper Jaffray & Co.

800 Nicollet Mall

Minneapolis, Minnesota 55402

Attention: Debt Capital Markets

Facsimile No. 612-313-3117

Telephone No: 612-303-1824

as the case may be, or as directed by such other Agent.)

(vi) Send Copy 3 to the Company.

Book-Entry Securities

A. The Company will assign a CUSIP number to the Book-Entry Security representing such Security and then advise the Trustee by electronic transmission of the Sale Information received from the Agent, such CUSIP number and the name of such Agent.

B. The Trustee will communicate to DTC and the Agent through DTC's Participant Terminal System, a pending deposit message specifying the following settlement information:

(1) The following Sale Information with respect to each Security:

(a) Taxpayer identification number of the purchaser.

(b) Principal amount of the Security.

(c) Fixed Rate Securities:

(i) interest rate;

(ii) interest payment dates; and

(iii) regular record dates.

(d) Floating Rate Securities:

(i) interest rate basis;

(ii) initial interest rate;

(iii) spread or spread multiplier, if any;

(iv) interest rate reset dates;

(v) interest rate reset period;

(vi) interest payment dates;

(vii) interest payment period;

(viii) regular record dates;

(ix) index maturity;

(x) calculation agent;

(xi) maximum and minimum interest rates, if any;

(xii) calculation date; and

(xiii) interest determination dates.

(e) Issue price.

(f) Trade date.

(g) Interest Commencement Date, which shall be the Settlement Date unless otherwise noted ("**Issue Date**" on Secured Notes).

(h) Maturity date.

(i) Net proceeds to the Company.

(j) Agent's commission.

(k) Redemption provisions, if any.

(l) Repayment provisions, if any.

(2) Identification numbers of the participant accounts maintained by DTC on behalf of the Trustee and the Agent.

(3) Identification as a Fixed Rate Book-Entry Security or Floating Rate Book-Entry Security.

(4) Initial Interest Payment Date for such Security, number of days by which such date succeeds the related record date for DTC purposes (or, in the case of Floating Rate Securities which reset daily or weekly, the date five calendar days preceding the Interest Payment Date) and, if then calculable, the amount of interest payable on such Interest Payment Date (which amount shall have been confirmed by the Trustee).

(5) CUSIP number of the Book-Entry Security representing such Security.

(6) Whether such Book-Entry Security represents any other Securities issued or to be issued in book-entry form.

C. The Company will complete and deliver to the Trustee a Book-Entry Security representing such Security in a form that has been approved by the Company, the Agents and the Trustee.

D. The Company will (by telecopy followed by an original copy) provide the Trustee with an opinion regarding the authentication of such Security and certified copies of governmental approvals specified in such opinion.

E. The Trustee will authenticate the Book-Entry Security representing such Security.

F. DTC will credit such Security to the participant account of the Trustee maintained by DTC.

G. The Trustee will enter a Same-Day Funds Settlement System ("**SDFS**") deliver order through DTC's Participant Terminal System instructing DTC (i) to debit such Security to the Trustee's participant account and credit such Security to the participant account, maintained by DTC, of the Agent which presented to the Company the offer to purchase such Security which was accepted by the Company (the " **Presenting Agent** ") and (ii) to debit the settlement account of the Presenting Agent and credit the settlement account of the Trustee maintained by DTC, in an amount equal to the price of such Security less such Agent's commission.

H. The Presenting Agent will enter an SDFS deliver order through DTC's Participant Terminal System instructing DTC (i) to debit such Security to the Presenting Agent's participant account and credit such Security to the participant account of the Participants maintained by DTC and (ii) to debit the settlement accounts of such Participants and credit the settlement account of the Presenting Agent maintained by DTC, in an amount equal to the initial public offering price of such Security.

I. Transfer of funds in accordance with SDFS deliver orders described in Settlement Procedures F and G will be settled in accordance with SDFS operating procedures in effect on the Settlement Date.

J. The Trustee will credit to an account of the Company maintained at the Trustee funds available for immediate use in the amount transferred to the Trustee in accordance with Settlement Procedure G.

K. The Trustee will send a copy of the Book-Entry Security by first class mail to the Company together with a statement setting forth the principal amount of Securities Outstanding as of the related Settlement Date after giving effect to such transaction and all other offers to purchase Securities of which the Company has advised the Trustee but which have not yet been settled.

L. The Agent will confirm the purchase of such Security to the purchaser either by transmitting to the Participant with respect to such Security a confirmation der through DTC's Participant Terminal System or by mailing a written confirmation to such purchaser.

M. Settlement Procedures Timetable:

(1) For orders of Securities accepted by the Company, Settlement Procedures A through K shall be completed as soon as possible but not later than the respective times (New York City time) set forth below:

Settlement Procedure	Time
A	11:00 a.m. on the trade date
B	2:00 p.m. on the trade date
C	3:00 p.m. on the Business Day before Settlement Date
D-E	9:00 a.m. on Settlement Date
F	10:00 a.m. on Settlement Date
G-H	No later than 2:00 p.m. on Settlement Date
I	4:45 p.m. on Settlement Date
J-K	5:00 p.m. on Settlement Date

(2) If a sale is to be settled more than one Business Day after trade date, Settlement Procedures A and B may, if necessary, be completed at any time prior to the specified times on the first Business Day after such trade date. In connection with a sale which is to be settled more than one Business Day after the trade date, if the initial interest rate for a Floating Rate Security is not known at the time that the Sale Information is given by the Presenting Agent to the Company, Settlement Procedures A and B shall be completed as soon as such rates have been determined, but no later than 11:00 a.m. and 2:00 p.m., New York City time, respectively, on the second Business Day before the Settlement Date. Settlement Procedure H is subject to extension in accordance with any extension of Fedwire closing deadlines and in the other events specified in the SDFS operating procedures in effect on the Settlement Date.

(3) If settlement of a Security issued in book-entry form is rescheduled or canceled, the Trustee will deliver to DTC, through DTC's Participant Terminal System, a cancellation message to such effect by no later than 2:00 p.m., New York City time, on the Business Day immediately preceding the scheduled Settlement Date.

Failure of Purchaser to Pay Selling Agent:

Certificated Securities

If a purchaser shall fail to make payment to the Selling Agent for any Security, the net proceeds to the Company which, theretofore, shall have been paid the Selling Agent to the Company, the Selling Agent will promptly notify the Mortgage Trustee or the Indenture Trustee, as the case may be, and the Company of such failure by telephone, promptly confirmed in writing or by facsimile transmission or by other acceptable written means. The Selling Agent promptly will return such Security to such Trustee. Promptly upon receipt of such Security by such Trustee, the Company will return to the Selling Agent an amount equal to the amount previously paid to the Company in respect of such Security. Such Trustee will cancel any Security in respect of which such a failure shall occur, make appropriate entries in its records and, unless otherwise instructed by the Company, destroy such Security.

Book-Entry Securities

If the Trustee fails to enter an SDFS deliver order with respect to a Book-Entry Security issued in book-entry form pursuant to paragraph F above, the Trustee may deliver to DTC, through DTC's Participant Terminal System, as soon as practicable a withdrawal message instructing DTC to debit such Security to the participant account of the Trustee maintained at DTC. DTC will process the withdrawal message, provided that such participant account contains a principal amount of the Book-Entry Security representing such Security that is at least equal to the principal amount to be debited. If withdrawal messages are processed with respect to all the Securities represented by a Book-Entry Security, the Trustee will mark such Book-Entry Security "canceled", make appropriate entries in its records and send such canceled Book-Entry Security to the Company. The CUSIP number assigned to such Book-Entry Security shall, in accordance with CUSIP Service Bureau procedures, be canceled and not immediately reassigned. If withdrawal messages are processed with respect to a portion of the Securities represented by a Book-Entry Security, the Trustee will exchange such Book-Entry Security for two Book-Entry Securities, one of which shall represent the Book-Entry Securities for which withdrawal messages are processed and shall be canceled immediately after issuance, and the other of which shall represent the other Securities previously represented by the surrendered Book-Entry Security and shall bear the CUSIP number of the surrendered Book-Entry Security.

If the purchase price for any Book-Entry Security is not timely paid to the Participants with respect to such Security by the beneficial purchaser thereof (or a person, including an indirect participant in DTC acting on behalf of such purchaser), such Participants and, in turn, the related Agent may enter SDFS deliver orders through DTC's Participant Terminal System reversing the orders entered pursuant to paragraphs F and G above, respectively. Thereafter, the Trustee will deliver the withdrawal message and take the related actions described in the preceding paragraph. If such failure shall have occurred for any reason other than default by the applicable Agent to perform its obligations hereunder or under the Distribution Agreement, the Company will reimburse such Agent on an equitable basis for its loss of the use of funds during the period when the funds were credited to the account of the Company.

Notwithstanding the foregoing, upon any failure to settle with respect to a Book-Entry Security, DTC may take any actions in accordance with its SDFS operating procedures then in effect. In the event of a failure to settle with respect to a Security that was to have been represented by a Book-Entry Security also representing other Securities, the Trustee will provide, in accordance with paragraphs C and D above, for the authentication and issuance of a Book-Entry Security representing such remaining Securities and will make appropriate entries in its records.

ANNEX II

Northwest Natural Gas Company

Medium-Term Notes

Terms Agreement

[Merrill Lynch, Pierce, Fenner & Smith

Incorporated

4 World Financial Center

15th Floor

New York, New York 10080]

[UBS Securities LLC

677 Washington Blvd.

Stamford, Connecticut 06901]

[J.P. Morgan Securities Inc.

270 Park Avenue

New York, New York 10017]

[Piper Jaffray & Co.

800 Nicollet Mall

Minneapolis, Minnesota 55402]

[Name of additional Agents, if any]

ıdies and Gentlemen:

Subject to the terms and conditions set forth herein and, to the extent provided below, in the Distribution Agreement, dated September 28, 2004, amended and restated on December 7, 2006 (the " **Distribution Agreement** "), amongst Northwest Natural Gas Company (the " **Company** "), on the one hand, and Merrill Lynch, Pierce, Fenner & Smith Incorporated, UBS Securities LLC, J.P. Morgan Securities Inc., Piper Jaffray & Co. and each other person which shall become a party to the Distribution Agreement (each an "Agent" and, together, the "Agents"), on the other, the Company proposes to issue and sell to [Merrill Lynch, Pierce, Fenner & Smith Incorporated] [UBS Securities LLC] [J.P. Morgan Securities Inc.] [Piper Jaffray & Co.] [Name of other Agent] the Securities (as defined in the Distribution Agreement) specified in the Schedule hereto (the " **Purchased Securities** "), at the time, place and purchase price and upon the terms and conditions set forth in such Schedule. Each of the provisions of the Distribution Agreement not specifically related to the solicitation by the Agents, as agents of the Company, of offers to purchase Securities is incorporated herein by reference, and shall be deemed to be part of this Terms Agreement to the same extent as if such provisions had been set forth herein. Each reference in the Distribution Agreement to the Pricing Disclosure Package shall be deemed to refer to the items specified next to the caption "Pricing Disclosure Package" in the Schedule hereto.

Each of the representations and warranties set forth in the Distribution Agreement shall be deemed to have been made by the Company at and as of the date of this Terms Agreement, except that each such representation and warranty which makes reference to the Prospectus shall be deemed to be a representation and warranty as of the date of the Distribution Agreement in relation to the Prospectus (as therein defined), and also a representation and warranty as of the date of this Terms Agreement in relation to the Prospectus as amended and supplemented with respect to the Purchased Securities.

A supplement to the Prospectus relating to the Purchased Securities, in the form heretofore delivered to and approved by you, is now proposed to be filed with the Commission in accordance with Rule 424(b) under the Act and the Term Sheet [and_________] specified next to the caption "Pricing Disclosure Package" in the Schedule hereto is now proposed to be filed with the Commission in accordance with Rule 433 under the Act.

Subject to the terms and conditions set forth herein and to those of the Distribution Agreement incorporated herein by reference, the Company agrees to issue and sell to [Merrill Lynch, Pierce, Fenner & Smith Incorporated] [UBS Securities LLC] [J.P. Morgan Securities Inc.] [Piper Jaffray & Co.] [Name of other Agent] and [Merrill Lynch, Pierce, Fenner & Smith Incorporated] [UBS Securities LLC] [J.P. Morgan Securities Inc.] [Piper Jaffray & Co.] [Name of other Agent] agrees to purchase from the Company the Purchased Securities, at the time and place, in the principal amount and at the purchase price set forth in the Schedule hereto.

If the foregoing is in accordance with your understanding, please sign and return to us three counterparts hereof, whereupon this letter, including those provisions of the Distribution Agreement incorporated herein by reference, shall constitute a binding agreement between you and the Company.

NORTHWEST NATURAL GAS COMPANY
By:

Title:

Accepted as of the date hereof:

[MERRILL LYNCH, PIERCE, FENNER & SMITH

INCORPORATED]

By:

Title:]
[UBS SECURITIES LLC
By:

Title:]

By:
Title:]
[J.P. MORGAN SECURITIES INC.
By:
'tle:]
IPER JAFFRAY & CO.
By:
Title:]

[Name of other Agent, if any]

Title of Purchased Securities:

Aggregate Principal Amount: $

Price to Public:

Purchase Price by [Merrill Lynch, Pierce, Fenner & Smith Incorporated] [UBS Securities LLC] [J.P. Morgan Securities Inc.] [Piper Jaffray & Co.] [Name of other Agent]:

% of the principal amount of the Purchased Securities [, plus accrued interest from

to] [and accrued amortization of discount from to]

Method of and Specified Funds for Payment of Purchase Price:

[By certified or official bank check or checks, payable to the order of the Company, in [[New York Clearing House] [immediately available] funds]

[By wire transfer to a bank account specified by the Company in [next day] [immediately available] funds]

Indenture: [Mortgage] [Note Indenture]

Interest Commencement Date which shall be the Settlement Date unless otherwise noted (**"Issue Date"** on Secured Notes):

Pricing Disclosure Package:

1. Prospectus, dated February 18, 2004
2. Prospectus Supplement, dated September 28, 2004
3. [Preliminary Pricing Supplement, dated__________]
4. [Term Sheet, dated____________]
5. [Other]

Time of Delivery:

Closing Location:

Stated Maturity Date:

Interest Rate or Rates (or Method of Determining Interest):

Interest Payment Dates: [months and dates]

Initial Interest Payment Date:

Regular Record Dates:

Redeemable at Company's Option: Yes__ No__

In Whole: Yes__ No__

In Part: Yes__ No__

Fixed Redemption Prices____ / Make-Whole Redemption Price____

Fixed Redemption Prices:

Initial Redemption Date:

Redemption Limitation Date:

Initial Redemption Price:

Reduction Percentage:

Make-Whole Redemption Price:

Make-Whole Spread:

Sinking Fund or Other Retirement Provisions, if any:

Repayable at Option of Holder: Yes__ No__

Repayment Date:

Repayment Price:

Election Period:

Documents to be Delivered as a Condition to the Closing:

[(1) The opinion of counsel to the Agents referred to in Section 5(h)]

[(2) The opinion of counsel to the Company referred to in Section 5(i)(i)]

[(3) The opinion of counsel to the Company referred to in Section 5(i)(ii)]

[(4) The opinion of counsel to the Company referred to in Section 5(i)(iii)]

[(5) The accountants letter referred to in Section 5(j)]

[(6) The officers certificate referred to in Section 5(i)(iv)]

Other Provisions (including Syndicate Provisions, if applicable):

ANNEX III

[Letterhead of C.J. Rue, Esq.]

[Date]

.lerrill Lynch, Pierce, Fenner & Smith

Incorporated

4 World Financial Center

15th Floor

New York, New York 10080

UBS Securities LLC

677 Washington Blvd.

Stamford, Connecticut 06901

J.P. Morgan Securities Inc.

270 Park Avenue

New York, New York 10017

Piper Jaffray & Co.

800 Nicollet Mall

Minneapolis, Minnesota 55402

Ladies and Gentlemen:

With reference to the issuance and sale from time-to-time by Northwest Natural Gas Company (the "**Company**"), pursuant to the Distribution Agreement, dated September 28, 2004, amended and restated on December 7, 2006 (the " **Agreement** "), between the Company and each of you, of not to exceed '60,000,000 in aggregate principal amount of (i) the Company's First Mortgage Bonds, designated Secured Medium-Term Notes, Series B (the "Secured Notes") to be ,sued under the Company's Mortgage and Deed of Trust, dated as of July 1, 1946, to Deutsche Bank Trust Company Americas (formerly known as Bankers Trust Company) (the "Corporate Trustee") and R.G. Page (Stanley Burg, successor), as trustees, as supplemented by twenty supplemental indentures (such Mortgage and Deed of Trust, as so supplemented, being hereinafter called the " **Mortgage** "), and (ii) the Company's Unsecured Medium-Term Notes, Series B (the " **Unsecured Notes** "), to be issued under the Company's Indenture, dated as of June 1, 1991 (the " **Indenture** "), to Deutsche Bank Trust Company Americas, as trustee (the " **Indenture Trustee** ") (the Secured Notes and the Unsecured Notes being hereinafter collectively referred to as the " **Notes** "), and the appointment of each of you as agents of the Company pursuant to the Agreement for the purposes of soliciting and receiving offers to purchase Notes, as agents, and purchasing Notes, as principals, from the Company, please be advised that, as counsel for the Company, I have participated in the preparation of or

reviewed (a) the Restated Articles of Incorporation, as amended, and Bylaws, as amended, of the Company; (b) the Mortgage; (c) the Indenture; (d) the Agreement; (e) the registration statement (File No. 333-112604) (the " **Registration Statement** "), filed by the Company with the Securities and Exchange Commission (the " **SEC** ") for the registration under the Securities Act of 1933, as amended (the "1933 Act"), of $200,000,000 of the Company's securities (which may include the Notes), and for the qualification under the Trust Indenture Act of 1939, as amended (the " **Trust Indenture Act** "), of the Mortgage and the Indenture, which Registration Statement became effective on February 18, 2004; (f) the prospectus, dated February 18, 2004, constituting a part of the Registration Statement in the form in which the Registration Statement became effective, or if such prospectus has been amended or supplemented subsequent to such effectiveness, as so amended and supplemented, including the documents incorporated therein by reference pursuant to Item 12 of Form S-3, as supplemented by the prospectus supplement relating to the Notes, dated September 28, 2004, filed with the Commission pursuant to Rule 424(b) under the Securities Act (together, the " **Prospectus** "); (g) the proceedings before the Oregon Public Utility Commission (the "OPUC") and the Washington Utilities and Transportation Commission (the " **WUTC** ") relating to the issuance and sale of the Notes; and (h) the records of various corporate and other proceedings relating to the authorization, issuance and sale of the Notes. I have also examined such other documents and satisfied myself as to such other matters as I have deemed necessary in order to render this opinion. I have not examined the Notes, except specimens thereof.

In preparation of this opinion, I have examined originals or photostatic certified copies of such certificates, agreements, documents and other papers, and have made such inquiries and investigations of law, as I deemed appropriate and necessary for the opinion hereinafter set forth. In my examination, I have assumed the authenticity of all documents submitted to me as certified or photostatic copies and the authenticity of the originals of such latter documents. As to certain matters of fact material to the opinion expressed herein, I have relied upon certificates of various corporate officers of the Company and public officials. I assume the accuracy of the material and factual matters contained therein.

I am of the opinion that:

1. The Company is a validly organized and existing corporation under the laws of the State of Oregon, is authorized to transact business in the State of Washington, and has corporate power to own its properties and conduct its business as described in the Prospectus.

2. The Company holds valid and subsisting franchises, licenses, permits and consents, free from burdensome restrictions and adequate for the conduct of its business, as and to the extent set forth in the Prospectus.

3. The Agreement has been duly and validly authorized, executed and delivered by the Company.

4. The Mortgage and the Indenture have been duly and validly authorized by all necessary corporate action, have been duly and validly executed and delivered, and are valid and binding instruments enforceable in accordance with their terms, subject, as to enforcement, to laws and principles of equity relating to or affecting generally the enforcement of creditors rights, including, without limitation, bankruptcy and insolvency.

5. The Mortgage constitutes a first security interest on all of the personal properties and fixtures owned by the Company that are described in the Mortgage and are intended to be subject to the lien thereof, subject only to Excepted Encumbrances (as defined in the Mortgage); and the description in the Mortgage of such properties and fixtures is adequate to constitute the Mortgage a security interest thereon.

6. The Company has good and sufficient title to all of the real properties owned by the Company that are described in the Mortgage and intended to be bject to the lien thereof, subject only to Excepted Encumbrances (as defined in the Mortgage) and to minor defects and irregularities of the nature customarily found .ı properties of like size and character; the description in the Mortgage of such properties is adequate to constitute the Mortgage a lien thereon; and the Mortgage is a valid first mortgage lien on such properties, subject to the exceptions noted above in this paragraph (6).

7. The form of the Secured Notes has been duly authorized and has been established in conformity with the provisions of the Mortgage; the form of the Unsecured Notes bearing interest at a fixed rate, has been duly authorized and has been established in conformity with the provisions of the Indenture; and the form of the Unsecured Notes, bearing interest at a variable rate or not bearing interest, when set forth in a Company Order or Orders (as defined in the Indenture) or established by procedures acceptable to the Indenture Trustee specified in a Company Order or Orders, will have been duly authorized and will have been established in conformity with the provisions of the Indenture.

8. The Secured Notes have been duly authorized by the resolutions adopted by the Company's Board of Directors on May 27, 1993, September 26, 1996, April 24, 1997, February 26, 1998, April 27, 2000, April 25, 2002 and December 18, 2003 (the " **Board Resolutions** "), and when the terms of the Secured Notes shall have been determined as contemplated by and in accordance with the Mortgage, the Board Resolutions and written orders or instructions evidencing determinations by officers of the Company, such terms will have been duly authorized by the Company and will have been established in conformity with the terms of the Mortgage.

9. The Unsecured Notes have been duly authorized by the Board Resolutions, and when the terms of the Unsecured Notes shall have been determined as contemplated by and in accordance with the Indenture, the Board Resolutions and, to the extent required by the Indenture and the Board Resolutions, by Officers' Certificates (as defined in the Indenture), Company Orders and procedures acceptable to the Indenture Trustee specified in such Company Orders, such terms will have been duly authorized by the Company and will have been established in conformity with the terms of the Indenture.

10. The Notes, when (a) executed by the Company, (b) completed, authenticated and delivered by the Corporate Trustee or the Indenture Trustee, as the case may be, (c) issued and delivered by the Company and (d) paid for, all as contemplated by and in accordance with the Mortgage, in the case of Secured Notes, the Indenture, in the case of Unsecured Notes, the

Board Resolutions, and (to the extent required by the Mortgage or the Indenture and the Board Resolutions) Officers' Certificates, Company Orders, procedures acceptable to the Indenture Trustee specified in such Company Orders, written orders or instructions evidencing determinations by the officers of the Company, the Agreement, the Administrative Procedure (as defined in the Agreement), and Terms Agreements (as defined in the Agreement), if any, will be duly issued under the Mortgage or the Indenture, as the case may be, and will constitute valid and legally binding obligations of the Company, entitled to the benefits provided by the Mortgage or the Indenture, as the case may be, and enforceable in accordance with their terms, subject, as to enforcement, to laws and principles of equity relating to or affecting generally the enforcement of creditors' rights, including, without limitation, bankruptcy and insolvency, and, in the case of the Secured Notes, entitled to the benefit of the security afforded by the Mortgage.

11. The issuance and sale of the Notes, the compliance by the Company with all of the provisions of the Notes, the Mortgage, the Indenture and the Agreement and the consummation of the transactions contemplated by the Agreement will not result in a breach or violation of any of the terms and provisions of, or constitute a default under, any statute, any indenture, mortgage, deed of trust or other agreement or instrument known to me to which the Company is a party or by which it is bound or to which any of the property of the Company is subject, the Company's Restated Articles of Incorporation, as amended, or Bylaws, as amended, or any order, rule or regulation known to me of any court or governmental agency or body having jurisdiction over the Company or any of its properties.

12. The OPUC has issued orders authorizing the issuance and sale by the Company of the Notes; and no further approval, authorization, consent or other order of any public board or body (other than in connection or in compliance with the provisions of the securities or blue sky laws of any jurisdiction and other than orders of the WUTC establishing compliance with applicable statutory provisions) is legally required for the issuance and sale of the Notes on the terms and conditions set forth in the Agreement.

13. The statements of Oregon and Federal law (other than the 1933 Act, the Securities Exchange Act of 1934 and the Trust Indenture Act), and legal conclusions based thereon, contained in, or in the documents incorporated by reference in, the Prospectus have been reviewed by me and are correct (except to the extent that any statement contained in a document incorporated or deemed to be incorporated by reference in the Prospectus may be deemed to be modified or superseded in the Prospectus or in any other subsequently filed document which also is or is deemed to be incorporated by reference in the Prospectus).

14. Except as described in the Prospectus, there are no pending material legal or governmental proceedings and, to my knowledge, no material threatened legal or governmental proceedings, to which the Company is a party or of which any of the property of the Company is the subject, other than ordinary routine litigation incidental to the kind of business conducted by the Company.

In the course of the preparation by the Company of the Registration Statement and the Prospectus, I had conferences with certain officers and employees of the Company, but I have made no independent verification of the accuracy or completeness of the representations and statements made to me by such person or the information included by the Company in the

Registration Statement and the Prospectus, and take no responsibility therefor, except as set forth in paragraph 12 hereof. However, my examination of the Registration Statement and the Prospectus and my discussions in the above-mentioned conferences did not disclose to me any information which causes me to believe that, when the Registration Statement became effective, it contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that, as of the date of this opinion, the Prospectus includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements therein, in the light of the circumstances under which they were made, not misleading; provided, that I do not express any belief as to the financial statements or other financial or statistical data contained in the Registration Statement or the Prospectus, or as to the Forms T-1 or T-2, or as to any information contained therein furnished to the Company in writing by any of you expressly for use therein.

This opinion is limited to the facts and law at the date hereof. In rendering the opinions set forth in paragraphs 10, 11 and 12 above, I have necessarily assumed that, at the time of any issuance, sale and delivery of a Note (i) the Board of Directors of the Company (or any committee thereof acting pursuant to authority properly delegated to such committee by the Board of Directors) has not taken any action to rescind or otherwise reduce its prior authorization of the issuance of the Notes and an officer of the Company, as stated in the resolutions of the Board of Directors (or any such committee) relating to the Notes, has executed and delivered such Notes, (ii) the WUTC has issued an order or orders establishing compliance with applicable statutory provisions with respect to the issuance and sale of such Note, (iii) the orders of the OPUC and the WUTC with respect to the Notes being sold remain in full force and effect and have not been modified or amended by the OPUC or the WUTC, respectively, and the Company complies with the terms of such orders, and (iv) the order of the SEC with respect to the Registration Statement, the Mortgage and the Indenture remains in full force and effect and has not been modified or amended by the SEC.

I do not express any opinion herein concerning any law other than the laws of the State of Oregon and the Federal laws of the United States. In rendering this opinion, I have relied, with your consent, as to certain matters of Washington law, upon the opinion of even date herewith addressed to you by Stoel Rives LLP, special Washington counsel to the Company, and, as to all matters governed by the laws of the State of New York, the 1933 Act, the Securities Exchange Act of 1934 and the Trust Indenture Act, upon the opinion of even date herewith addressed to you by Thelen Reid Brown Raysman & Steiner LLP, New York, New York, counsel for the Company.

You, the Trustees and, as to matters governed by the laws of the State of Oregon, Thelen Reid Brown Raysman & Steiner LLP and your counsel, Simpson Thacher & Bartlett LLP, may rely upon this opinion in connection with the issuance and sale of the Notes. Neither you nor any of them may rely upon this opinion for any other purpose, and no other person may rely upon this opinion for any purpose without, in each case, my prior written consent.

Very truly yours,

C.J. Rue, Esq.

ANNEX IV

[Letterhead of Thelen Reid Brown Raysman & Steiner LLP]

[Date]

,ierrill Lynch, Pierce, Fenner & Smith

Incorporated

4 World Financial Center

15th Floor

New York, New York 10080

UBS Securities LLC

677 Washington Blvd.

Stamford, Connecticut 06901

J.P. Morgan Securities Inc.

270 Park Avenue

New York, New York 10017

Piper Jaffray & Co.

800 Nicollet Mall

Minneapolis, Minnesota 55402

Ladies and Gentlemen:

With reference to the issuance and sale from time-to-time by Northwest Natural Gas Company (the "**Company**"), pursuant to the Distribution Agreement, dated September 28, 2004, amended and restated on December 7, 2006 (the " **Agreement** "), between the Company and each of you, of not to exceed '60,000,000 in aggregate principal amount of (i) the Company's First Mortgage Bonds, designated Secured Medium-Term Notes, Series B (the "Secured Notes"), to ɛ issued under the Company's Mortgage and Deed of Trust, dated as of July 1, 1946, to Deutsche Bank Trust Company Americas (formerly known as Bankers Trust Company) (the "Corporate Trustee") and R.G. Page (Stanley Burg, successor), as trustees, as supplemented by twenty supplemental indentures (such Mortgage and Deed of Trust, as so supplemented, being hereinafter called the " **Mortgage** "), and (ii) the Company's Unsecured Medium-Term Notes, Series B (the " **Unsecured Notes** "), to be issued under the Company's Indenture, dated as of June 1, 1991 (the " **Indenture** "), to Deutsche Bank Trust Company Americas, as trustee (the " **Indenture Trustee** ") (the Secured Notes and the Unsecured Notes being hereinafter collectively referred to as the " **Notes** "), and the appointment of each of you as agents of the Company pursuant to the Agreement for the purposes of soliciting and receiving offers to purchase Notes, as agents, and purchasing Notes, as principals, from the Company, please be advised that, as counsel to the Company, we have participated in the preparation of or reviewed (a) the Restated Articles of Incorporation, as amended, and Bylaws, as amended, of the

Company; (b) the Mortgage; (c) the Indenture; (d) the Agreement; (e) the registration statement (File No. 333-112604) (the "**Registration Statement**"), filed by the Company with the Securities and Exchange Commission (the " **SEC** ") for the registration under the Securities Act of 1933, as amended (the " **1933 Act** "), of $200,000,000 of the Company's securities (which may include the Notes), and for the qualification under the Trust Indenture Act of 1939, as amended (the " **Trust Indenture Act** "), of the Mortgage and the Indenture, which Registration Statement became effective on February 18, 2004; (f) the prospectus, dated February 18, 2004, constituting a part of the Registration Statement in the form in which the Registration Statement became effective, or if such prospectus has been amended or pplemented subsequent to such effectiveness, as so amended and supplemented, including the documents incorporated therein by reference pursuant to Item 12 of orm S-3, as supplemented by the prospectus supplement relating to the Notes, dated September 28, 2004, filed with the Commission pursuant to Rule 424(b) under the Securities Act (together, the "Prospectus"); (g) the records of the proceedings before the Oregon Public Utility Commission (the "OPUC") and the Washington Utilities and Transportation Commission (the "WUTC") relating to the issuance and sale of the Notes; and (h) the records of various corporate and other proceedings relating to the authorization, issuance and sale of the Notes. We have also examined such other documents and satisfied ourselves as to such other matters as we have deemed necessary in order to render this opinion. We have not examined the Notes, except specimens thereof.

In the preparation of this opinion, we have examined originals or photostatic or certified copies of such certificates, agreements, documents and other papers, and have made such inquiries and investigations of law, as we deemed appropriate and necessary for the opinion hereinafter set forth. In our examination, we have assumed the authenticity of all documents submitted to us as originals, the conformity to original documents of all documents submitted to us as certified or photostatic copies and the authenticity of the originals of such latter documents. As to certain matters of fact material to the opinion expressed herein, we have relied upon certificates of various corporate officers of the Company and public officials. We assume the accuracy of the material and factual matters contained therein.

We are of the opinion that:

1. The Company is a validly organized and existing corporation under the laws of the State of Oregon, and is authorized to transact business in the State of Washington.

2. The Agreement has been duly and validly authorized, executed and delivered by the Company.

3. The Mortgage and the Indenture have been duly and validly authorized by all necessary corporate action, have been duly and validly executed and delivered, have been duly qualified under the Trust Indenture Act, and are valid and binding instruments enforceable in accordance with their terms, subject, as to enforcement, to laws and principles of equity relating to or affecting generally the enforcement of creditors' rights, including, without limitation, bankruptcy and insolvency.

4. The form of the Secured Notes has been duly authorized and has been established in conformity with the provisions of the Mortgage and conforms to the description

thereof contained in the Prospectus; the form of the Unsecured Notes, bearing interest at a fixed rate, has been duly authorized and has been established in conformity with the provisions of the Indenture and conforms to the description thereof contained in the Prospectus; and the form of the Unsecured Notes, bearing interest at a variable rate or not bearing interest, when set forth in a Company Order or Orders (as defined in the Indenture) or established by procedures acceptable to the Indenture Trustee specified in a Company Order or Orders, will have been duly authorized and will have been established in conformity with the provisions of the Indenture.

5. The Secured Notes have been duly authorized by the resolutions adopted by the Company's Board of Directors on May 27, 1993, September 26, ٫96, April 24, 1997, February 26, 1998, April 27, 2000, April 25, 2002 and December 18, 2003 (the "Board Resolutions"), and when the terms of the Secured Notes shall have been determined as contemplated by and in accordance with the Mortgage, the Board Resolutions and written orders or instructions evidencing determinations by Officers of the Company, such terms will have been duly authorized by the Company and will have been established in conformity with the terms of the Mortgage.

6. The Unsecured Notes have been duly authorized by the Board Resolutions, and when the terms of the Unsecured Notes shall have been determined as contemplated by and in accordance with the Indenture, the Board Resolutions and, to the extent required by the Indenture and the Board Resolutions, by Officers' Certificates (each, as defined in the Indenture), Company Orders and procedures acceptable to the Indenture Trustee specified in such Company Orders, such terms will have been duly authorized by the Company and will have been established in conformity with the terms of the Indenture.

7. The Notes, when (a) executed by the Company, (b) completed, authenticated and delivered by the Corporate Trustee or the Indenture Trustee, as the case may be, (c) issued and delivered by the Company and (d) paid for, all as contemplated by and in accordance with the Mortgage, in the case of the Secured Notes, the Indenture, in the case of Unsecured Notes, the Board Resolutions, and (to the extent required by the Mortgage or the Indenture and the Board Resolutions) Officers' Certificates, Company Orders, procedures acceptable to the Indenture Trustee specified in such Company Orders, written orders or instructions evidencing determinations by the officers of the Company, the Agreement, the Administrative Procedure (as defined in the Agreement) and Terms Agreements (as defined in the Agreement), if any, will be duly issued under the Mortgage or the Indenture, as the case may be, and will constitute valid and legally binding obligations of the Company, entitled to the benefits provided by the Mortgage or the Indenture, as the case may be, and enforceable in accordance with their terms, subject, as to enforcement, to laws and principles of equity relating to or affecting generally the enforcement of creditors' rights, including, without limitation, bankruptcy and insolvency, and, in the case of the Secured Notes, entitled to the benefit of the security afforded by the Mortgage.

8. The issuance and sale of the Notes, the compliance by the Company with all of the provisions of the Notes, the Mortgage, the Indenture and the Agreement and the consummation of the transactions contemplated by the Agreement will not result in a breach or violation of any of the terms and provisions of, or constitute a default under, the Mortgage and the Indenture or the Company's Restated Articles of Incorporation, as amended, or Bylaws, as amended.

9. The OPUC has issued orders authorizing the issuance and sale by the Company of the Notes; and no further approval, authorization, consent or other order of any public board or body (other than in connection or in compliance with the provisions of the securities or blue sky laws of any jurisdiction and other than orders of the WUTC establishing compliance with applicable statutory provisions) is legally required for the issuance and sale of the Notes through each of you, as agent, on the terms and conditions set forth in the Agreement.

10. The Registration Statement has become effective under the 1933 Act, and, to our knowledge, no stop order suspending the effectiveness thereof has been issued and no proceedings for that purpose are pending before or have been proposed by the SEC; the Mortgage and the Indenture have been duly qualified under the Trust Indenture Act; the Registration Statement at the time it became effective complied, and the Prospectus (excluding the documents incorporated therein by reference) as of the date of this opinion complies, as to form, in all material respects with the requirements of the 1933 Act, the Trust Indenture Act (except with respect to the Forms T-1 and Form T-2, upon which we express no opinion) and the rules and regulations of the SEC thereunder; and the documents incorporated by reference in the Prospectus pursuant to Item 12 of Form S-3 (other than the financial statements and other financial or statistical data contained therein, upon which we express no opinion), as of their respective dates of filing, complied as to form in all material respects with the requirements of the Securities Exchange Act of 1934, as amended (the " **Exchange Act** "), and the rules and regulations of the SEC thereunder.

In the course of the preparation by the Company of the Registration Statement and the Prospectus, we had conferences with certain officers and employees of the Company, with the counsel for the Company and with you and your counsel, but we made no independent verification of the accuracy or completeness of the representations and statements made to us by such persons or the information included by the Company in the Registration Statement and the Prospectus and take no responsibility therefor, except insofar as set forth in paragraph 4 hereof. In passing upon the form of the Registration Statement and the Prospectus we have, therefore, assumed the accuracy and completeness of such representations, statements and information, except as aforesaid. However, our examination of the Registration Statement and the Prospectus and our discussions in the above-mentioned conferences did not disclose to us any information which gives us reason to believe that, when the Registration Statement became effective, it contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that, as of the date of this opinion, the Prospectus includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements therein, in the light of the circumstances under which they were made, not misleading; provided, that we do not express any belief as to the financial statements or other financial or statistical data contained in the Registration Statement or the Prospectus, or as to the Forms T-1 or T-2, or as to any information contained therein furnished to the Company in writing by any of you expressly for use therein.

This opinion is limited to the facts and law at the date hereof. In rendering the opinions set forth in paragraphs 7 and 9 above, we have necessarily assumed that, at the time of

any issuance, sale and delivery of a Note (i) the Board of Directors of the Company (or any committee thereof acting pursuant to authority properly delegated to such committee by the Board of Directors) has not taken any action to rescind or otherwise reduce its prior authorization of the issuance of the Notes and an officer of the Company, as stated in the resolutions of the Board of Directors (or any such committee) relating to the Notes, has executed and delivered such Notes, (ii) the WUTC has issued an order or orders establishing compliance with applicable statutory provisions with respect to the issuance and sale of such Note, (iii) the orders of the OPUC and the WUTC with respect to the Notes being sold remain in full force and effect and have not been modified or amended by the OPUC or the WUTC, respectively, and the Company complies with the terms of such orders and (iv) the order of the SEC with respect to the Registration Statement, the Mortgage and the Indenture remains in full force and effect and has not been modified or amended by the SEC.

We do not express any opinion herein concerning any law other than the laws of the State of Oregon, the State of Washington and the Federal laws of the United States. Accordingly, in rendering this opinion, we have relied, with your consent, as to all matters governed by the laws of the State of Oregon, upon the opinion of even date herewith addressed to you by C.J. Rue, Esq., counsel for the Company, and, as to all matters governed by the laws of the State of Washington, upon the opinion of Stoel Rives LLP, special Washington counsel to the Company. We understand that you are relying upon the opinions of C.J. Rue, Esq., and Stoel Rives LLP as to all matters governed by the laws of the State of Oregon and Washington, as the case may be, including titles to property and franchises and the lien of the Mortgage, upon which we express no opinion.

You, the Trustees, and as to matters governed by the laws of the State of New York and the 1933 Act, the Exchange Act and the Trust Indenture Act, C.J. Rue, Esq., may rely upon this opinion in connection with the issuance and sale of the Notes. Neither you nor any of them may rely upon this opinion for any other purpose, and no other person may rely upon this opinion for any purpose without, in each case, our prior written consent.

Very truly yours,
THELEN REID BROWN RAYSMAN &
STEINER LLP

ANNEX V

[Letterhead of Stoel Rives LLP]

[Date]

Merrill Lynch, Pierce, Fenner & Smith

Incorporated

4 World Financial Center

15th Floor

New York, New York 10080

UBS Securities LLC

677 Washington Blvd.

Stamford, Connecticut 06901

J.P. Morgan Securities Inc.

270 Park Avenue

New York, New York 10017

Piper Jaffray & Co.

800 Nicollet Mall

Minneapolis, Minnesota 55402

Ladies and Gentlemen:

With reference to the issuance and sale from time-to-time by Northwest Natural Gas Company (the "**Company**"), pursuant to the Distribution Agreement, dated September 28, 2004, amended and restated on December 7, 2006 (the "Agreement"), between the Company and each of you, of not to exceed $60,000,000 in aggregate principal amount of (i) the Company's First Mortgage Bonds, designated Secured Medium-Term Notes, Series B (the " **Secured Notes** ") to be issued under the Company's Mortgage and Deed of Trust, dated as of July 1, 1946, to Deutsche Bank Trust Company Americas (formerly known as Bankers Trust Company) (the " **Corporate Trustee** ") and R.G. Page (Stanley Burg, successor), as trustees, as supplemented by twenty supplemental indentures (such Mortgage and Deed of Trust, as so supplemented, being hereinafter called the " **Mortgage** "), and (ii) the Company's Unsecured Medium-Term Notes, Series B (the " **Unsecured Notes** "), to be issued under the Company's Indenture, dated as of June 1, 1991 (the " **Indenture** "), to Deutsche Bank Trust Company Americas, as trustee (the " **Indenture Trustee** ") (the Secured Notes and the Unsecured Notes being hereinafter collectively referred to as the " **Notes** "), and the appointment of each of you as agents of the Company pursuant to the Agreement for the purposes of soliciting and receiving offers to purchase Notes, as agents, and purchasing Notes, as principals, from the Company, please be advised that, as special Washington counsel to the Company, we have reviewed (a) the

Mortgage; (b) the Indenture; (c) the Agreement; and (d) the proceedings before the Washington Utilities and Transportation Commission (the "**WUTC**") relating to the issuance and sale of the Notes. We have also examined such other documents and satisfied ourselves as to such other matters as we have deemed necessary in order to render this opinion. We have not examined the Notes, except for forms thereof.

In preparation of this opinion, we have examined originals or photostatic copies of such certificates, agreements, documents and other papers, and have ıde such inquiries and investigations of law, as we deemed appropriate and necessary for the opinion hereinafter set forth. In our examination, we have assumed the .uthenticity of all documents submitted to us as certified or photostatic copies and the authenticity of the originals of such latter documents. We have also assumed that the Mortgage, the Indenture and the Agreement have been duly authorized, executed and delivered by, and are legally binding on, each of the parties thereto.

As to certain matters of fact material to the opinion expressed herein, we have relied upon certificates of various corporate officers of the Company and public officials. We assume the accuracy of the material and factual matters contained therein.

Based upon the foregoing and subject to the following qualifications, we are of the opinion that:

1. The Company is authorized to transact business in the State of Washington.

2. The Mortgage constitutes a first security interest on all of the personal properties and fixtures owned by the Company in the State of Washington that are described in the Mortgage and are intended to be subject to the lien thereof, subject only to Excepted Encumbrances (as defined in the Mortgage); and the description in the Mortgage of such properties and fixtures is adequate to constitute the Mortgage a security interest thereon.

3. The Company has good and sufficient title to all of the real properties owned by the Company in the State of Washington that are described in the Mortgage and intended to be subject to the lien thereof, subject only to Excepted Encumbrances (as defined in the Mortgage) and to minor defects and irregularities of the nature customarily found in properties of like size and character; the description in the Mortgage of such properties is adequate to constitute the Mortgage a lien thereon; and the Mortgage is a valid first mortgage lien on such properties, subject to the exceptions noted above in this paragraph 3.

4. The issuance and sale of the Notes, the compliance by the Company with all of the provisions of the Notes, the Mortgage, the Indenture and the Agreement and the consummation of the transactions contemplated by the Agreement will not violate any law, rule or regulation of the State of Washington or any political subdivision thereof known to us to be applicable to the Company.

This opinion is limited to the facts and law at the date hereof. In rendering the opinions set forth in paragraph 4 above, we have necessarily assumed that, at the time of any issuance, sale and delivery of a Note (i) the Board of Directors of the Company (or any committee thereof acting pursuant to authority properly delegated to such committee by the Board of Directors) has not taken any action to rescind or otherwise reduce its prior authorization

of the issuance of the Notes and an officer of the Company, as stated in the resolutions of the Board of Directors (or any such committee) relating to the Notes, has executed and delivered such Notes, (ii) the WUTC has issued an order or orders establishing compliance with applicable statutory provisions with respect to the issuance and sale of such Note, and (iii) that each such order of the WUTC with respect to the Notes being sold remains in full force and effect and has not been modified or amended by the WUTC and the Company complies with the terms of each such order.

We do not express any opinion herein concerning any laws other than the laws of the State of Washington.

In giving the foregoing opinions, we express no opinion as to any securities or blue sky laws of any jurisdiction.

You, the Trustees, C.J. Rue, Esq., counsel for the Company, Thelen Reid Brown Raysman & Steiner, counsel to the Company, and your counsel, Simpson Thacher & Bartlett LLP, as to matters governed by the laws of the State of Washington, may rely upon this opinion in connection with the issuance and sale of the Notes. Neither you nor any of them may rely upon this opinion for any other purpose, and no other person may rely upon this opinion for any purpose without, in each case, our prior written consent.

Very truly yours,

STOEL RIVES LLP

[Contents of Letter of Independent Registered Public Accounting Firm]

The letter of each independent registered public accounting firm will state in effect that, for the periods during which such firm was the independent ɜistered public accounting firm for the Company:

1. They are an independent registered public accounting firm with respect to the Company within the meaning of the Act and the applicable published Rules and Regulations;

2. In their opinion, the financial statements examined by them and incorporated by reference in the Registration Statement comply as to form in all material respects with the applicable accounting requirements of the Exchange Act and the published rules and regulations thereunder;

3. On the basis of limited procedures, not constituting an examination made in accordance with generally accepted auditing standards, including a reading of the latest available interim financial statements of the Company, if any, a reading of the minute books of the Company since December 31, 2005, inquiries of officials of the Company responsible for financial and accounting matters and such other inquiries and procedures as may be specified in such letter, nothing came to their attention that caused them to believe that:

(a)(1) the latest interim consolidated financial statements included or incorporated by reference in the Registration Statement do not comply as to form in all material respects with the applicable accounting requirements of the Exchange Act and the published rules and regulations thereunder as they apply to Form 10-Q or (2) said interim consolidated financial statements are not in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the audited consolidated financial statements incorporated by reference in the Registration Statement;

(b) at the date of the latest available interim balance sheet of the Company and at a subsequent specified date not more than five days prior to the Time of Delivery, there has been any change in the capital stock (except for (i) shares of the Company's Common Stock issued under the Company's Dividend Reinvestment Plan, Restated Stock Option Plan or Employee Stock Purchase Plan and (ii) shares of Common Stock repurchased pursuant to the Company's Repurchase Program) or any increase in the long-term debt of the Company, or any decrease in net assets, in each case as compared with amounts shown in the balance sheet as of the date of the latest financial statements incorporated by reference in the Registration Statement, except in each case for changes, increases or decreases which the Registration Statement discloses have occurred or may occur, which were occasioned by the declaration of dividends or which are described in such letter; or

(c) for the latest period for which financial information is available subsequent to the latest financial statements included or incorporated by reference in the Prospectus, there were any decreases in operating revenues, net income and earnings available for common stock, as compared to the corresponding period in the prior year,

except in each case for decreases which the Registration Statement discloses have occurred or may occur, which were occasioned by the declaration of dividends or which are described in such letter; and

4. They have performed certain other specified procedures with respect to certain amounts and percentages set forth in the Registration Statement or in he documents incorporated by reference therein, as have been requested by your counsel and approved by the Company, and have found them to be in agreement with e records of the Company and the computations to be arithmetically correct.

ANNEX VII

[Letterhead of Stoel Rives LLP]

[Date]

.⁄lerrill Lynch, Pierce, Fenner & Smith

Incorporated

4 World Financial Center

15th Floor

New York, New York 10080

UBS Securities LLC

677 Washington Blvd.

Stamford, Connecticut 06901

J.P. Morgan Securities Inc.

270 Park Avenue

New York, New York 10017

Piper Jaffray & Co.

800 Nicollet Mall

Minneapolis, Minnesota 55402

Ladies and Gentlemen:

With reference to the issuance and sale from time-to-time by Northwest Natural Gas Company (the "**Company**"), pursuant to the Distribution Agreement, dated September 28, 2004, amended and restated on December 7, 2006 (the "Agreement"), between the Company and each of you, of not to exceed '60,000,000 in aggregate principal amount of (i) the Company's First Mortgage Bonds, designated Secured Medium-Term Notes, Series B (the " **Secured Notes** ") to ꜿ issued under the Company's Mortgage and Deed of Trust, dated as of July 1, 1946, to Deutsche Bank Trust Company Americas (formerly known as Bankers Trust Company) (the " **Corporate Trustee** ") and R.G. Page (Stanley Burg, successor), as trustees, as supplemented by twenty supplemental indentures (such Mortgage and Deed of Trust, as so supplemented, being hereinafter called the "Mortgage"), and (ii) the Company's Unsecured Medium-Term Notes, Series B (the " **Unsecured Notes** "), to be issued under the Company's Indenture, dated as of June 1, 1991 (the " **Indenture** "), to Deutsche Bank Trust Company Americas, as trustee (the " **Indenture Trustee** ") (the Secured Notes and the Unsecured Notes being hereinafter collectively referred to as the " **Notes** "), and the appointment of each of you as agents of the Company pursuant to the Agreement for the purposes of soliciting and receiving offers to purchase Notes, as agents, and purchasing Notes, as principals, from the Company, please be advised that, as special Washington counsel to the Company, we have reviewed (a) the

Mortgage; (b) the Indenture; (c) the Agreement; and (d) the proceedings before the Washington Utilities and Transportation Commission (the "**WUTC**") relating to the issuance and sale of the Notes. We have also examined such other documents and satisfied ourselves as to such other matters as we have deemed necessary in order to render this opinion. We have not examined the Notes, except for forms thereof.

In preparation of this opinion, we have examined originals or photostatic copies of such certificates, agreements, documents and other papers, and have ade such inquiries and investigations of law, as we deemed appropriate and necessary for the opinion hereinafter set forth. In our examination, we have assumed the uthenticity of all documents submitted to us as certified or photostatic copies and the authenticity of the originals of such latter documents. We have also assumed that the Mortgage, the Indenture and the Agreement have been duly authorized, executed and delivered by, and are legally binding on, each of the parties thereto.

As to certain matters of fact material to the opinion expressed herein, we have relied upon certificates of various corporate officers of the Company and public officials. We assume the accuracy of the material and factual matters contained therein.

Based upon the foregoing and subject to the following qualifications, we are of the opinion that the WUTC has issued an order dated________ , 200_ in Docket___ -______ , establishing compliance with applicable statutory provisions with respect to the issuance and sale by the Company of up to $______ aggregate principal amount of the Notes; and under the laws of the State of Washington, no further approval, authorization, consent or other order of any public board or body is legally required for the issuance and sale of such Notes through each of you, as agent, on the terms and conditions set forth in the Agreement.

This opinion is limited to the facts and law at the date hereof. In rendering the opinions set forth above, we have necessarily assumed that, at the time of any issuance, sale and delivery of a Note (i) the Board of Directors of the Company (or any committee thereof acting pursuant to authority properly delegated to such committee by the Board of Directors) has not taken any action to rescind or otherwise reduce its prior authorization of the issuance of the Notes as stated in the resolutions of the Board of Directors (or any such committee) relating to the Notes, and an officer of the Company has executed and delivered such Notes and (ii) each order of the WUTC with respect to the Notes being sold remains in full force and effect and has not been modified or amended by the WUTC and the Company complies with the terms of each such order.

We are members of the bar of the State of Washington and do not express any opinion herein concerning any laws other than the laws of the State of Washington.

In giving the foregoing opinions, we express no opinion as to any securities or blue sky laws of any jurisdiction.

You, the Trustees, C.J. Rue, Esq., counsel for the Company, Thelen Reid Brown Raysman & Steiner LLP, counsel to the Company, and your counsel, Simpson Thacher & Bartlett LLP, as to matters governed by the laws of the State of Washington, may rely upon this opinion in connection with the issuance and sale of the Notes. Neither you nor any of them may rely upon this opinion for any other purpose, and no other person may rely upon this opinion for any purpose without, in each case, our prior written consent.

Very truly yours,

STOEL RIVES LLP

ANNEX VIII

Filing under Rule 433

Dated_______________

Registration No. 333-112604

$160,000,000

NORTHWEST NATURAL GAS COMPANY

Secured Medium-Term Notes, Series B

(A Series of First Mortgage Bonds)

and

Unsecured Medium-Term Notes, Series B

Due from Nine Months to 30 Years from Date of Issue

CUSIP No.: 66765R__
Secured____ Unsecured____
Principal amount ($): $
Issue price (%):
Net proceeds to Company ($):

Repayable at the option of holder: Yes__ No__

Repayment Date:

Repayment Price:

Election Period:

Selling Agent(s):

Type of Transaction:

[Agency Transaction] [Principal Transaction]

Stated interest rate (%):____%
Maturity date:
Original issue date:
Interest payment dates:______ and______, commencing______

Redeemable: Yes__ No__

In whole__
In whole or in part__
Fixed redemption price: Yes__ No__

Initial redemption date:

Initial redemption price:

Reduction Percentage:

Redemption limitation date:

Make-Whole Redemption Price: Yes__ No__

Make-Whole Spread:

[The issuer has filed a registration statement (including a prospectus) with the Securities and Exchange Commission for the offering to which this communication relates. Before you invest, you should read the prospectus in that registration statement and other documents the issuer has filed with the Securities and Exchange Commission for more complete information about the issuer and this offering. You may get these documents for free by visiting EDGAR on the Securities and Exchange Commission's Web site at www.sec.gov . Alternatively, the issuer, any underwriter or any dealer participating in the offering will arrange to send you the prospectus if you request it by calling [Merrill Lynch, Pierce, Fenner & Smith Incorporated toll-free at______,] [UBS Securities LLC toll-free at________,] [J.P. Morgan Securities Inc. toll-free at______] [Piper Jaffray & Co. toll-free at________.]]

Exhibit 1

Northwest Natural Gas Company

$__________

Medium-Term Notes, Series B

________, ______

Merrill Lynch, Pierce, Fenner & Smith

Incorporated

4 World Financial Center

15th Floor

New York, New York 10080

UBS Securities LLC

677 Washington Blvd.

Stamford, Connecticut 06901

J.P. Morgan Securities Inc.

270 Park Avenue

New York, New York 10017

Piper Jaffray & Co.

800 Nicollet Mall

Minneapolis, Minnesota 55402

ısert Names of Additional Existing Agents, if any]

[Insert Name of New Agent]

Ladies and Gentlemen:

Reference is hereby made to the Distribution Agreement, dated September 28, 2004, amended and restated on December 7, 2006 (the "**Distribution Agreement** "), a copy of which has previously been delivered to you, between Northwest Natural Gas Company, an Oregon corporation (the "Company"), and each of Merrill Lynch, Pierce, Fenner & Smith Incorporated, UBS Securities LLC, J.P. Morgan Securities Inc., Piper Jaffray & Co. and [Insert Names of Additional Existing Agents, if any], with respect to the issue and sale by the Company of its First Mortgage Bonds, designated Secured Medium-Term Notes, Series B, and its Unsecured Medium-Term Notes, Series B (collectively, the " **Securities** "). Capitalized terms used herein without definition shall have the meanings assigned to them in the Distribution Agreement.

Subject to the terms and conditions set forth in the Distribution Agreement, the Company hereby appoints [Insert Name of New Agent] as agent of the Company for the purpose of soliciting and receiving offers to purchase the Securities. In connection with such appointment, [Insert Name of New Agent] is hereby entitled to the benefits and subject to the duties of an Agent under the terms and conditions of the Distribution Agreement (including the Administrative Procedures) and by its execution hereof is hereby made a party to the Distribution Agreement. In connection with such appointment, [Insert Name of New Agent] shall receive as of the date hereof: [To be agreed upon by the Company and the New Agent]

Any communication under the Distribution Agreement will be made in accordance with Section 12 of the Distribution Agreement, and if to [Insert Name of New Agent] shall be sufficient in all respects when delivered or sent by facsimile transmission or registered mail to [Insert Address of New Agent], attention: [Insert Name], facsimile transmission number [Insert New Agent Number].

This Agreement may be executed in any number of counterparts, each of which when so executed shall be deemed to be an original and all of which taken gether shall constitute one and the same agreement.

If the foregoing correctly sets forth our agreement, please indicate your acceptance hereof in the space provided for that purpose below.

Very truly yours,
NORTHWEST NATURAL GAS COMPANY
By:

Title:

The foregoing Agreement is hereby confirmed and accepted as of the date hereof.

[INSERT NAME OF NEW AGENT]
By:

Title:

Exhibit 10C

NORTHWEST NATURAL GAS COMPANY

RESTATED STOCK OPTION PLAN

(as amended as of December 14, 2006)

1. **Purpose.** The purpose of this Restated Stock Option Plan, formerly referred to as the 1985 Stock Option Plan (the "Plan"), is to enable Northwest Natural Gas Company (the "Company") to attract and retain experienced and able employees and to provide additional incentive to these employees to exert their best efforts for the Company and its shareholders.

2. **Shares Subject to the Plan.** Except as provided in paragraph 10, the total number of shares of the Company's Common Stock, $3-1/6 par value per share ("Common Stock"), covered by all options granted under the Plan shall not exceed 2,400,000 authorized but unissued or reacquired shares. If any option under the Plan expires or is cancelled or terminated and is unexercised in whole or in part, the shares allocable to the unexercised portion shall again become available for options under the Plan.

3. **Duration of the Plan.** The Plan shall continue until options have been granted and exercised with respect to all of the shares available for the Plan under paragraph 2 (subject to any adjustments under paragraph 10), unless sooner terminated by action of the Board of Directors. The Board of Directors has the right to suspend or terminate the Plan at any time except with respect to then outstanding options.

4. **Administration.**

4.1 ***Board of Directors.*** The Plan shall be administered by the Board of Directors, which shall determine and designate from time to time the employees to whom options shall be granted and the number of shares, option price, the period of each option, the time or times at which options may be exercised, and any other term of the grant, all of which shall be set forth in an option agreement between the Company and the optionee. Subject to the provisions of the Plan, the Board of Directors may from time to time adopt rules and regulations relating to administration of the Plan, and the interpretation and construction of the provisions of the Plan by the Board of Directors shall be final and conclusive.

4.2 ***Committee.*** The Board of Directors may delegate to any committee of the Board of Directors (the "Committee") any or all authority for administration of the Plan. Members of the Committee are not eligible to receive an option pursuant to the Plan while on the Committee. If a Committee is appointed, all references to the Board of Directors in the Plan shall mean and relate to the Committee except (i) as otherwise provided by the Board of Directors and (ii) that only the Board of Directors may terminate or amend the Plan as provided in paragraphs 3 and 11.

5. **Eligibility; Grants.**

5.1 ***Eligibility***. Options may be granted under the Plan only to officers and other employees (including employees who are directors) of the Company or any parent or subsidiary of the Company.

5.2 ***Grants***. Options granted under the Plan may be Incentive Stock Options as defined in §422 of the Internal Revenue Code of 1986, as amended ("IRC"), or Non-Statutory Stock Options. A Non-Statutory Stock Option means an option other than an Incentive Stock Option. The Board of Directors has the sole discretion to determine which options shall be Incentive Stock Options and which options shall be Non-Statutory Stock Options, and, at the time of grant, it shall specifically designate each option granted under the Plan as an Incentive Stock Option or a Non-Statutory Stock Option. In the case of Incentive Stock Options, all terms shall be consistent with the requirements of the IRC and applicable regulations. No Incentive Stock Option may be granted under the Plan on or after the tenth anniversary of the last action by the Board of Directors approving an increase in the number of shares available for issuance under the Plan, which action was subsequently approved within 12 months by the shareholders.

6. **Limitation on Amount of Grants**. No employee may be granted options under the Plan for more than 200,000 shares of Common Stock in any fiscal year.

7. **Option Price**. The option price per share under each option granted under the Plan shall be determined by the Board of Directors, but the option price for an Incentive Stock Option and a Non-Statutory Stock Option shall be not less than 100 percent of the fair market value of the shares covered by the option on the date the option is granted. Except as otherwise expressly provided, for purposes of the Plan, the fair market value shall be deemed to be the closing sales price for the Common Stock as reported by the New York Stock Exchange and published in the *Wall Street Journal* for the date the option is granted, or such other fair market value of the Common Stock as determined by the Board of Directors of the Company.

8. **Duration of Options**. Each option granted under the Plan shall continue in effect for the period fixed by the Board of Directors, except that no Incentive Stock Option shall be exercisable after the expiration of 10 years from the date it is granted and no Non-Statutory Stock Option shall be exercisable after the expiration of 10 years plus seven days from the date it is granted.

9. **Nonassignability**. Except as otherwise provided by the Board of Directors, each option granted under the Plan by its terms shall be nonassignable and nontransferable by the optionee except by will or by the laws of descent and distribution of the state or country of the optionee's domicile at the time of death, and each option by its terms shall be exercisable during the optionee's lifetime only by the optionee.

10. **Changes in Capital Structure**. If the outstanding shares of Common Stock are increased or decreased or changed into or exchanged for a different number or kind of shares or other securities of the Company or of another corporation, by reason of any reorganization, merger, consolidation, plan of exchange, recapitalization, reclassification, stock split-up,

combination of shares, or dividend payable in shares, appropriate adjustment shall be made by the Board of Directors in the number and kind of shares for the purchase of which options may be granted under the Plan and in all other share amounts set forth in the Plan. Any such adjustment made by the Board of Directors shall be conclusive.

11. **Amendment of Plan.** The Board of Directors may at any time and from time to time modify or amend the Plan in such respects as it deems advisable cause of changes in the law while the Plan is in effect or for any other reason. After the Plan has been approved by the shareholders and except as provided in the applicable option agreement, however, no change in an option already granted to an employee shall be made without the written consent of such employee. Furthermore, unless approved at an annual meeting or a special meeting by a vote of shareholders in accordance with Oregon law, no amendment or change shall be made in the Plan (a) increasing the total number of shares which may be purchased under the Plan, (b) changing the minimum purchase price specified in the Plan, (c) increasing the maximum option period, or (d) materially modifying the requirements for eligibility for participation in the Plan.

12. **Approvals.** The obligations of the Company under the Plan are subject to the approval of the Oregon Public Utility Commission, the Washington Utilities and Transportation Commission, and such other state and federal authorities or agencies with jurisdiction in the matter. The Company will use its best efforts to take steps required by state or federal law or applicable regulations, including rules and regulations of the Securities and Exchange Commission and any stock exchange on which the Company's shares may then be listed, in connection with the granting of any option under the Plan, the issuance or sale of any shares purchased on exercise of any option under the Plan, or the listing of such shares on said exchange. The foregoing notwithstanding, the Company shall not be obligated to issue or deliver shares of Common Stock under the Plan if the Company is advised by its legal counsel that such issuance or delivery would violate applicable state or federal laws. The Company shall not be obligated to register shares issuable on exercise of options under the Securities Act of 1933.

13. **Employment Rights.** Nothing in the Plan or any option granted pursuant to the Plan shall confer on any optionee any right to be continued in the employment of the Company or to interfere in any way with the right of the Company by whom such optionee is employed to terminate such optionee's employment at any time, with or without cause.

EXHIBIT 11

NORTHWEST NATURAL GAS COMPANY

Statement Re: Computation of Per Share Earnings

Thousands, except per share amounts

(Unaudited)

	12 Months Ended December 31,		
	2006	2005	2004
Net income	$ 63,415	$ 58,149	$ 50,572
Convertible debenture interest less taxes	—	—	200
Net income - diluted	$ 63,415	$ 58,149	$ 50,772
Average common shares outstanding - basic	27,540	27,564	27,016
Stock-based compensation	117	57	40
Convertible debentures	—	—	227
Average common shares outstanding - diluted	27,657	27,621	27,283
Earnings per share of common stock - basic	$ 2.30	$ 2.11	$ 1.87
Earnings per share of common stock - diluted	$ 2.29	$ 2.11	$ 1.86

For the years ended December 31, 2006, 2005 and 2004, 105,600 shares, 6,000 shares and 201,800 shares, respectively, represent the number of stock options which were excluded from the calculation of diluted earnings per share because the effect was antidilutive.

EXHIBIT 12

NORTHWEST NATURAL GAS COMPANY

Statement Re: Ratio of Earnings to Fixed Charges

Thousands, except per share amounts

(Unaudited)

	Year Ended Dec. 31,				
	2006	2005	2004	2003	2002
Fixed Charges, as defined:					
Interest on Long-Term Debt	$ 34,651	$ 34,330	$ 33,776	$ 33,258	$ 32,264
Other Interest	4,648	2,665	2,184	2,048	1,620
Amortization of Debt Discount and Expense	716	808	773	696	799
Interest Portion of Rentals	1,465	1,357	1,489	1,622	1,578
Total Fixed Charges, as defined	$ 41,480	$ 39,160	$ 38,222	$ 37,624	$ 36,261
Earnings, as defined:					
Net Income	$ 63,415	$ 58,149	$ 50,572	$ 45,983	$ 43,792
Taxes on Income	36,234	32,720	26,531	23,340	23,444
Fixed Charges, as above	41,480	39,160	38,222	37,624	36,261
Total Earnings, as defined	$ 141,129	$ 130,029	$ 115,325	$ 106,947	$ 103,497
Ratio of Earnings to Fixed Charges	3.40	3.32	3.02	2.84	2.85

EXHIBIT 23

Consent of Independent Registered Public Accounting Firm

We hereby consent to the incorporation by reference in the Registration Statements on Form S-8 (Nos. 33-63017, 333-46430, 333-55002, 333-70218, 333-100885, and 333-120955, 333-134973 and 333-139819, and Post-Effective Amendment No. 1 to Registration Statement No. 2-76276) and in the Registration Statements on Form S-˜ (Nos. 33-53795, 333-68184, 333-112604, and 333-123898, and Post-Effective Amendment No. 1 to Registration Statement Nos. 33-1304 and 33-20384) of ›rthwest Natural Gas Company of our report dated February 28, 2007 relating to the consolidated financial statements, financial statement schedule, management's assessment of the effectiveness of internal control over financial reporting and the effectiveness of internal control over financial reporting, which appears in this Form 10-K.

/s/ PricewaterhouseCoopers LLP

Portland, Oregon

February 28, 2007

EXHIBIT 31.1

CERTIFICATION

I, Mark S. Dodson, certify that:

1. I have reviewed this annual report on Form 10-K of Northwest Natural Gas Company;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 28, 2007

/s/ Mark S. Dodson
Mark S. Dodson
President and Chief Executive Officer

EXHIBIT 31.2

CERTIFICATION

I, David H. Anderson, certify that:

1. I have reviewed this annual report on Form 10-K of Northwest Natural Gas Company;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

    (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

    (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

    (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

    (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

    (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

    (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 28, 2007

/s/ David H. Anderson
David H. Anderson
Senior Vice President and Chief Financial Officer

NORTHWEST NATURAL GAS COMPANY

Certificate Pursuant to Section 906

of Sarbanes – Oxley Act of 2002

Each of the undersigned, MARK S. DODSON, the President and Chief Executive Officer, and DAVID H. ANDERSON, the Senior Vice President and Chief Financial Officer, of NORTHWEST NATURAL GAS COMPANY (the Company), DOES HEREBY CERTIFY that:

1. The Company's Annual Report on Form 10-K for the year ended December 31, 2006 (the Report) fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

2. Information contained in the Report fairly presents, in all material respects, the financial condition and results of operation of the Company.

IN WITNESS WHEREOF, each of the undersigned has caused this instrument to be executed this 28th day of February 2007.

/s/ Mark S. Dodson
President and
Chief Executive Officer
/s/ David H. Anderson
Senior Vice President and
Chief Financial Officer

A signed original of this written statement required by Section 906 has been provided to Northwest Natural Gas Company and will be retained by Northwest Natural Gas Company and furnished to the Securities and Exchange Commission or its staff upon request.

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Form 10-K

PIEDMONT NATURAL GAS CO INC - PNY

Filed: January 12, 2007 (period: October 31, 2006)

Annual report which provides a comprehensive overview of the company for the past year

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

Form 10-K

(Mark One)

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

For the fiscal year ended October 31, 2006

Or

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

For the Transition period from to

Commission file number 1-6196

Piedmont Natural Gas Company, Inc.

(Exact name of registrant as specified in its charter)

North Carolina	**56-0556998**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
4720 Piedmont Row Drive, Charlotte, North Carolina	**28210**
(Address of principal executive offices)	*(Zip Code)*

Registrant's telephone number, including area code
(704) 364-3120

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, no par value	New York Stock Exchange

Indicate by check mark if the registrant is a well-known seasoned issuer as defined in Rule 405 of the securities Act. Yes ☑ No ☐

Indicate by check mark if the registrant is not required to file reports pursuant to section 13 or 15(d) of the Act. Yes ☐ No ☑

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☐

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

Large accelerated filer ☑ Accelerated filer ☐ Non-accelerated filer ☐

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

State the aggregate market value of the voting common equity held by non-affiliates of the registrant as of April 30, 2006.

Common Stock, no par value — $1,825,389,696

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

Class	Outstanding at January 8, 2007
Common Stock, no par value	74,606,758

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the Annual Meeting of Shareholders on March 7, 2007, are incorporated by reference into

Piedmont Natural Gas Company, Inc.
2006 FORM 10-K ANNUAL REPORT
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PART I

Item 1. *Business*

Piedmont Natural Gas Company, Inc. (Piedmont) was incorporated in New York in 1950 and began operations in 1951. In 1994, we merged into a newly formed North Carolina corporation with the same name for the purpose of changing our state of incorporation to North Carolina.

Piedmont is an energy services company primarily engaged in the distribution of natural gas to 1,016,000 residential, commercial and industrial customers in portions of North Carolina, South Carolina and Tennessee, including 62,000 customers served by municipalities who are our wholesale customers. We are invested in joint venture, energy-related businesses, including unregulated retail natural gas marketing, interstate natural gas storage and intrastate natural gas transportation.

In the Carolinas, our service area is comprised of numerous cities, towns and communities. We maintain service offices in Anderson, Gaffney, Greenville and Spartanburg in South Carolina and Charlotte, Salisbury, Greensboro, Winston-Salem, High Point, Burlington, Hickory, Indian Trail, Spruce Pine, Reidsville, Fayetteville, New Bern, Wilmington, Tarboro, Elizabeth City, Rockingham and Goldsboro in North Carolina. In North Carolina, we also provide wholesale natural gas service to Greenville, Monroe, Rocky Mount and Wilson. In Tennessee, our service area is the metropolitan area of Nashville, including wholesale natural gas service to Gallatin and Smyrna.

Effective at the close of business on September 30, 2003, we purchased 100% of the common stock of North Carolina Natural Gas Corporation (NCNG) from Progress Energy, Inc. (Progress), for $417.5 million in cash plus $32.4 million for estimated working capital. We paid an additional $.3 million for actual working capital in our second quarter ended April 30, 2004. At the time of the acquisition, NCNG, a regulated natural gas distribution company, served 176,000 customers in eastern North Carolina, including 57,000 customers served by four municipalities who were wholesale customers of NCNG. NCNG was merged into Piedmont immediately following the closing.

On September 30, 2003, we also purchased for $7.5 million in cash Progress' equity interest in Eastern North Carolina Natural Gas Company (EasternNC). At that time, EasternNC was a regulated utility with a certificate of public convenience and necessity to provide natural gas service to 14 counties in eastern North Carolina that previously were not served with natural gas. Progress' equity interest in EasternNC consisted of 50% of EasternNC's outstanding common stock and 100% of EasternNC's outstanding preferred stock. Effective at the close of business on October 25, 2005, we purchased for $1 the remaining 50% interest in common stock of EasternNC from Albemarle Pamlico Economic Development Corporation. EasternNC was merged into Piedmont immediately following the closing.

We have two reportable business segments, regulated utility and non-utility activities. Operations of our non-utility activities segment are comprised of our equity method investments in joint ventures. Operations of both segments are conducted within the United States of America. For further information on equity method investments and business segments, see Note 11 and Note 12, respectively, to the consolidated financial statements.

Operating revenues shown in the consolidated statements of income represent revenues from the regulated utility segment. The cost of purchased gas is a component of operating revenues. Increases or decreases in purchased gas costs from suppliers are passed on to customers through purchased gas adjustment procedures. Therefore, our operating revenues are impacted by changes in gas costs as well as by changes in volumes of gas sold and transported. For the year ended October 31, 2006, 44% of our operating revenues were from residential customers, 26% from commercial customers, 11% from industrial and power generation customers, 18% from secondary market activity and 1% from various other sources. Operations of the non-utility activities segment are included in the consolidated statements of income in "Income from equity method investments."

Our utility operations are regulated by the North Carolina Utilities Commission (NCUC), the Public Service Commission of South Carolina (PSCSC) and the Tennessee Regulatory Authority (TRA) as to rates,

service area, adequacy of service, safety standards, extensions and abandonment of facilities, accounting and depreciation. We are regulated by the NCUC as to the issuance of securities. We are subject to or affected by various federal regulations. These federal regulations include regulations that are particular to the natural gas industry, such as regulations of the Federal Energy Regulatory Commission (FERC) that affect the availability of and the prices paid for the interstate transportation and storage of natural gas, regulations of the Department of Transportation that affect the construction, operation, maintenance, integrity and safety of natural gas distribution and transmission systems, and regulations of the Environmental Protection Agency relating to the use and release into the environment of hazardous wastes. In addition, we are subject to numerous regulations, such as those relating to employment practices, which are generally applicable to companies doing business in the United States of America.

We hold non-exclusive franchises for natural gas service in the communities we serve, with expiration dates from 2006 to 2055. The franchises are adequate for the operation of our gas distribution business and do not contain materially burdensome restrictions or conditions. Eight franchise agreements have expired as of October 31, 2006, and four will expire during the 2007 fiscal year. We continue to operate in those areas pursuant to the provisions of the expired franchises with no significant impact on our business. The likelihood of cessation of service under an expired franchise is remote. We believe that these franchises will be renewed or service continued with no material adverse impact on us, as most government entities do not want to prevent their citizens from having access to gas service or to interfere with our required system maintenance.

The natural gas distribution business is seasonal in nature as variations in weather conditions generally result in greater revenues and earnings during the winter months when temperatures are colder. For further information on weather sensitivity and the impact of seasonality on working capital, see "Financial Condition and Liquidity" in Item 7 of this Form 10-K. As is prevalent in the industry, we inject natural gas into storage during the summer months (principally April through October) when customer demand is lower for withdrawal from storage during the winter months (principally November through March) when customer demand is higher. During the year ended October 31, 2006, the amount of natural gas in storage varied from 13.6 million dekatherms (one dekatherm equals 1,000,000 BTUs) to 25.7 million dekatherms, and the aggregate commodity cost of this gas in storage varied from $104.6 million to $204.8 million.

During the year ended October 31, 2006, 106.6 million dekatherms of gas were sold to or transported for large industrial and power generation customers, compared with 106.7 million dekatherms in 2005. Deliveries to temperature-sensitive residential and commercial customers, whose consumption varies with the weather, totaled 83.6 million dekatherms in 2006, compared with 89 million dekatherms in 2005. Weather in 2006, as measured by degree days, was 6% warmer than normal and in 2005 was 5% warmer than normal.

The following is a five-year comparison of operating statistics for the years ended October 31, 2002 through 2006. The information presented is not comparable for all periods due to the acquisitions of NCNG and an equity interest in EasternNC effective September 30, 2003, and the remaining 50% interest of EasternNC effective October 25, 2005.

	2006	2005	2004	2003	2002
Operating Revenues (in thousands):					
Sales and Transportation:					
Residential	$ 841,051	$ 686,304	$ 624,487	$ 524,933	$ 358,027
Commercial	498,956	421,499	360,355	299,281	191,988
Industrial	205,384	215,505	179,302	112,986	102,127
For Power Generation	22,963	16,248	18,782	3,071	2,368
For Resale	11,342	40,122	38,074	1,948	374
Total	1,579,696	1,379,678	1,221,000	942,219	654,884
Secondary Market Sales	337,278	373,353	301,886	273,369	173,592
Miscellaneous	7,654	8,060	6,853	5,234	3,552
Total	$ 1,924,628	$ 1,761,091	$ 1,529,739	$ 1,220,822	$ 832,028

	2006	2005	2004	2003	2002
Gas Volumes — Dekatherms (in thousands):					
System Throughput:					
Residential	49,119	52,966	54,412	52,603	40,047
Commercial	34,476	36,000	35,483	33,648	25,892
Industrial	80,490	81,102	83,957	60,054	58,414
For Power Generation	26,099	25,591	18,580	2,396	1,734
For Resale	8,472	8,779	8,912	623	41
Total	198,656	204,438	201,344	149,324	126,128
Secondary Market Sales	40,994	47,057	51,707	45,937	55,679
Number of Retail Customers Billed (12-month average):					
Residential	815,579	792,061	771,037	657,965	620,642
Commercial	92,692	91,645	90,328	75,924	72,323
Industrial	3,008	3,146	3,194	2,626	2,583
For Power Generation	12	16	13	5	3
For Resale	19	15	15	4	3
Total	911,310	886,883	864,587	736,524	695,554
Average Per Residential Customer:					
Gas Used — Dekatherms	60.23	66.87	70.57	79.95	64.53
Revenue	$ 1,031.23	$ 866.48	$ 809.93	$ 797.81	$ 576.87
Revenue Per Dekatherm	$ 17.12	$ 12.96	$ 11.48	$ 9.98	$ 8.94
Cost of Gas (in thousands):					
Natural Gas Commodity Costs	$ 1,229,326	$ 1,226,999	$ 943,890	$ 790,118	$ 408,407
Capacity Demand Charges	99,333	117,287	125,178	89,514	89,103
Natural Gas Withdrawn From (Injected Into) Storage, net	15,709	(35,151)	(11,116)	(44,069)	11,620
Regulatory Charges (Credits), net	56,781	(47,183)	(16,582)	2,379	(12,896)
Total	$ 1,401,149	$ 1,261,952	$ 1,041,370	$ 837,942	$ 496,234
Supply Available for Distribution (dekatherms in thousands):					
Natural Gas Purchased	140,999	155,614	163,257	143,716	136,206
Transportation Gas	101,414	97,959	91,795	52,895	48,179
Natural Gas Withdrawn From (Injected Into) Storage, net	(197)	856	775	(2,490)	(1,461)
Company Use	(127)	(133)	(135)	(147)	(139)
Total	242,089	254,296	255,692	193,974	182,785

We purchase natural gas under firm contractual commitments to meet our design-day requirements for firm sales customers. These contracts provide that we pay a reservation fee to the supplier to reserve or guarantee the availability of gas supplies for delivery. Under these provisions, absent force majeure conditions, any disruption of supply deliverability is subject to penalty and damage assessment against the supplier. We ensure the delivery of the gas supplies to our distribution system to meet the peak day, seasonal and annual needs of our firm customers by using a variety of firm transportation and storage capacity arrangements. The

pipeline capacity contracts require the payment of fixed demand charges to reserve firm transportation or storage entitlements. We align the contractual agreements for supply with the firm capacity agreements in terms of volumes, receipt and delivery locations and demand fluctuations. We may supplement firm contractual commitments with other supply arrangements to serve our interruptible market, or as an alternate supply for inventory withdrawals or injections.

As of October 31, 2006, we had contracts for the following pipeline firm transportation capacity in dekatherms of daily deliverability:

Williams-Transco (including certain upstream arrangements with Dominion and Texas Gas)	645,400
El Paso-Tennessee Pipeline	74,100
Duke-Texas Eastern	37,000
Duke-East Tennessee (through arrangements with Transco)	25,000
NiSource-Columbia Gas (through arrangements with Transco and Columbia Gulf)	42,800
NiSource-Columbia Gulf	10,000
Total	834,300

As of October 31, 2006, we had the following assets or contracts for local peaking facilities and storage for seasonal or peaking capacity in dekatherms of daily deliverability to meet the firm demands of our markets. This deliverability varies from five days to one year:

Piedmont Liquefied Natural Gas (LNG)	278,000
Pine Needle LNG	263,400
Williams-Transco Storage	86,100
NiSource-Columbia Gas Storage	96,400
El Paso-Tennessee Pipeline Storage	55,900
Duke Energy (delivered peaking service)	76,000
Total	855,800

As of October 31, 2006, we own or have under contract 29.5 million dekatherms of storage capacity, either in the form of underground storage or LNG. This capability is used to supplement or replace regular pipeline supplies.

The source of the gas we distribute is primarily the Gulf Coast production region, and is purchased primarily from major producers and marketers. The natural gas production, processing and pipeline infrastructure in the Gulf of Mexico was significantly affected by hurricanes in August and September 2005, with supplies being shut-in at various levels for extended periods due to lack of power, damage to facilities and lack of gas flow. As part of our long-term plan to diversify our reliance away from the Gulf Coast region, we have contracted with an underground storage facility that is under construction in West Virginia and have a firm transportation contract pending for additional pipeline capacity that accesses gas supplies from Canada and the Rocky Mountains. For further information on gas supply and regulation, see "Gas Supply and Regulatory Proceedings" in Item 7 of this Form 10-K and Note 3 to the consolidated financial statements.

During the year ended October 31, 2006, approximately 5% of our margin (operating revenues less cost of gas) was generated from deliveries to industrial or large commercial customers that have the capability to burn a fuel other than natural gas. The alternative fuels are primarily fuel oil and propane and, to a much lesser extent, coal or wood. Our ability to maintain or increase deliveries of gas to these customers depends on a number of factors, including weather conditions, governmental regulations, the price of gas from suppliers and the price of alternate fuels. Under FERC regulations, certain large-volume customers located in proximity to the interstate pipelines delivering gas to us could attempt to bypass us and take delivery of gas directly from the pipeline or from a third party connecting with the pipeline. During the fiscal year ended October 31, 2006, no bypass activity was experienced. The future level of bypass activity cannot be predicted.

The regulated utility competes in the residential and commercial customer markets with other energy products. The most significant competition between natural gas and electricity is for space heating, water heating and cooking. There are four major electric companies within our service areas. We continue to attract the majority of the new residential construction market on or near our distribution mains, and we believe that the consumer's preference for natural gas is influenced by such factors as reliability, comfort, convenience and environmental factors. Natural gas has historically maintained a price advantage over electricity in our service areas; however, with a tighter national supply and demand balance, wholesale natural gas prices and price volatility have increased over recent years. Increases in the price of natural gas can negatively impact our competitive position by decreasing or eliminating the price benefits of natural gas to the consumer.

As indicated above, many of our customers can utilize a fuel other than natural gas, and our ability to maintain industrial market share is largely dependent on price. The relationship between supply and demand has the greatest impact on the price of natural gas. With a tighter balance between domestic supply and demand, the cost of natural gas from non-domestic sources may play a greater role in establishing the future market prices of natural gas. The price of oil depends upon a number of factors beyond our control, including the relationship between supply and demand and the policies of foreign and domestic governments. Our liquidity could be impacted, either positively or negatively, as a result of alternate fuel decisions made by industrial customers. With higher wholesale gas prices, we anticipate that there may be more fuel switching by large industrial customers in the near term.

During the year ended October 31, 2006, our largest customer contributed $15.8 million, or less than 1%, to total operating revenues.

Our costs for research and development are not material and are primarily limited to gas industry-sponsored research projects.

Compliance with federal, state and local environmental protection laws have had no material effect on construction expenditures, earnings or competitive position. For further information on environmental issues, see "Environmental Matters" in Item 7 of this Form 10-K.

As of October 31, 2006, our fiscal year end, we had 2,051 employees, compared with 2,124 as of October 31, 2005.

Our reports on Form 10-K, Form 10-Q and Form 8-K, and amendments to these reports, are available at no cost on our website at www.piedmontng.com as soon as reasonably practicable after the report is filed with or furnished to the Securities and Exchange Commission.

Item 1A. *Risk Factors*

A decrease in the availability of adequate upstream, interstate pipeline transportation capacity and natural gas supply could reduce our earnings. We purchase all of our gas supply from interstate sources that must then be transported to our service territory. Interstate pipeline companies transport the gas to our system under firm service agreements that are designed to meet the requirements of our core markets. A significant disruption to that supply or interstate pipeline capacity due to unforeseen events, including but not limited to, hurricanes, freeze off of natural gas wells, terrorist attacks or other acts of war could reduce our normal interstate supply of gas, which could reduce our earnings. Moreover, if additional natural gas infrastructure, including but not limited to exploration and drilling platforms, processing and gathering systems, off-shore pipelines and interstate pipelines cannot be built at a pace that meets demand, then our growth opportunities would be limited and our earnings negatively impacted.

Changes in federal laws or regulations could reduce the availability or increase the cost of our interstate pipeline capacity and/or gas supply and thereby reduce our earnings. Congress has enacted laws that give the FERC the power to regulate the interstate transportation of natural gas and the terms and conditions of service. Additionally, Congress has enacted laws that deregulate the price of natural gas sold at the wellhead. Any Congressional legislation or agency regulation that would alter the current statutory and regulatory structure in a way to significantly raise costs that could not be recovered in rates from our customers or reduce the availability of supply or capacity would negatively impact our earnings.

Further increases in the wholesale price of natural gas could reduce our earnings. In recent years, natural gas prices have increased dramatically due to growing demand and limitations on North American gas production. The cost we pay for natural gas is passed directly through to our customers. Therefore, significant increases in the price of natural gas may cause our existing customers to conserve or motivate them to switch to alternate sources of energy. Significant price increases could also cause new home developers and new customers to select alternative sources of energy. Decreases in the volume of gas we sell could reduce our earnings, and a decline in new customers could impede growth in our future earnings. In addition, during periods when natural gas prices are significantly higher than historical levels, customers may have trouble paying the resulting higher bills and bad debt expenses may increase and reduce our earnings.

Weather conditions may cause our earnings to vary from year to year. Our earnings can vary from year to year, depending in part on weather conditions. Currently, we have in place regulatory mechanisms that account for this and normalize our margin for weather, providing for an adjustment up or down to take into account colder-than-normal or warmer-than-normal weather. We estimate that approximately 50% to 60% of our annual gas sales are to temperature-sensitive customers. As a result, mild winter temperatures can cause a decrease in the amount of gas we sell and deliver in any year. If our rates and tariffs were modified to eliminate weather protection, then we would be exposed to significant risk associated with weather and our earnings could vary as a result.

Governmental actions at the state level could result in lower earnings. Our regulated utility segment is regulated by the NCUC, the PSCSC and the TRA. These agencies set the rates that we charge our customers for our services. If a state regulatory commission were to prohibit us from setting rates that timely recover our costs and a reasonable return by significantly lowering our allowed return or negatively altering our cost allocation, rate design, cost trackers (including cost of gas) or other tariff provisions, then our earnings could be impacted. Additionally, the state agencies foster a competitive regulatory model that, for example, allows us to recover any margin losses associated with negotiated transactions designed to retain large volume customers that could use alternative fuels or that may directly access natural gas supply through their own connection to an interstate pipeline. If there were changes in regulatory philosophies that altered our ability to compete for these customers, then we could lose customers, or incur significant unrecoverable expenses to retain them. Both scenarios would impact our earnings.

Operational interruptions to our gas distribution activities caused by accidents, strikes or acts of terrorism could adversely impact earnings. Inherent in our gas distribution activities are a variety of hazards and operation risks, such as leaks, ruptures and mechanical problems that, if severe enough or led to operational interruptions, could cause substantial financial losses. In addition, these risks could result in loss of human life, significant damage to property, environmental damage, impairment of our operations and substantial loss to us. The location of pipeline and storage facilities near populated areas, including residential areas, commercial business centers, industrial sites and other public gathering places, could increase the level of damages resulting from these risks. Additionally, the fact that we have a workforce that is partially represented by the union exposes us to the risk of a strike. The occurrence of any of these events could adversely affect our financial position, results of operations and cash flows.

Increases in our debt ratios could adversely affect our ability to service our debt obligations and our ability to access capital on favorable terms. An increase in our leverage could adversely affect us by:

- increasing the cost of future debt financing;
- making it more difficult for us to satisfy our existing financial obligations;
- limiting our ability to obtain additional financing, if we need it, for working capital, acquisitions, debt service requirements or other purposes;
- increasing our vulnerability to adverse economic and industry conditions;

- requiring us to dedicate a substantial portion of our cash flows from operations to payments on our debt, which would reduce funds available for operations, future business opportunities or other purposes; and
- limiting our flexibility in planning for, or reacting to, changes in our business and the industry in which we compete.

We do not generate sufficient cash flows to meet all our cash needs. Historically, we have made large capital expenditures in order to finance the expansion and upgrading of our distribution system. We have also purchased and will continue to purchase natural gas to store in inventory. Moreover, we have made several equity method investments and will continue to pursue other similar investments, all of which are and will be important to our revenues and profits. We have funded a portion of our cash needs for these purposes, as well as contributions to our employee pensions and benefit plans, through borrowings under credit arrangements and by offering new securities into the market. Our dependency on external sources of financing creates the risks that our profits could decrease as a result of high capital costs and that we may not be able to secure external sources of cash necessary to fund our operations and new investments on terms acceptable to us.

As a result of cross-default provisions in our borrowing arrangements, we may be unable to satisfy all of our outstanding obligations in the event of a default on our part. The terms of our senior indebtedness, including our credit facility, contain cross-default provisions which provide that we will be in default under such agreements in the event of certain defaults under the indenture or other loan agreements. Accordingly, should an event of default occur under any of those agreements, we face the prospect of being in default under all of our debt agreements, obliged in such instance to satisfy all of our outstanding indebtedness and unable to satisfy all of our outstanding obligations simultaneously. In such an event, we might not be able to obtain alternative financing or, if we are able to obtain such financing, we might not be able to obtain it on terms acceptable to us.

We are exposed to credit risk of counterparties with whom we do business. Adverse economic conditions affecting, or financial difficulties of, counterparties with whom we do business could impair the ability of these counterparties to pay for our services or fulfill their contractual obligations. We depend on these counterparties to remit payments or fulfill their contractual obligations on a timely basis. Any delay or default in payment or failure of the counterparties to meet their contractual obligation could adversely affect our financial position, results of operations or cash flows.

Poor investment performance of pension plan holdings and other factors impacting pension plan costs could unfavorably impact our liquidity and results of operations. Our costs of providing non-contributory defined benefit pension plans are dependent on a number of factors, such as the rates of return on plan assets, discount rates, the level of interest rates used to measure the required minimum funding levels of the plans, future government regulation and our required or voluntary contributions made to the plans. Without sustained growth in the pension investments over time to increase the value of our plan assets and depending upon the other factors impacting our costs as listed above, we could be required to fund our plans with significant amounts of cash. Such cash funding obligations could have a material impact on our liquidity by reducing cash flows and could negatively affect results of operations.

We are subject to numerous environmental laws and regulations that may require significant expenditures or increase operating costs. We are subject to numerous federal and state environmental laws and regulations affecting many aspects of our present and future operations. These laws and regulations can result in increased capital, operating and other costs. These laws and regulations generally require us to obtain and comply with a wide variety of environmental licenses, permits, inspections and approvals. Compliance with these laws and regulations can require significant expenditures for clean-up costs and damages arising out of contaminated properties. Failure to comply may result in fines, penalties and injunctive measures affecting operating assets.

An overall economic downturn could negatively impact our earnings. A lower level of economic activity in our markets could result in a decline in energy consumption which could adversely affect our revenues or restrict our future growth. Additionally, a significant slow down in the housing market in our service area could restrict our future growth and negatively impact our earnings.

Our inability to attract and retain professional and technical employees could impact our earnings. Our ability to implement our business strategy and serve our customers is dependent upon the continuing ability to employ talented professionals and attract and retain a technically skilled workforce. Without such a skilled workforce, our ability to provide quality service to our customers and meet our regulatory requirements will be challenged and this could negatively impact our earnings.

Item 1B. *Unresolved Staff Comments*

None.

Item 2. *Properties*

All property shown in the consolidated balance sheets in "Utility Plant" is owned by us and used in our regulated utility segment. This property consists of intangible plant, production plant, storage plant, transmission plant, distribution plant and general plant as categorized by natural gas utilities, with 94% of the total invested in distribution and transmission plant to serve our customers. We have approximately 3,100 miles of lateral pipelines up to 30 inches in diameter that connect our distribution systems with the transmission systems of our pipeline suppliers. We distribute natural gas through approximately 23,300 miles (three-inch equivalent) of distribution mains. The lateral pipelines and distribution mains are located on or under public streets and highways, or property owned by others, for which we have obtained the necessary legal rights to place and operate our facilities on private property. All of these properties are located within our service areas in North Carolina, South Carolina and Tennessee. Utility Plant includes "Construction work in progress" which primarily represents distribution, transmission and general plant projects that have not been placed into service pending completion.

None of our property is encumbered and all property is in use.

We own or lease for varying periods our corporate headquarters building located in Charlotte, North Carolina and district and regional offices in the locations shown below. Lease payments for these various offices totaled $3.8 million for the year ended October 31, 2006.

North Carolina	South Carolina	Tennessee
Burlington	Anderson	Nashville
Cary	Gaffney	
Charlotte	Greenville	
Elizabeth City	Spartanburg	
Fayetteville		
Goldsboro		
Greensboro		
Hickory		
High Point		
Indian Trail		
New Bern		
Reidsville		
Rockingham		
Salisbury		
Spruce Pine		
Tarboro		
Wilmington		
Winston-Salem		

Property shown in the consolidated balance sheets in "Other Physical Property" is owned by the parent company and one of its subsidiaries. The property owned by the parent company primarily consists of

residential and commercial water heaters leased to natural gas customers. The property owned by the subsidiary is real estate. None of our other subsidiaries directly own property as their operations consist solely of participating in joint ventures as an equity member.

Item 3. *Legal Proceedings*

From time to time, we conduct business with natural gas marketers who act as agents for various industrial customers of ours or who purchase natural gas directly for their own account. We previously had such an arrangement with National Gas Distributors LLC (NGD), which filed a voluntary bankruptcy petition on January 20, 2006. The bankruptcy trustee for this petition claimed that certain amounts paid by NGD to us for gas supply constitute preference payments, and sought their return. We have disputed these claims and vigorously defended our position on the matter. In October 2006, we agreed to settle with the NGD bankruptcy trustee in order to avoid protracted litigation and the expense thereof. The settlement has been submitted to the bankruptcy court for approval. During the fourth quarter, we recorded our estimated liability under the settlement, which does not have a material adverse impact on our financial position, results of operations or cash flows.

Otherwise, we have only routine litigation in the normal course of business.

Item 4. *Submission of Matters to a Vote of Security Holders*

No matters were submitted to a vote of security holders during our fourth quarter ended October 31, 2006.

PART II

Item 5. *Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities*

(a) Our common stock (symbol PNY) is traded on the New York Stock Exchange (NYSE). The following table provides information with respect to the high and low sales prices from the NYSE Composite for each quarterly period for the years ended October 31, 2006 and 2005.

2006	**High**	**Low**
Quarter ended:		
January 31	$ 24.94	$ 21.26
April 30	25.23	23.21
July 31	26.17	23.31
October 31	27.27	24.72
2005	**High**	**Low**
Quarter ended:		
January 31	$ 24.35	$ 22.01
April 30	24.44	21.76
July 31	24.99	22.84
October 31	25.80	22.33

(b) As of January 8, 2007, our common stock was owned by 16,191 shareholders of record.

(c) The following table provides information with respect to quarterly dividends paid on common stock for the years ended October 31, 2006 and 2005. We expect that comparable cash dividends will continue to be paid in the future.

)06	Dividends Paid per Share
Quarter ended:	
January 31	23.00¢
April 30	24.00¢
July 31	24.00¢
October 31	24.00¢

2005	Dividends Paid per Share
Quarter ended:	
January 31	21.50¢
April 30	23.00¢
July 31	23.00¢
October 31	23.00¢

The amount of cash dividends that may be paid on common stock is restricted by provisions contained in certain note agreements under which long-term debt was issued, with those for the senior notes being the most restrictive. We cannot pay or declare any dividends or make any other distribution on any class of stock or make any investments in subsidiaries or permit any subsidiary to do any of the above (all of the foregoing being "restricted payments") except out of net earnings available for restricted payments. As of October 31, 2006, net earnings available for restricted payments were greater than retained earnings; therefore, our retained earnings were not restricted.

The following table provides information with respect to repurchases of our common stock under the Common Stock Open Market Purchase Program during the fourth quarter ended October 31, 2006.

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Program	Maximum Number of Shares that May Yet be Purchased Under the Program*
				6,649,474
8/1/06 - 8/31/06	37,400	$ 25.81	37,400	6,612,074
9/1/06 - 9/30/06	—	$ —	—	6,612,074
10/1/06 - 10/31/06	—	$ —	—	6,612,074
Total	37,400	$ 25.81	37,400	

* The Common Stock Open Market Purchase Program was announced on June 4, 2004, to purchase up to three million shares of common stock for reissuance under our dividend reinvestment, stock purchase and incentive compensation plans. On December 16, 2005, the Board of Directors approved an increase in the number of shares in this program from three million to six million to reflect the two-for-one stock split in 2004. The Board also approved the purchase of up to four million additional shares of common stock and amended the program to provide for purchases to maintain our debt-to-equity capitalization ratios at target levels. These combined actions increased the total authorized share repurchases from three million to ten million shares.

Item 6. *Selected Financial Data*

The following table provides selected financial data for the years ended October 31, 2002 through 2006. The information presented is not comparable for all periods due to the acquisitions of North Carolina Natural Gas Corporation (NCNG) and an equity interest in Eastern North Carolina Natural Gas Company (EasternNC) effective September 30, 2003, and the remaining 50% interest of EasternNC effective October 25, 2005, as discussed in Note 2 to the consolidated financial statements.

	2006	2005	2004	2003	2002
			In thousands except per share amounts		
Operating Revenues	$ 1,924,628	$ 1,761,091	$ 1,529,739	$ 1,220,822	$ 832,028
Margin (Operating Revenues less Cost of Gas)	$ 523,479	$ 499,139	$ 488,369	$ 382,880	$ 335,794
Net Income	$ 97,189	$ 101,270	$ 95,188	$ 74,362	$ 62,217
Earnings per Share of Common Stock:					
Basic	$ 1.28	$ 1.32	$ 1.28	$ 1.11	$ 0.95
Diluted	$ 1.28	$ 1.32	$ 1.27	$ 1.11	$ 0.94
Cash Dividends per Share of Common Stock	$ 0.950	$ 0.905	$ 0.8525	$ 0.8225	$ 0.7925
Total Assets	$ 2,733,939	$ 2,602,490	$ 2,392,164	$ 2,339,283	$ 1,478,014
Long-Term Debt (less current maturities)	$ 825,000	$ 625,000	$ 660,000	$ 460,000	$ 462,000

Item 7. *Management's Discussion and Analysis of Financial Condition and Results of Operations*

Forward-Looking Statements

This report as well as other documents we file with the Securities and Exchange Commission (SEC) may contain forward-looking statements. In addition, our senior management and other authorized spokespersons may make forward-looking statements in print or orally to analysts, investors, the media and others. These statements are based on management's current expectations and information currently available and are believed to be reasonable and are made in good faith. However, the forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those projected in the statements. Factors that may make the actual results differ from anticipated results include, but are not limited to:

- Regulatory issues, including those that affect allowed rates of return, terms and conditions of service, rate structures and financings. We monitor our effectiveness in achieving the allowed rates of return and initiate rate proceedings or operating changes as needed. In addition, we purchase natural gas transportation and storage services from interstate and intrastate pipeline companies whose rates and services are regulated.

- Residential, commercial and industrial growth in our service areas. The ability to grow our customer base and the pace of that growth are impacted by general business and economic conditions such as interest rates, inflation, fluctuations in the capital markets and the overall strength of the economy in our service areas and the country, and fluctuations in the wholesale prices of natural gas and competitive energy sources.

- Deregulation, regulatory restructuring and competition in the energy industry. We face competition from electric companies and energy marketing and trading companies, and we expect this competitive environment to continue. We must be able to adapt to the changing environments and the competition.
- The potential loss of large-volume industrial customers to alternate fuels or to bypass, or the shift by such customers to special competitive contracts at lower per-unit margins.

- Regulatory issues, customer growth, deregulation, economic and capital market conditions, the cost and availability of natural gas and weather conditions can impact our ability to meet internal performance goals.
- The capital-intensive nature of our business. In order to maintain growth, we must add to our natural gas distribution system each year. The cost of this construction may be affected by the cost of obtaining governmental approvals, compliance with federal and state pipeline safety and integrity regulations, development project delays and changes in project costs. Weather, general economic conditions and the cost of funds to finance our capital projects can materially alter the cost of a project.
- Capital market conditions. Our internally generated cash flows are not adequate to finance the full cost of capital expenditures. As a result, we rely on access to both short-term and long-term capital markets as a significant source of liquidity for capital requirements not satisfied by cash flows from operations. Changes in the capital markets could affect access to and cost of capital.
- Changes in the availability and cost of natural gas. To meet firm customer requirements, we must acquire sufficient gas supplies and pipeline capacity to ensure delivery to our distribution system while also ensuring that our supply and capacity contracts allow us to remain competitive. Natural gas is an unregulated commodity market subject to supply and demand and price volatility. Producers, marketers and pipelines are subject to operating and financial risks associated with exploring, drilling, producing, gathering, marketing and transporting natural gas and have risks that increase our exposure to supply and price fluctuations.
- Changes in weather conditions. Weather conditions and other natural phenomena can have a material impact on our earnings. Severe weather conditions, including destructive weather patterns such as hurricanes, can impact our suppliers and the pipelines that deliver gas to our distribution system. Weather conditions directly influence the supply of, demand for and the cost of natural gas.
- Changes in environmental, safety and system integrity regulations and the cost of compliance. We are subject to extensive federal, state and local regulations. Compliance with such regulations may result in increased capital or operating costs.
- Ability to retain and attract professional and technical employees. To provide quality service to our customers and meet regulatory requirements, we are dependent on our ability to recruit, train, motivate and retain qualified employees.
- Changes in accounting regulations and practices. We are subject to accounting regulations and practices issued periodically by accounting standard-setting bodies. New accounting standards may be issued that could change the way we record revenues, expenses, assets and liabilities. Future changes in accounting standards could affect our reported earnings or increase our liabilities.
- Earnings from our equity method investments. We invest in companies that have risks that are inherent in their businesses and we assume such risks as an equity investor.

Other factors may be described elsewhere in this report. All of these factors are difficult to predict and many of them are beyond our control. For these reasons, you should not rely on these forward-looking statements when making investment decisions. When used in our documents or oral presentations, the words "expect," "believe," "project," "anticipate," "intend," "should," "could," "will," "assume," "can," "estimate," "forecast," "future," "indicate," "outlook," "plan," "predict," "seek," "target," "would" and variations of such words and similar expressions are intended to identify forward-looking statements.

Forward-looking statements are only as of the date they are made and we do not undertake any obligation to update publicly any forward-looking statement either as a result of new information, future events or otherwise except as required by applicable laws and regulations. Please reference our website at www.piedmontng.com for current information. Our reports on Form 10-K, Form 10-Q and Form 8-K and amendments to these reports are available at no cost on our website as soon as reasonably practicable after the report is filed with or furnished to the SEC.

Overview

Piedmont Natural Gas Company is an energy services company primarily engaged in the distribution of natural gas to residential, commercial and industrial customers in portions of North Carolina, South Carolina and Tennessee. We also have equity method investments in joint venture, energy-related businesses. Our operations are comprised of two business segments — the regulated utility segment and the non-utility activities segment.

The regulated utility segment is the largest segment of our business with approximately 97% of our consolidated assets. This segment is regulated by three state regulatory commissions that approve rates and tariffs that are designed to give us the opportunity to generate revenues to cover our gas and non-gas costs and to earn a fair rate of return for our shareholders. Factors critical to the success of the regulated utility include a safe, reliable natural gas distribution system and the ability to recover the costs and expenses of the business in rates charged to customers. For the twelve months ended October 31, 2006, 82% of our earnings before taxes came from our regulated utility segment.

The non-utility activities segment consists of our equity method investments in joint venture, energy-related businesses that are involved in unregulated retail natural gas marketing, interstate natural gas storage and intrastate natural gas transportation. We invest in joint ventures that are aligned with our business strategies to complement or supplement income from utility operations. We continually monitor performance of these ventures against expectations.

Weather conditions directly influence the volumes of natural gas delivered by the regulated utility. Significant portions of our revenues are generated during the winter season. During warm winters or unevenly cold winters, heating customers may significantly reduce their consumption of natural gas. In South Carolina and Tennesee, we have weather normalization adjustment (WNA) mechanisms that are designed to protect a portion of our revenues against warmer-than-normal weather as deviations from normal weather can affect our financial performance and liquidity. The WNA also serves to offset the impact of colder-than-normal weather by reducing the amounts we can charge our customers. In North Carolina, through a general rate case proceeding in 2005, a Customer Utilization Tracker (CUT) has eliminated the WNA effective November 1, 2005. The CUT provides for the recovery of our approved margin per customer independent of both weather and other consumption patterns of residential and commercial customers. For further information, see Note 3 to the consolidated financial statements.

Over the past few years, there have been significant increases in the wholesale cost of natural gas. The relationship between supply and demand has the greatest impact on wholesale gas prices. Increased wholesale prices for natural gas are being driven by increased demand that is exceeding the growth in accessible supply. Continued high gas prices could shift our customers' preference away from natural gas toward other energy sources, particularly in the industrial market. High gas prices could also affect consumption levels as customers react to high bills. We expect that the wholesale price of natural gas will remain high relative to historic levels and volatile until natural gas supply and demand are in better balance.

The majority of our natural gas supplies come from the Gulf Coast region. We believe that diversification of our supply portfolio is in our customers' best interest. We have a firm transportation contract pending with Midwestern Gas Transmission Company for additional pipeline capacity that will provide access to Canadian and Rocky Mountain gas supplies via the Chicago hub, primarily to serve our Tennessee markets. Due to regulatory delays impacting the commencement of construction for the winter of 2006-2007, Midwestern has only been able to provide a portion of the original contracted capacity. It is anticipated that the entire capacity will be available during the 2007-2008 winter. We have also executed an agreement with Hardy Storage Company LLC for market-area storage capacity in West Virginia with an anticipated in-service date in April 2007.

Part of our strategic plan is to manage our gas distribution business through control of our operating costs, implementation of new technologies and sound rate and regulatory initiatives. We are working to enhance the value and growth of our utility assets by good management of capital spending, including improvements for current customers and the pursuit of customer growth opportunities in our service areas. We strive for quality customer service by investing in systems, processes and people. We work with our state regulators to maintain fair rates of return and balance the interests of our customers and shareholders.

Our strategic plan includes a focus on maintaining a debt-to-capitalization ratio within a range of 45 to 50%. We will continue to stress the importance of maintaining a strong balance sheet and investment-grade credit ratings to support our operating and investment needs.

As part of an ongoing, larger effort aimed at streamlining business processes, capturing operational and organizational efficiencies and improving customer service, we restructured our management group in 2006. We expect the restructuring to generate savings of $7 to $7.5 million annually beginning in fiscal 2007. For further information, see Note 14 to the consolidated financial statements.

Results of Operations

Net income decreased $4.1 million in 2006 compared with 2005 primarily due to the following changes which decreased net income:

- $12.4 million increase in operations and maintenance expenses, primarily due to restructuring charges and customer service initiatives.
- $8.1 million increase in utility interest charges.
- $4.5 million increase in depreciation expense.
- $3.3 million increase in general taxes.
- $1.7 million decrease from the non-recurring 2005 gain on the sale of corporate office land.
- $1.6 million increase related to the non-recurring 2005 income tax expense true-up of the effective federal income tax rate following the sale of our propane interests.
- $1.5 million decrease from the non-recurring 2005 gain on the sale of marketable securities.

These changes were partially offset by the following changes which increased net income:

- $24.3 million increase in margin (operating revenues less cost of gas).
- $2.3 million increase in earnings from equity method investments.
- $1.4 million decrease in charitable contributions.
- $.6 million decrease from the 2005 inclusion of minority interest in income of consolidated subsidiary.

The net income increase of $6.1 million in 2005 compared with 2004 was primarily due to the following changes which increased net income:

- $10.8 increase in margin.
- $3.1 million decrease in utility interest charges.
- $1.5 million gain on the sale of marketable securities.
- $7.4 million decrease in charitable contributions.
- $1.6 million decrease in income tax expense due to true-up of the effective federal income tax rate following the sale of our propane interests.

These changes were partially offset by the following changes which decreased net income:

- $6.7 million increase in operations and maintenance expenses.
- $4.7 million decrease from the non-recurring gain in 2004 on the sale of our equity method investment in propane.
- $2.9 million increase in depreciation expense.
- $2.8 million increase in general taxes.

Compared with the prior year, weather in our service area, as measured by degree days, was 2% warmer in 2006 and 2005 and 9% warmer in 2004. Volumes of gas delivered to customers were 198.7 million dekatherms in 2006, compared with 204.4 million dekatherms in 2005 and 201.3 million dekatherms in 2004. In addition to volumes delivered to customers, secondary market sales volumes were 41 million dekatherms in 2006, compared with 47.1 million dekatherms in 2005 and 51.7 million dekatherms in 2004.

Operating revenues in 2006 increased $163.5 million compared with 2005 primarily due to the following increases:

- $197.8 million from increased commodity gas costs passed through to customers.
- $30.4 million from the CUT mechanism put in place as of November 1, 2005, as compared with the North Carolina WNA surcharge in 2005 of $4.7 million. As discussed in "Financial Condition and Liquidity" below, the CUT mechanism was in place throughout 2006, to offset the impact of conservation and weather that is warmer or colder than normal on residential and commercial customer billings and margin. The CUT replaced the WNA in North Carolina in 2006.

These increases were partially offset by the following decreases:

- $36.1 million from secondary market activity. Secondary market transactions consist of off-system sales and capacity release arrangements.
- $32.6 million from changes in the composition of delivery services, including the impacts of sales revenues versus transportation revenues and sales and transportation services to power generation customers.

Operating revenues in 2005 increased $231.4 million compared with 2004 primarily due to the following increases:

- $133.4 million from increased commodity gas costs passed through to customers.
- $71.5 million from secondary market activity.
- $11.1 million from changes in the composition of delivery services, including the impacts of sales revenues versus transportation revenues and sales and transportation services to power generation customers.

- $6.3 million from the WNA due to charges of $8.4 million in 2005 compared with charges of $2.1 million in 2004.

In general rate proceedings, state regulatory commissions authorize us to recover a margin, which is the applicable billing rate less cost of gas, on each unit of gas delivered. The commissions also authorize us to recover margin losses resulting from negotiating lower rates to industrial customers when necessary to remain competitive. The ability to recover such negotiated margin reductions is subject to continuing regulatory approvals.

Cost of gas in 2006 increased $139.2 million compared with 2005 primarily due to $197.8 million from increased commodity gas costs, partially offset by the following decreases:

- $37.6 million from lower secondary market activity.
- $28.6 million from lower volumes and changes in the composition of delivery services.

Cost of gas in 2005 increased $220.6 million compared with 2004 primarily due to the following increases:

- $133.4 million from increased commodity gas costs.
- $68.5 million from increased secondary market activity.
- $13.1 million from increased volumes and changes in the composition of delivery services.

Margin increased $24.3 million in 2006 compared with 2005 primarily due to growth in the residential and commercial customer base, plus base rate increases of $22.8 million. This net increase was negatively impacted by decreased consumption because of conservation in the residential and commercial classes in South Carolina and Tennessee.

Margin increased $10.8 million in 2005 compared with 2004 primarily due to growth in the residential and commercial customer base, partially offset by decreased consumption because of warmer weather, equipment efficiencies and conservation.

Operations and maintenance expenses increased $12.4 million in 2006 compared with 2005 primarily due to the following increases:

- $7.4 million in payroll primarily due to $7.9 million in one-time costs associated with the management restructuring program, increases in long-term incentive plan accruals and costs associated with providing improved customer service, partially offset by decreases in accruals for short-term incentive plans.
- $6 million in outside services primarily due to our enhanced customer service initiative.
- $1.8 million in rents and leases due to leasing of corporate office space, partially offset by a reduction of 2006 expenses related to copier leases.
- $2 million in other corporate expense primarily due to $.5 million of conservation programs approved by the NCUC as a part of a rate case settlement and $.75 million in conservation programs under the CUT settlement, and amortization of deferred operations and maintenance expenses of EasternNC. For further information, see Note 3 to the consolidated financial statements.

These increases were partially offset by the following decreases:

- $2.2 million in postretirement health care and life insurance costs.
- $1.3 million in the provision for uncollectibles.
- $.8 million from reduced telecommunications costs.
- $.8 million from reduced risk insurance premium costs.

Operations and maintenance expenses increased $6.7 million in 2005 compared with 2004 primarily due to the following increases:

- $5.5 million in employee benefits expense primarily due to pension and postretirement health care and life insurance costs.
- $3.8 million in payroll costs primarily due to increases in vacation benefits, merit and bargaining unit contract increases and long-term incentive plan accruals.
- $1.2 million in utilities expenses primarily due to increased telecommunication costs.
- $1.1 million in rents and leases primarily due to buyout of lease contracts on printers and copiers and other maintenance costs.
- $.6 million in transportation expenses primarily due to an increase in fuel costs.

These increases were partially offset by the following decreases:

- $2.3 million due to the accrual in the prior year of the projected benefit obligation for a retirement plan for certain current and former members of the Board of Directors.
- $2 million in outside consultant fees primarily for a continuous business process improvement program and an integrated mapping project.
- $1.4 million in other corporate expenses primarily due to accruals for severance agreements and sales tax expense in 2004 that did not recur in 2005 and lower bank fees.

Depreciation expense increased from $82.3 million to $89.7 million over the three-year period 2004 to 2006 primarily due to increases in plant in service.

General taxes increased $3.3 million in 2006 compared with 2005 primarily due to the following changes:

- $2.2 million increase in property taxes.
- $.6 million increase in other gross receipts taxes.
- $.5 million increase in payroll taxes.

General taxes increased $2.8 million in 2005 compared with 2004 primarily due to the following changes:

- $1.8 million increase in property taxes as the expense in 2004 reflected the impact of a favorable court ruling that reduced assessed property values and the estimated tax accruals for prior periods.
- $.3 million increase in other property taxes.
- $.4 million increase in payroll taxes.

Income from equity method investments increased $2.3 million in 2006, compared with 2005 primarily due to increases in earnings from SouthStar of $.9 million, Pine Needle of $.3 million and Hardy Storage of $1 million.

Income from equity method investments increased $.3 million in 2005 compared with 2004 primarily due to increases in earnings from SouthStar of $2.3 million, partially offset by the absence of $2.2 million in propane earnings due to the sale of our propane interests.

The gain on sale of equity method investments of $4.7 million in 2004 resulted from the sale of our propane interests effective January 20, 2004. See Note 11 to the consolidated financial statements.

The gain on sale of marketable securities of $1.5 million in 2005 resulted from the sale in February 2005 of common units of Energy Transfer Partners, L.P., which we received in connection with the sale of our propane interests in 2004.

The equity portion of the allowance for funds used during construction (AFUDC) was zero in 2006 and 2005 and $.9 million in 2004. AFUDC is allocated between equity and debt based on actual amounts computed and the ratio of construction work in progress to average short-term borrowings.

Non-operating income is comprised of non-regulated merchandising and service work, subsidiary operations, interest income and other miscellaneous income. Non-operating income in 2005 included a pre-tax gain on the sale of the corporate office land of $1.7 million. Changes in all other non-operating income were not significant.

Charitable contributions decreased $1.4 million in 2006 compared with 2005 primarily due to the $1 million contribution made to the Piedmont Natural Gas Foundation in 2005. Charitable contributions decreased $7.4 million in 2005 compared with 2004 primarily due to the initial commitment in October 2004 of $7 million to the newly established charitable foundation.

Utility interest charges increased $8.1 million in 2006 compared with 2005 primarily due to the following changes:

- $6.5 million increase in interest on short-term debt due to higher balances outstanding at interest rates that were approximately two percentage points higher in 2006 than in 2005. See further discussion in "Financial Condition and Liquidity" below.
- $3.7 million increase in interest on long-term debt due to the issuance on June 20, 2006 of $200 million of insured quarterly notes due June 1, 2036.
- $2.1 decrease in net interest expense on amounts due to/from customers due to higher net receivables in 2006.
- $.8 million decrease due to an increase in AFUDC allocated to debt.

- $.5 million increase in interest expense on regulatory treatment of certain components of deferred income taxes.

Utility interest charges decreased $3.1 million in 2005 compared with 2004 primarily due to the following changes:

- $3.5 million decrease in net interest expense on amounts due to/from customers due to higher net receivables in 2005.
- $1 million decrease in interest on short-term debt from commercial paper used to temporarily finance the NCNG and EasternNC acquisitions.
- $1.5 million decrease due to an increase in AFUDC allocated to debt.
- $1.7 million increase in interest on short-term debt due to higher balances outstanding at higher interest rates, largely due to purchases of gas at higher prices.
- $1.2 million increase in interest on long-term debt due to higher balances outstanding, including amounts due to the permanent financing of the NCNG and EasternNC acquisitions.

Our Business

Piedmont Natural Gas Company, Inc., which began operations in 1951, is an energy services company primarily engaged in the distribution of natural gas to 1,016,000 residential, commercial and industrial customers in portions of North Carolina, South Carolina and Tennessee, including 62,000 customers served by municipalities who are our wholesale customers. We are invested in joint venture, energy-related businesses, including unregulated retail natural gas marketing, interstate natural gas storage and intrastate natural gas transportation.

In 1994, our predecessor, which was incorporated in 1950 under the same name, was merged into a newly formed North Carolina corporation for the purpose of changing our state of incorporation to North Carolina.

Effective at the close of business on September 30, 2003, we purchased 100% of the common stock of NCNG from Progress Energy, Inc. (Progress), for $417.5 million in cash plus $32.4 million for estimated working capital. We paid an additional $.3 million for actual working capital in the second quarter ended April 30, 2004. At the time of the acquisition, NCNG, a regulated natural gas distribution company, served 176,000 customers in eastern North Carolina, including 57,000 customers served by four municipalities who were wholesale customers of NCNG. NCNG was merged into Piedmont immediately following the closing.

On September 30, 2003, we also purchased for $7.5 million in cash Progress' equity interest in EasternNC. At that time, EasternNC was a regulated utility with a certificate of public convenience and necessity from the NCUC to provide natural gas service to 14 counties in eastern North Carolina that previously were not served with natural gas. Progress' equity interest in EasternNC consisted of 50% of EasternNC's outstanding common stock and 100% of EasternNC's outstanding preferred stock. Effective at the close of business on October 25, 2005, we purchased for $1 the remaining 50% interest in common stock of EasternNC from Albemarle Pamlico Economic Development Corporation. EasternNC was merged into Piedmont immediately following the closing. For further information on this transaction, see Note 2 to the consolidated financial statements.

We continually assess the nature of our business and explore alternatives to traditional utility regulation. Non-traditional ratemaking initiatives and market-based pricing of products and services provide additional challenges and opportunities for us. We also regularly evaluate opportunities for obtaining natural gas supplies from different production regions and supply sources to maximize our natural gas portfolio flexibility and reliability. For further information, see "Gas Supply and Regulatory Proceedings" below and Note 3 and Note 6 to the consolidated financial statements.

We have two reportable business segments, regulated utility and non-utility activities. For further information on business segments, see Note 12 to the consolidated financial statements.

Our utility operations are regulated by the North Carolina Utilities Commission (NCUC), the Public Service Commission of South Carolina (PSCSC) and the Tennessee Regulatory Authority (TRA) as to rates, service area, adequacy of service, safety standards, extensions and abandonment of facilities, accounting and depreciation. We are regulated by the NCUC as to the issuance of securities. We are subject to or affected by various federal regulations. These federal regulations include regulations that are particular to the natural gas industry, such as regulations of the Federal Energy Regulatory Commission (FERC) that affect the availability of and the prices paid for the interstate transportation and storage of natural gas, regulations of the Department of Transportation that affect the construction, operation, maintenance, integrity and safety of natural gas distribution and transmission systems, and regulations of the Environmental Protection Agency relating to the use and release into the environment of hazardous wastes. In addition, we are subject to numerous regulations, such as those relating to employment practices, which are generally applicable to companies doing business in the United States of America.

In the Carolinas, our service area is comprised of numerous cities, towns and communities. We maintain service offices in Anderson, Gaffney, Greenville and Spartanburg in South Carolina and Charlotte, Salisbury, Greensboro, Winston-Salem, High Point, Burlington, Hickory, Indian Trail, Spruce Pine, Reidsville, Fayetteville, New Bern, Wilmington, Tarboro, Elizabeth City, Rockingham and Goldsboro in North Carolina. In North Carolina, we also provide wholesale natural gas service to Greenville, Monroe, Rocky Mount and Wilson. In Tennessee, our service area is the metropolitan area of Nashville, including wholesale natural gas service to Gallatin and Smyrna.

Our regulatory commissions approve rates and tariffs that are designed to give us the opportunity to generate revenues to cover our gas and non-gas costs and to earn a fair rate of return for our shareholders. Through October 31, 2005, we had WNA mechanisms in all three states that partially offset the impact of unusually cold or warm weather on bills rendered during the months of November through March for weather-sensitive customers. The WNA formula calculates the actual weather variance from normal, using 30 years of history, which results in an increase in revenues when weather is warmer than normal and a decrease in revenues when weather is colder than normal. The gas cost portion of our costs is recoverable through purchased gas adjustment (PGA) procedures and is not affected by the WNA. Effective November 1, 2005, the WNA was eliminated in North Carolina and replaced with the CUT that provides for the recovery of our approved margin per customer independent of both weather and other consumption patterns of residential and commercial customers. The CUT tracks our margin earned monthly and will result in semi-annual rate adjustments to refund any over-collection or recover any under-collection. For further information on the CUT, see Note 3 to the consolidated financial statements.

We invest in joint ventures to complement or supplement income from our regulated utility operations. If an opportunity aligns with our overall business strategies, we analyze and evaluate the project with a major factor being a projected rate of return greater than the returns allowed in our utility operations, due to the higher risk of such projects. We participate in the governance of the venture by having a management representative on the governing board of the venture. We monitor actual performance against expectations. Decisions regarding existing joint ventures are based on many factors, including performance results and continued alignment with our business strategies.

Financial Condition and Liquidity

To meet our capital and liquidity requirements, we rely on certain resources, including cash flows from operating activities, access to capital markets, cash generated from our investments in joint ventures and short-term bank borrowings. We believe that these sources will continue to allow us to meet our needs for working capital, construction expenditures, anticipated debt redemptions and dividend payments.

Cash Flows from Operating Activities. The natural gas business is seasonal in nature. Operating cash flows may fluctuate significantly during the year and from year to year due to working capital changes within our utility and non-utility operations resulting from such factors as weather, natural gas purchases and prices, gas inventory storage activity, collections from customers and deferred gas cost recoveries. We rely on operating cash flows and short-term bank borrowings to meet seasonal working capital needs. During our first

and second quarters, we generally experience overall positive cash flows from the sale of flowing gas and gas in storage and the collection of amounts billed to customers during the peak heating season (November through March). Cash requirements generally increase during the third and fourth quarters due to increases in natural gas purchases for storage, paying down short-term debt and decreases in receipts from customers.

During the peak heating season, our accounts payable increase to reflect amounts due to our natural gas suppliers for commodity and pipeline capacity. The value of the gas can vary significantly from period to period due to volatility in the price of natural gas, which is a function of market fluctuations in the price of natural gas, along with our changing requirements for storage volumes. Our natural gas costs and amounts due to/from customers represent the difference between natural gas costs that we have paid to suppliers and amounts that we have collected from customers. These natural gas costs can cause cash flows to vary significantly from period to period along with variations in the timing of collections of gas costs under our gas cost recovery mechanisms.

Cash flows from operations are impacted by weather, which affects gas purchases and sales. Warmer weather can lead to lower revenues from fewer volumes of natural gas sold or transported. Colder weather can increase volumes sold to weather-sensitive customers, but may lead to conservation by customers in order to reduce their consumption. Temperatures above normal can lead to reduced operating cash flows, thereby increasing the need for short-term borrowings to meet current cash requirements.

Net cash provided by operating activities was $103.8 million in 2006, $183.4 million in 2005 and $183.7 million in 2004. Net cash provided by operating activities reflects a $4.1 million decrease in net income for 2006, compared with 2005, as well as changes in working capital as described below:

- Trade accounts receivable and unbilled utility revenues decreased $19.5 million primarily due to a decrease in volumes sold to customers of 5.5 million dekatherms as compared with the prior year due to the current winter period being 6% warmer than normal and 2% warmer than the similar prior period.
- Amounts due to/from customers increased $54.5 million related to the deferral of gas costs yet to be billed and collected from customers.
- Gas in storage decreased $13.7 million primarily due to decreases in average gas costs and the amount of inventory storage dekatherms in 2006 as compared with 2005.
- Prepaid gas costs decreased $6.6 million primarily due to a decrease in average gas costs. Under asset management agreements, prepaid gas costs during the summer months represent purchases of gas that are not available for sale, and therefore not recorded in inventory, until November 1, the beginning of the winter period.
- Trade accounts payable decreased $102.5 million this year primarily due to a decrease in the cost of the natural gas commodity.

Our regulatory commissions approve rates that are designed to give us the opportunity to generate revenues, assuming normal weather, to cover our gas costs and fixed and variable non-gas costs and to earn a fair return for our shareholders. We have had a WNA mechanism in South Carolina and Tennessee that partially offsets the impact of unusually cold or warm weather on bills rendered in November through March for weather-sensitive customers. The WNA in South Carolina and Tennessee generated charges to customers of $4.1 million in 2006, $3.7 million in 2005 and $4 million in 2004. In Tennessee, adjustments are made directly to the customer's bill. In South Carolina, the adjustments are calculated at the individual customer level and recorded in a deferred account for subsequent collection from or refund to all customers in the class. Effective November 1, 2005, we have a CUT mechanism in North Carolina that provides for any over- or under-collection of approved margin per customer that operates independently of weather or other usage and consumption patterns of residential and commercial customers. The CUT mechanism provided margin of $30.4 million as compared to North Carolina WNA that generated charges to customers of $4.7 million in 2005 and refunds to customers of $1.9 million in 2004. Our gas costs are recoverable through PGA procedures and are not affected by the WNA or the CUT.

The financial condition of the natural gas marketers and pipelines that supply and deliver natural gas to our distribution system can increase our exposure to supply and price fluctuations. We believe our risk exposure to the financial condition of the marketers and pipelines is not significant based on our receipt of the products and services prior to payment and the availability of other marketers of natural gas to meet our firm supply needs if necessary.

We have commission approval in North Carolina, South Carolina and Tennessee that places additional credit requirements on the retail natural gas marketers that schedule gas into our system.

The regulated utility competes with other energy products, such as electricity and propane, in the residential and commercial customer markets. The most significant product competition is with electricity for space heating, water heating and cooking. Numerous factors can influence customer demand for natural gas, such as price volatility, the availability of natural gas in relation to other energy forms, general economic conditions, weather, energy conservation and the ability to convert from natural gas to other energy sources. Increases in the price of natural gas can negatively impact our competitive position by decreasing the price benefits of natural gas to the consumer. This can impact our cash needs if customer growth slows, resulting in reduced capital expenditures, or if customers conserve, resulting in reduced gas purchases and customer billings.

In the industrial market, many of our customers are capable of burning a fuel other than natural gas, with fuel oil being the most significant competing energy alternative. Our ability to maintain industrial market share is largely dependent on price. The relationship between supply and demand has the greatest impact on the price of natural gas. With a tighter balance between domestic supply and demand, the cost of natural gas from non-domestic sources may play a greater role in establishing the future market price of natural gas. The price of oil depends upon a number of factors beyond our control, including the relationship between supply and demand and the policies of foreign and domestic governments and organizations. Our liquidity could be impacted, either positively or negatively, as a result of alternate fuel decisions made by industrial customers.

Cash Flows from Investing Activities. Net cash used in investing activities was $167.6 million in 2006, $159 million in 2005 and $65.7 million in 2004. Net cash used in investing activities was primarily for utility construction expenditures. Gross utility construction expenditures were $204.1 million in 2006, a 7% increase over the $191.4 million in 2005, primarily due to expenditures for the automated meter reading project as well as additions to transmission and distribution mains and transmission plant. Reimbursements from the bond fund decreased $13.9 million from 2005 as construction of gas infrastructure in eastern North Carolina has now been completed. For further information about the bond fund, see Note 3 to the consolidated financial statements.

We have a substantial capital expansion program for construction of distribution facilities, purchase of equipment and other general improvements. This program primarily supports the growth in our customer base. Gross utility construction expenditures totaling $144.8 million, primarily to serve customer growth, are budgeted for 2007; however, we are not contractually obligated to expend capital until the work is completed. Due to projected growth in our service areas, significant utility construction expenditures are expected to continue and are a part of our long-range forecasts that are prepared at least annually and typically cover a forecast period of five years.

During 2006, we contributed $23.7 million to Hardy Storage Company LLC, a joint venture investee of one of our non-utility subsidiaries, for construction of a FERC regulated interstate storage facility. On June 29, Hardy Storage signed a note purchase agreement for interim notes and a revolving equity bridge facility to fund the project. Upon securing this financing, we received $30 million as reimbursement for construction costs we had funded through capital contributions, including the $23.7 million mentioned above. We anticipate contributing $26.6 million to Hardy Storage when the interim notes and revolving equity bridge facility are converted to a mortgage-style note after the project goes in service in April 2007.

During 2006, the restrictions on cash totaling $13.2 million were removed in connection with implementing the NCUC order in the general rate proceeding discussed in Note 4 to the consolidated financial

statements. As ordered by the NCUC, such cash had been held in an expansion fund to extend natural gas service to unserved areas of the state.

On May 12, 2005, we sold our corporate office building located in Charlotte, North Carolina for $6.7 million in cash, net of expenses. In accordance with utility plant accounting, we recorded the disposition of the land as a pre-tax gain of $1.7 million in "Other Income (Expense)" in the consolidated statement of income and a loss of $1.8 million on the disposition of the building as a charge to "Accumulated depreciation" in the consolidated balance sheet, based on the sales price allocation from an independent third party. Under the terms of the purchase and sale agreement, we leased back the building from the new owner until our new office space was ready for occupancy. We relocated to our new office space in November 2005 under a negotiated ten-year lease with renewal options. The lease payments for the ten-year term range from $3 million to $3.4 million annually.

We received $2.4 million in cash in 2005 from the sale of marketable securities which we received in connection with the sale of our propane interests in 2004.

We received $36.1 million in cash in 2004 from the sale of equity method investments, $26.9 million from our investment in US Propane, L.P. and $9.2 million from our investment in Greenbrier Pipeline Company, LLC.

In 2003, we acquired 100% of the common stock of NCNG and a 50% equity interest in EasternNC from Progress. In 2005, we acquired the remaining 50% equity interest in EasternNC. These acquisitions were a part of our focus on growing our core utility business. For further information regarding the acquisitions, see Note 1.E and Note 2 to the consolidated financial statements.

Cash Flows from Financing Activities. Net cash provided by (used in) financing activities was $65.6 million in 2006, $(22.9) million in 2005 and $(123.5) million in 2004. Funds are primarily provided from bank borrowings and the issuance of common stock through dividend reinvestment and employee stock plans, net of purchases under the common stock repurchase program. Financing activities in 2004 also reflect the temporary and permanent financing of the acquisitions of NCNG and EasternNC. When required, we sell common stock and long-term debt to cover cash requirements when market and other conditions favor such long-term financing. As of October 31, 2006, our current assets were $476 million and our current liabilities were $400.4 million, primarily due to seasonal requirements as discussed above.

As of October 31, 2006, we had committed lines of credit under our new senior credit facility effective April 24, 2006, of $350 million with the ability to expand up to $600 million, for which we pay an annual fee of $35,000 plus six basis points for any unused amount up to $350 million. Outstanding short-term borrowings increased from $158.5 million as of October 31, 2005, to $170 million as of October 31, 2006, primarily due to higher gas costs and a slower recovery of customer receivables from an increased number of customers on our equal payment plan, partially offset by the issuance of new long-term debt discussed below. During the twelve months ended October 31, 2006, short-term borrowings ranged from zero to $378.5 million, and when borrowing, interest rates ranged from 4.07% to 5.67% (weighted average of 5.03%).

As of October 31, 2006, we had letters of credit under the old lines of credit of $1.2 million issued and outstanding. On November 1, 2006, under our new credit facility, we had available letters of credit of $5 million of which $1.4 million was issued and outstanding. The letters of credit are used to guarantee claims from self-insurance under our general liability policies.

As of October 31, 2006, unused lines of credit available under our new senior credit facility totaled $180 million. As of November 1, 2006, including the issuance of the letters of credit, unused lines of credit available totaled $178.6 million.

The level of short-term borrowings can vary significantly due to changes in the wholesale prices of natural gas and to the level of purchases of natural gas supplies to serve customer demand and for storage. Short-term debt may increase when wholesale prices for natural gas increase because we must pay suppliers for the gas before we collect our costs from customers through their monthly bills. Gas prices could continue to increase and fluctuate. If wholesale gas prices remain high, we may incur more short-term debt to pay for

natural gas supplies and other operating costs since collections from customers could be slower and some customers may not be able to pay their gas bills on a timely basis.

During 2006, we issued $18.4 million of common stock through dividend reinvestment and stock purchase plans. On April 7,)06, we entered into an accelerated share repurchase (ASR) program and repurchased and retired 1 million shares of common stock for $23.9 million. On June 6, 2006, we settled the transaction and paid an additional $.4 million. Under the ASR and the Common Stock Open Market Purchase Program discussed in Note 5 to the consolidated financial statements, during 2006 we paid $50.2 million for 2.1 million shares of common stock that are available for reissuance to these plans. During 2005, 1.1 million shares were repurchased for $26.1 million.

On November 7, 2006, we entered into another ASR where we purchased and retired 1 million shares of our common stock from an investment bank at the closing price of $26.48 per share. Total consideration paid to purchase the shares was $26.6 million, including $118,800 in commission and fees.

Through the ASR program, we will repurchase and subsequently retire approximately four million shares of common stock for a period not to exceed December 31, 2010, including the 1 million shares repurchased in April 2006 and the 1 million shares as repurchased in November 2006. These repurchases are in addition to shares that are repurchased on a normal basis through the open market program.

We increased our common stock dividend on an annualized basis by $.05 per share in 2006, $.06 per share in 2005 and $.03 per share in 2004. Dividends of $72.1 million, $69.4 million and $63.3 million for 2006, 2005 and 2004, respectively, were paid on common stock. The amount of cash dividends that may be paid on common stock is restricted by provisions contained in certain note agreements under which long-term debt was issued; however, as of October 31, 2006, our retained earnings were not restricted. For further information, see Note 4 to the consolidated financial statements.

On June 20, 2006, we sold $200 million of long-term debt available to us under a shelf registration filed with the SEC. The remaining balance of unused long-term financing available under this shelf registration statement is $109.4 million. This new issuance of long-term debt was used to pay off $188 million of short-term debt on June 20 and to pay off a portion of the sinking fund of $35 million on the 9.44% Senior Notes due July 30.

As of October 31, 2006, our capitalization consisted of 48% in long-term debt and 52% in common equity. Our long-term targeted capitalization ratio is 45-50% in long-term debt and 50-55% in common equity. Accomplishing this capital structure objective and maintaining sufficient cash flow are necessary to maintain attractive credit ratings.

As of October 31, 2006, all of our long-term debt was unsecured. Our long-term debt is rated "A" by Standard & Poor's Ratings Services and "A3" by Moody's Investors. Currently, with respect to our long-term debt, the credit agencies maintain their stable utlook. There is no guarantee that a rating will remain in effect for any given period of time or that a rating will not be lowered or withdrawn by a rating agency if, in its judgment, circumstances warrant a change.

Credit ratings impact our ability to obtain short-term and long-term financing and the cost of such financings. In determining our credit ratings, the rating agencies consider various factors. The more significant quantitative factors include:

- Ratio of total debt to total capitalization, including balance sheet leverage,
- Ratio of net cash flows to capital expenditures,
- Funds from operations interest coverage,
- Ratio of funds from operations to average total debt,
- Pension liabilities and funding status, and
- Pre-tax interest coverage.

Qualitative factors include, among other things:

- Stability of regulation in the jurisdictions in which we operate,
- Consistency of our earnings over time,
- Risks and controls inherent in the distribution of natural gas,
- Predictability of cash flows,
- Quality of business strategy and management,
- Corporate governance guidelines and practices,
- Industry position, and
- Contingencies.

We are subject to default provisions related to our long-term debt and short-term borrowings. The default provisions of our senior notes are:

- Failure to make principal, interest or sinking fund payments,
- Interest coverage of 1.75 times,
- Total debt cannot exceed 70% of total capitalization,
- Funded debt of all subsidiaries in the aggregate cannot exceed 15% of total company capitalization,
- Failure to make payments on any capitalized lease obligation,
- Bankruptcy, liquidation or insolvency, and
- Final judgment against us in excess of $1 million that after 60 days is not discharged, satisfied or stayed pending appeal.

The default provisions of our medium-term notes are:

- Failure to make principal, interest or sinking fund payments,
- Failure after the receipt of a 90-day notice to observe or perform for any covenant or agreement in the notes or in the indenture under which the notes were issued, and
- Bankruptcy, liquidation or insolvency.

There are cross-default provisions in all of our debt agreements, and thus failure to satisfy any of the default provisions would result in total outstanding issues of debt becoming due. As of October 31, 2006, we are in compliance with all default provisions.

As of October 31, 2006, our estimated future contractual obligations were as follows.

	Payments Due by Period				
	Less than 1 Year	1-3 Years	4-5 Years	After 5 Years	Total
			In thousands		
Long-term debt(1)	$ —	$ 90,000	$ 60,000	$ 675,000	$ 825,000
Interest on long-term debt(1)	43,146	128,920	68,230	406,261	646,557
Pipeline and storage capacity(2)	124,454	402,142	261,636	452,888	1,241,120
Gas supply(3)	29,539	1,148	—	—	30,687
Telecommunications and information technology(4)	20,337	74,264	25,801	—	120,402
Qualified and nonqualified pension plan funding(5)	17,100	46,900	—	—	64,000
Postretirement benefits plan funding(5)	3,000	6,900	—	—	9,900
Operating leases(6)	6,316	14,010	7,660	13,641	41,627
Letter of credit	1,400	4,200	2,800	—	8,400
Other purchase obligations(7)	28,406	—	—	—	28,406
Total	$ 273,698	$ 768,484	$ 426,127	$ 1,547,790	$ 3,016,099

(1) See Note 4 to the consolidated financial statements.

(2) 100% recoverable through purchased gas adjustment (PGA) procedures.

(3) Reservation fees that are 100% recoverable through PGA procedures.

(4) Consists primarily of maintenance fees for hardware and software applications, usage fees, local and long-distance data costs, frame relay, and cell phone and pager usage fees.

(5) Estimated funding beyond three years is not available. See Note 8 to the consolidated financial statements.

(6) See Note 7 to the consolidated financial statements.

(7) Consists primarily of pipeline products, vehicles, contractors and merchandise.

)ff-balance Sheet Arrangements

We have no off-balance sheet arrangements other than operating leases that are reflected in the table above and discussed in Note 7 to the consolidated financial statements.

Piedmont Energy Partners, Inc., a wholly owned subsidiary of Piedmont, has entered into a guaranty in the normal course of business. The guaranty involves levels of performance and credit risk that are not included on our consolidated balance sheets. The possibility of having to perform on the guaranty is largely dependent upon the future operations of the joint venture, third parties or the occurrence of certain future events. For further information on this guaranty, see Note 11 to the consolidated financial statements.

Critical Accounting Policies and Estimates

We prepare the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America. We 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 revenues and expenses during the periods reported. Actual results may differ significantly from these estimates and assumptions. We base our estimates on historical experience, where applicable, and other relevant factors that we believe are reasonable under the circumstances. On an ongoing basis, we evaluate estimates and assumptions and make adjustments in subsequent periods to reflect more current information if we determine that modifications in assumptions and estimates are warranted.

Management considers an accounting estimate to be critical if it requires assumptions to be made that were uncertain at the time the estimate was made and changes in the estimate or a different estimate that could have been used would have had a material impact on our financial condition or results of operations. We consider regulatory accounting, revenue recognition, goodwill and pension and postretirement benefits to be our critical accounting estimates. Management has discussed the selection and development of the critical accounting policies and estimates presented below with the Audit Committee of the Board of Directors.

Regulatory Accounting. Our regulated utility segment is subject to regulation by certain state and federal authorities. Our accounting policies conform to Statement of Financial Accounting Standards (SFAS) No. 71, "Accounting for the Effects of Certain Types of Regulation" (Statement 71), and are in accordance with accounting requirements and ratemaking practices prescribed by the regulatory authorities. The application of these accounting policies allows us to defer expenses and revenues on the balance sheet as regulatory assets and liabilities when those expenses and revenues will be allowed in the ratemaking process in a period different from the period in which they would have been reflected in the income statement by an unregulated company. We then recognize these deferred regulatory assets and liabilities through the income statement in the period in which the same amounts are reflected in rates. If we, for any reason, cease to meet the criteria for application of regulatory accounting treatment for all or part of our operations, we would eliminate from the balance sheet the regulatory assets and liabilities related to those portions ceasing to meet such criteria and include them in the income statement for the period in which the discontinuance of regulatory accounting treatment occurs. Such an event could have a material effect on our results of operations in the period this action was recorded. Regulatory assets as of October 31, 2006 and 2005, totaled $143.5 million and $85.8 million, respectively. Regulatory liabilities as of October 31, 2006 and 2005, totaled $337 million and $333.3 million, respectively. The detail of these regulatory assets and liabilities is presented in Note 1.B to the consolidated financial statements.

Revenue Recognition. Utility sales and transportation revenues are based on rates approved by state regulatory commissions. Base rates charged to customers may not be changed without formal approval by the regulatory commission in that jurisdiction; however, the wholesale cost of gas component of rates may be adjusted periodically under PGA procedures. Through October 31, 2005, a WNA factor, based on the margin or base rate component of the billing rate, was included in rates charged to residential and commercial customers during the winter period of November through March in all jurisdictions except EasternNC. The WNA is designed to offset the impact of warmer-than-normal or colder-than-normal weather on customer billings during the winter season. Effective November 1, 2005, the WNA was eliminated in North Carolina and replaced with the CUT that provides for the recovery of our approved margin per customer independent of both weather and other consumption patterns of residential and commercial customers. The CUT tracks our margin earned monthly and will result in semi-annual rate adjustments to refund any over- collection or recover any under-collection. Without the WNA or CUT, our operating revenues in 2006 would have been lower by $34.6 million.

Revenues are recognized monthly on the accrual basis, which includes estimated amounts for gas delivered to customers but not yet billed under the cycle-billing method from the last meter reading date to month end. Meters are read throughout the month based on an approximate 30-day usage cycle; therefore, at any point in time, volumes are delivered to customers that have not been metered and billed. The unbilled revenue estimate reflects factors requiring judgment related to estimated usage by customer class, changes in weather during the period and the impact of the WNA or CUT mechanisms, as applicable. Secondary market, or wholesale, sales revenues are recognized when the physical sales are delivered based on contract or market prices.

Goodwill. All of our goodwill is attributable to the regulated utility segment. We evaluate goodwill for impairment annually, or more frequently if impairment indicators arise, using a weighted average of the guideline company method of the market approach and the discounted cash flow method of the income approach on the premise of continued use, which assumes that a buyer and seller contemplate the continued use of the reporting unit at its present location as part of current and future operations. The guideline company method of the market approach is based on market multiples of companies that are representative of our peers in the natural gas distribution industry. The discounted cash flow method of the income approach consists of

estimating annual future cash flows and individually discounting them back to the present value. These calculations are dependent on several subjective factors, including the timing of future cash flows, future growth rates and the discount rate. The calculations also 'efine the reporting unit as the domestic natural gas distribution business. An impairment charge would be recognized if the carrying ılue of the reporting unit, including goodwill, exceeded its fair value.

Our annual goodwill impairment assessment was performed on October 31, 2006, and we determined that there was no impairment to the carrying value of our goodwill. In addition, there were no impairment indicators during 2006.

Using a discounted cash flow model to estimate fair value is subjective and requires significant judgment in applying a discount rate, growth assumptions and continued cash flows. An increase or decrease of 100 basis points in the weighted average cost of capital would have the following effects.

In thousands	100 Basis Point Increase	100 Basis Point Decrease
Change in fair value of the regulated utility segment	$ (155,000)	$ 220,000

The 100 basis point increase or decrease in the weighted average cost of capital would not have required the recording of an impairment charge.

Pension and Postretirement Benefits. We have a defined-benefit pension plan for the benefit of eligible full-time employees. We also provide certain postretirement health care and life insurance benefits to eligible full-time employees. Our reported costs of providing these benefits, as described in Note 8 to the consolidated financial statements, are impacted by numerous factors, including the provisions of the plans, changing employee demographics and various actuarial calculations, assumptions and accounting mechanisms. Because of the complexity of these calculations, the long-term nature of these obligations and the importance of the assumptions used, our estimate of these costs is a critical accounting estimate.

Several statistical and other factors, which attempt to anticipate future events, are used in calculating the expenses and liabilities related to the plans. These factors include assumptions about the discount rate used in determining future benefit obligations, projected health care cost trend rates, expected long-term return on plan assets and rate of future compensation increases, within certain guidelines. In addition, we also use subjective factors such as withdrawal and mortality rates to estimate projected benefit obligations. The actuarial assumptions used may differ materially from actual results due to changing market and economic conditions, higher or lower withdrawal rates or longer or shorter life spans of participants. These differences may result in a significant impact on the amount of pension expense or other postretirement benefit costs recorded in future periods.

The discount rate has been separately determined for each plan by projecting the plan's cash flows and developing a zero-coupon pot rate yield curve using non-arbitrage pricing and Moody's AA or better-rated non-callable bonds. Based on this approach, the eighted average discount rate used in the measurement of the benefit obligation for the qualified pension plans changed from 6% in 2005 to 5.78% in 2006. For the nonqualified pension plans, the weighted average discount rate used in the measurement of the benefit obligation changed from 5.75% in 2005 to 5.67% in 2006. Similarly, based on this approach, the weighted average discount rate for postretirement benefits changed from 5.89% in 2005 to 5.74% in 2006. Based on our review of actual cost trend rates and projected future trends in establishing health care cost trend rates, we changed our health care cost trend rate from 9.75% in 2005 to 9% in 2006, declining gradually to 5% in 2012.

In determining our expected long-term rate of return on plan assets, we review past long-term performance, asset allocations and long-term inflation assumptions. We target our asset allocations for qualified pension plan assets and other postretirement benefit assets to be approximately 60% equity securities and 40% fixed income securities. The expected long-term rate of return on plan assets was 8.5% in 2004, 2005 and 2006, and will be maintained at 8.5% in 2007. Based on a fairly stagnant inflation trend, our age-related assumed rate of increase in future compensation levels was 3.97% in 2004 and 2005, and increased to 4.05% in 2006 due to a change in the demographics of the participants.

The following reflects the sensitivity of pension cost to changes in certain actuarial assumptions for our qualified pension plans, assuming that the other components of the calculation are constant.

Actuarial Assumption	Change in Assumptio	Impact on 2006 Pension Cost	Impact on Projected Benefit Obligation
		Increase (Decrease) In thousands	
Discount rate	(.25)%	$ 558	$ 6,546
Rate of return on plan assets	(.25)%	503	N/A
Rate of increase in compensation	.25 %	841	4,332

The following reflects the sensitivity of postretirement benefit cost to changes in certain actuarial assumptions, assuming that the other components of the calculation are constant.

Actuarial Assumption	Change in Assumptio	Impact on 2006 Postretirement Benefit Cost	Impact on Accumulated Postretirement Benefit Obligation
		Increase (Decrease) In thousands	
Health care cost trend rate	.25 %	$ 51	$ 318
Rate of return on plan assets	(.25)%	37	N/A
Discount rate	(.25)%	161	719

We utilize a number of accounting mechanisms that reduce the volatility of reported pension costs. Differences between actuarial assumptions and actual plan results are deferred and amortized into cost when the accumulated differences exceed 10% of the greater of the projected benefit obligation or the market-related value of the plan assets. If necessary, the excess is amortized over the average remaining service period of active employees.

Gas Supply and Regulatory Proceedings

We continue to pursue the diversification of our supply portfolio through pipeline capacity arrangements that access new sources of supply and market-area storage and that diversify supply concentration away from the Gulf Coast region. We have a firm ansportation contract pending with Midwestern Gas Transmission Company for 120,000 dekatherms per day of additional pipeline capacity that will provide access to Canadian and Rocky Mountain gas supplies via the Chicago hub, primarily to serve our Tennessee markets. Due to regulatory delays impacting commencement of construction, we have only contracted for 40,000 of the total 120,000 dekatherms per day of capacity for the winter of 2006-2007 with the difference being covered by short-term firm winter arrangements. It is anticipated that the entire capacity will be available during the 2007-2008 winter. We have also executed an agreement with Hardy Storage Company LLC for market-area storage capacity in West Virginia with an anticipated in-service date in April 2007. We have a 50% equity interest in this project which is more fully discussed in Note 11 to the consolidated financial statements.

Secondary market transactions permit us to market gas supplies and transportation services by contract with wholesale or off-system customers. These sales contribute smaller per-unit wholesale margins to earnings; however, the program allows us to act as a wholesale marketer of natural gas and transportation capacity in order to generate operating margin from sources not restricted by the capacity of our retail distribution system. In North Carolina and South Carolina, a sharing mechanism is in effect where 75% of any margin is passed through to customers. Secondary market transactions in Tennessee are included in the performance incentive plan discussed in Note 3 to the consolidated financial statements.

Regulatory proceedings in South Carolina under the South Carolina Rate Stabilization Act were completed during 2006 that will impact 2007 earnings. For further information about these regulatory proceedings and other regulatory information, see Note 3 to the consolidated financial statements.

Equity Method Investments

For information about our equity method investments, see Note 11 to the consolidated financial statements.

Environmental Matters

We have developed an environmental self-assessment plan to assess our facilities and program areas for compliance with federal, state and local environmental regulations and to correct any deficiencies identified. As a member of the North Carolina MGP Initiative Group, we, along with other responsible parties, work directly with the North Carolina Department of Environment and Natural Resources to set priorities for manufactured gas plant (MGP) site remediation. For additional information on environmental matters, see Note 13 to the consolidated financial statements.

Accounting Pronouncements

In March 2005, the Financial Accounting Standards Board (FASB) issued Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations" (FIN 47), to clarify the term "conditional asset retirement" as used in SFAS 143, "Accounting for Asset Retirement Obligations." FIN 47 requires that a liability be recognized for the fair value of a conditional asset retirement obligation (ARO) when incurred, if the fair value of the liability can be reasonably estimated. Uncertainty about the timing or method of settlement of a conditional asset retirement obligation would be factored into the measurement of the liability when sufficient information exists. This interpretation is effective no later than the end of fiscal years ending after December 15, 2005. As of October 31, 2006, we adopted FIN 47 and recorded an asset retirement cost of $7 million as part of "Utility Plant," a liability for the conditional asset retirement obligation of $19.1 million and a regulatory asset of $12.1 million. We received regulatory approval to establish a regulatory asset for the accumulated accretion expense and accumulated depreciation. Consequently, the adoption of FIN 47 did not have an impact on our results of operations or cash flows. Additionally, had FIN 47 been applied to the prior year presented with this report, the conditional ARO would have been $17.1 million and $18.1 million at November 1, 2004 and October 31, 2005, respectively. In accordance with FIN 47, such amounts are not reflected in the balance sheet as of October 31, 2005.

In June 2006, the FASB issued Interpretation 48, "Accounting for Uncertainty in Income Taxes" (FIN 48), to clarify the accounting for uncertain tax positions in accordance with SFAS 109, "Accounting for Income Taxes." FIN 48 defines a minimum recognition threshold that a tax position must meet to be recognized in an enterprise's financial statements. Additionally, FIN 48 provides guidance on derecognition, measurement, classification, interim period accounting, disclosure and transition requirements in accounting for uncertain tax positions. This interpretation is effective the beginning of the first annual period commencing after December 15, 2006. We are currently assessing the impact FIN 48 may have on our consolidated financial statements; however, we believe the adoption of FIN 48 will not have a material impact on our financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" (Statement 157). Statement 157 provides enhanced guidance for using fair value to measure assets and liabilities and applies whenever other standards require (or permit) assets or liabilities to be measured at fair value, but does not expand the use of fair value in any new circumstances. Statement 157 establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data, for example, the reporting entity's own data. Under Statement 157, fair value measurements would be separately disclosed by level within the fair value hierarchy. Statement 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years, with earlier application encouraged. Accordingly, we will adopt Statement 157 no later than our first fiscal quarter in 2008. We believe the adoption of Statement 157 will not have a material effect on our financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans" (Statement 158). Statement 158 requires an employer to fully recognize the obligations associated with single-employer defined benefit pension, retiree healthcare and other postretirement plans in the financial statements by recognizing in its statement of financial position an asset for a plan's overfunded status or a liability for a plan's underfunded status rather than only disclosing the funded status in the footnotes to the financial statements. Statement 158 requires employers to recognize changes in the funded status of a defined benefit postretirement plan in the year in which the changes occur. Those changes will be reported in accumulated other comprehensive income (OCI) in the stockholders' equity section of the balance sheet. Statement 158 also requires that the company measure a plan's assets and its obligations that determine its funded status as of the end of the employer's fiscal year.

Statement 158 provides different effective dates for the recognition and related disclosure provisions and for the required change to a fiscal year-end measurement date. The requirement to recognize the funded status of a benefit plan and the related disclosure requirements initially will apply as of the end of the fiscal year ending after December 15, 2006. The requirement to measure plan assets and benefit obligations as of the date of the employer's fiscal year end statement of financial position will be effective for fiscal years ending after December 15, 2008, and will not be applied retrospectively. Accordingly, we will adopt the funded status portion of Statement 158 as of October 31, 2007. The measurement date portion of Statement 158 does not apply to us because our pension plan measurement date is already the same as our fiscal year end date. We believe the adoption of Statement 158 will not have a material effect on our financial position, results of operations or cash flows.

If Statement 158 had been adopted for the current year ended October 31, 2006, the effect on the consolidated balance sheets would have been a non-cash charge of $42.3 million as a regulatory asset of $25.6 million and deferred income taxes of $16.7 million with a reduction of $14.6 million to prepaid pension and an increase in accrued postretirement benefits of $27.7 million. The actual charge at October 31, 2007, could be substantially different depending on the discount rate, asset returns and plan population at that time. Based on a preliminary assessment of prior regulatory treatment of postretirement benefits, management believes that regulatory asset or liability treatment will be afforded to any regulatory asset or liability that would otherwise be recorded in accumulated OCI resulting from the implementation of Statement 158. We intend to meet with our regulators in fiscal year 2007 to discuss the regulatory accounting and rate treatment of Statement 158.

Item 7A. *Quantitative and Qualitative Disclosures about Market Risk*

We hold all financial instruments discussed below for purposes other than trading. We are potentially exposed to market risk due to changes in interest rates and the cost of gas. Our exposure to interest rate changes relates primarily to short-term debt. We are exposed to interest rate changes to long-term debt when we are in the market to issue long-term debt. As of October 31, 2006, all of our long-term debt was issued at fixed rates. Exposure to gas cost variations relates to the wholesale supply, demand and price of natural gas.

Interest Rate Risk

We have short-term borrowing arrangements to provide working capital and general corporate funds. The level of borrowings under such arrangements varies from period to period depending upon many factors, including our investments in capital projects. Future short-term interest expense and payments will be impacted by both short-term interest rates and borrowing levels.

As of October 31, 2006, we had $170 million of short-term debt outstanding under committed bank lines of credit at a weighted average interest rate of 5.57%. The carrying amount of our short-term debt approximates fair value. A change of 100 basis points in the underlying average interest rate for our short-term debt would have caused a change in interest expense of approximately $1.8 million during 2006.

As of October 31, 2006, information about our long-term debt is presented below.

	Expected Maturity Date							Fair Value as of October 3
	2007	2008	2009	2010	2011		Total	2006
				In millions				
Fixed Rate Long-term Debt	$ —	$ —	$ 30	$ 60	$ 60	$ 675	$ 825	$ 914
Average Interest Rate	—	—	7.35 %	7.80 %	6.55 %	6.64 %	6.74 %	

Commodity Price Risk

In the normal course of business, we utilize exchange-traded contracts of various duration for the forward sale and purchase of a portion of our natural gas requirements. We manage our gas supply costs through a portfolio of short- and long-term procurement contracts with various suppliers. Due to cost-based rate regulation in our utility operations, we have limited financial exposure to changes in commodity prices as historically we have recovered all changes in purchased gas costs and the costs of hedging our gas supplies are passed on to customers through PGA procedures.

Additional information concerning market risk is set forth in "Financial Condition and Liquidity" in Item 7 of this Form 10-K.

Item 8. ***Financial Statements and Supplementary Data***

Consolidated financial statements required by this item are listed in Item 15 (a) 1 in Part IV of this Form 10-K on page 73.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Piedmont Natural Gas Company, Inc.

We have audited the accompanying consolidated balance sheets of Piedmont Natural Gas Company, Inc. and subsidiaries ("Piedmont") as of October 31, 2006 and 2005, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended October 31, 2006. These financial statements are the responsibility of Piedmont's management. Our responsibility is to express an opinion on the financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the accompanying consolidated financial statements present fairly, in all material respects, the financial position of Piedmont Natural Gas Company, Inc. and subsidiaries at October 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended October 31, 2006 in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Piedmont's internal control over financial reporting as of October 31, 2006, based on the criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated January 12, 2007 expressed an unqualified opinion on management's assessment of the effectiveness of Piedmont's internal control over financial reporting and an unqualified opinion on the effectiveness of Piedmont's internal control over financial reporting.

/s/ Deloitte & Touche LLP
Charlotte, North Carolina
January 12, 2007

Piedmont Natural Gas Company, Inc.

Consolidated Balance Sheets

October 31, 2006 and 2005

	2006	2005
	In thousands	
ASSETS		
Utility Plant:		
Utility plant in service	$ 2,714,606	$ 2,532,263
Less accumulated depreciation	733,682	672,502
Utility plant in service, net	1,980,924	1,859,761
Construction work in progress	94,386	79,314
Total utility plant, net	2,075,310	1,939,075
Other Physical Property, at cost (net of accumulated depreciation of $2,040 in 2006 and $1,888 in 2005)	1,154	731
Current Assets:		
Cash and cash equivalents	8,886	7,065
Restricted cash	—	13,108
Trade accounts receivable (less allowance for doubtful accounts of $1,239 in 2006 and $1,188 in 2005)	90,493	107,535
Income taxes receivable	30,849	21,570
Other receivables	160	12,102
Unbilled utility revenues	45,938	48,414
Inventories:		
Gas in storage	138,183	151,865
Materials, supplies and merchandise	6,221	5,331
Gas purchase options, at fair value	3,147	22,843
Amounts due from customers	89,635	52,161
Prepayments	62,356	62,821
Other	96	96
Total current assets	475,964	504,911
Investments, Deferred Charges and Other Assets:		
Equity method investments in non-utility activities	75,330	71,520
Goodwill	47,383	47,383
Unamortized debt expense	11,306	4,822
Regulatory cost of removal asset	12,086	—
Other	35,406	34,048
Total investments, deferred charges and other assets	181,511	157,773
Total	$ 2,733,939	$ 2,602,490
CAPITALIZATION AND LIABILITIES		
Capitalization:		
Stockholders' equity:		
Cumulative preferred stock — no par value — 175 shares authorized	$ —	$ —
Common stock — no par value — shares authorized: 200,000 in 2006 and 100,000 in 2005; shares outstanding: 75,464 in 2006 and 76,698 in 2005	532,764	562,880
Paid-in capital	56	—
Retained earnings	348,765	323,565
Accumulated other comprehensive income (loss)	1,340	(2,253)
Total stockholders' equity	882,925	884,192
Long-term debt	825,000	625,000
Total capitalization	1,707,925	1,509,192
Current Liabilities:		
Current maturities of long-term debt	—	35,000
Notes payable	170,000	158,500
Trade accounts payable	80,304	182,847
Other accounts payable	50,935	45,325
Income taxes accrued	1,184	6,201
Accrued interest	21,273	16,491
Customers' deposits	22,308	20,162
Deferred income taxes	25,085	23,128
General taxes accrued	18,522	16,450
Amounts due to customers	123	17,124
Other	10,655	7,336
Total current liabilities	400,389	528,564
Deferred Credits and Other Liabilities:		
Deferred income taxes	235,411	213,050
Unamortized federal investment tax credits	3,417	3,951
Cost of removal obligations	330,104	288,989
Other	56,693	58,744
Total deferred credits and other liabilities	625,625	564,734
Total	$ 2,733,939	$ 2,602,490

See notes to consolidated financial statements.

Piedmont Natural Gas Company, Inc.

Consolidated Statements of Income

For the Years Ended October 31, 2006, 2005 and 2004

	2006	2005	2004
	In thousands except per share amounts		
Operating Revenues	$ 1,924,628	$ 1,761,091	$ 1,529,739
Cost of Gas	1,401,149	1,261,952	1,041,370
Margin	523,479	499,139	488,369
Operating Expenses:			
Operations and maintenance	219,353	206,983	200,282
Depreciation	89,696	85,169	82,276
General taxes	33,138	29,807	27,011
Income taxes	50,543	51,880	51,485
Total operating expenses	392,730	373,839	361,054
Operating Income	130,749	125,300	127,315
Other Income (Expense):			
Income from equity method investments	29,917	27,664	27,381
Gain on sale of equity method investments	—	—	4,683
Gain on sale of marketable securities	—	1,525	—
Allowance for equity funds used during construction	—	—	946
Non-operating income	1,147	3,830	2,285
Charitable contributions	(321)	(1,717)	(9,124)
Non-operating expense	(106)	(28)	(324)
Income taxes	(11,887)	(10,446)	(10,562)
Total other income (expense), net of tax	18,750	20,828	15,285
Utility Interest Charges:			
Interest on long-term debt	49,915	46,173	44,957
Allowance for borrowed funds used during construction	(3,893)	(3,137)	(1,669)
Other	6,288	1,220	4,076
Total utility interest charges	52,310	44,256	47,364
Income before Minority Interest in Income of Consolidated Subsidiary	97,189	101,872	95,236
Less Minority Interest in Income of Consolidated Subsidiary	—	602	48
Net Income	$ 97,189	$ 101,270	$ 95,188
Average Shares of Common Stock:			
Basic	75,863	76,680	74,359
Diluted	76,156	76,992	74,797
Earnings Per Share of Common Stock:			
Basic	$ 1.28	$ 1.32	$ 1.28
Diluted	$ 1.28	$ 1.32	$ 1.27

See notes to consolidated financial statements.

Piedmont Natural Gas Company, Inc.

Consolidated Statements of Cash Flows

For the Years Ended October 31, 2006, 2005 and 2004

	2006	2005	2004
		In thousands	
Cash Flows from Operating Activities:			
Net income	$ 97,189	$ 101,270	$ 95,188
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	94,111	91,677	87,336
Amortization of investment tax credits	(534)	(541)	(550)
Allowance for doubtful accounts	51	102	(1,658)
Allowance for funds used during construction	(3,893)	(3,137)	(2,615)
Gain on sale of corporate office land	—	(1,659)	—
Earnings from equity method investments	(29,917)	(27,664)	(27,381)
Distributions of earnings from equity method investments	28,442	23,649	26,078
Gain on sale of equity method investments	—	—	(4,683)
Gain on sale of marketable securities	—	(1,525)	—
Deferred income taxes	22,021	18,278	17,835
Changes in assets and liabilities:			
Receivables	19,395	(43,214)	(6,683)
Inventories	12,791	(24,004)	(6,695)
Amounts due from customers	(37,474)	(23,329)	(13,750)
Other assets	7,581	(20,164)	(18,221)
Accounts payable	(94,095)	94,530	8,941
Amounts due to customers	(17,001)	(9,255)	5,163
Other liabilities	5,146	8,362	25,434
Total adjustments	6,624	82,106	88,551
Net cash provided by operating activities	103,813	183,376	183,739
Cash Flows from Investing Activities:			
Utility construction expenditures	(204,116)	(191,407)	(139,146)
Reimbursements from bond fund	15,955	29,841	41,497
Contributions to equity method investments	(23,696)	(6,162)	(113)
Distributions of capital from equity method investments	28,968	695	213
Proceeds from sale of corporate office building and land	—	6,660	—
Proceeds from sale of marketable securities	—	2,394	—
Proceeds from sale of equity method investments	—	—	36,096
Purchase of NCNG and EasternNC (working capital adjustment)	—	—	(271)
Decrease (increase) in restricted cash	13,108	(376)	(5,983)
Other	2,227	(683)	1,958
Net cash used in investing activities	(167,554)	(159,038)	(65,749)
Cash Flows from Financing Activities:			
Increase in notes payable, net of expenses of $405 in 2006	11,095	49,000	—
Decrease in commercial paper	—	—	(445,559)
Proceeds from issuance of long-term debt, net of expenses	193,360	—	197,981
Retirement of long-term debt	(35,000)	—	(2,000)
Proceeds from sale of common stock, net of expenses	—	—	173,828
Issuance of common stock through dividend reinvestment and employee stock plans	18,377	23,536	20,018
Repurchases of common stock	(50,163)	(26,119)	(4,487)
Dividends paid	(72,107)	(69,366)	(63,267)
Net cash provided by (used in) financing activities	65,562	(22,949)	(123,486)
Net Increase (Decrease) in Cash and Cash Equivalents	1,821	1,389	(5,496)
Cash and Cash Equivalents at Beginning of Year	7,065	5,676	11,172
Cash and Cash Equivalents at End of Year	$ 8,886	$ 7,065	$ 5,676
Cash Paid During the Year for:			
Interest	$ 54,669	$ 48,888	$ 43,868
Income taxes	56,615	35,888	44,396
Noncash Investing and Financing Activities:			
Accrued construction expenditures	$ 2,837	$ 2,036	$ 2,615
Guaranty	1,820	—	—

See notes to consolidated financial statements.

Piedmont Natural Gas Company, Inc.

Consolidated Statements of Stockholders' Equity

For the Years Ended October 31, 2006, 2005 and 2004

	Common Stock	Paid-in Capital	Retained Earnings	Accumulated Other Income (Loss)	Total
	In thousands except per share amounts				
Balance, October 31, 2003	$ 372,651	$ —	$ 259,476	$ (1,932)	$ 630,195
Comprehensive Income:					
Net income			95,188		95,188
Other comprehensive income:					
Unrealized gain on marketable securities, net of tax of $391				597	
Unrealized gain from hedging activities of equity method investments, net of tax of $292				381	
Reclassification adjustment of realized loss from hedging activities of equity method investments included in net income, net of tax of $512				788	1,766
Total comprehensive income					96,954
Common Stock Issued	195,503				195,503
Common Stock Repurchased	(4,487)				(4,487)
Dividends Declared ($.8525 per share)			(63,267)		(63,267)
Balance, October 31, 2004	563,667	—	291,397	(166)	854,898
Comprehensive Income:					
Net income			101,270		101,270
Other comprehensive income:					
Reclassification adjustment of realized gain on marketable securities included in net income, net of tax of ($391)				(597)	
Unrealized gain from hedging activities of equity method investments, net of tax of $287				436	
Reclassification adjustment of realized gain from hedging activities of equity method investments included in net income, net of tax of ($1,280)				(1,926)	(2,087)
Total comprehensive income					99,183
Common Stock Issued	25,332				25,332
Common Stock Repurchased	(26,119)				(26,119)
Tax Benefit from Dividends Paid on ESOP Shares			264		264
Dividends Declared ($.905 per share)			(69,366)		(69,366)
Balance, October 31, 2005	562,880	—	323,565	(2,253)	884,192
Comprehensive Income:					
Net income			97,189		97,189
Other comprehensive income:					
Minimum pension liability, net of tax of ($51)				(78)	
Unrealized gain from hedging activities of equity method investments, net of tax of $3,013				4,644	
Reclassification adjustment of realized gain from hedging activities of equity method investments included in net income, net of tax of ($665)				(973)	3,593
Total comprehensive income					100,782
Common Stock Issued	20,047				20,047
Common Stock Repurchased	(50,163)				(50,163)
Share-Based Compensation Expense		56			56
Tax Benefit from Dividends Paid on ESOP Shares			118		118
Dividends Declared ($.95 per share)			(72,107)		(72,107)
Balance, October 31, 2006	$ 532,764	$ 56	$ 348,765	$ 1,340	$ 882,925

The components of accumulated other comprehensive income (loss) as of October 31, 2006 and 2005, are as follows.

	2006	2005
	In thousands	
Minimum pension liability	$ (78)	$ —
Unrealized gain (loss) from hedging activities of equity method investments	1,418	(2,253)
Accumulated other comprehensive income (loss)	$ 1,340	$ (2,253)

See notes to consolidated financial statements

Piedmont Natural Gas Company, Inc.

Notes to Consolidated Financial Statements

. **Summary of Significant Accounting Policies**

A. Operations and Principles of Consolidation.

Piedmont Natural Gas Company, Inc. (Piedmont) is an energy services company primarily engaged in the distribution of natural gas to residential, commercial and industrial customers in portions of North Carolina, South Carolina and Tennessee. We are invested in joint venture, energy-related businesses, including unregulated retail natural gas marketing, interstate natural gas storage and intrastate natural gas transportation. Our utility operations are regulated by three state regulatory commissions. For further information on regulatory matters, see Note 3 to the consolidated financial statements.

The consolidated financial statements reflect the accounts of Piedmont, its wholly owned subsidiaries and, through October 25, 2005, its 50% equity interest in Eastern North Carolina Natural Gas Company (EasternNC). On October 25, 2005, we purchased the remaining 50% interest in EasternNC and merged it into Piedmont. See Note 2 to the consolidated financial statements for further information on acquisitions.

Investments in non-utility activities are accounted for under the equity method as we do not have controlling voting interests or otherwise exercise control over the management of such companies. Our ownership interest in each entity is recorded in "Equity method investments in non-utility activities" in the consolidated balance sheets. Earnings or losses from equity method investments are recorded in "Income from equity method investments" in the consolidated statements of income. For further information on equity method investments, see Note 11 to the consolidated financial statements. Revenues and expenses of all other non-utility activities are included in "Non-operating income" in the consolidated statements of income. Significant inter-company transactions have been eliminated in consolidation where appropriate; however, we have not eliminated inter-company profit on sales to affiliates and costs from affiliates in accordance with Statement of Financial Accounting Standards (SFAS) No. 71, "Accounting For The Effects of Certain Types of Regulation" (Statement 71).

B. Rate-Regulated Basis of Accounting.

Our utility operations are subject to regulation with respect to rates, service area, accounting and various other matters by the regulatory commissions in the states in which we operate. Statement 71 provides that rate-regulated public utilities account for and report assets and liabilities consistent with the economic effect of the manner in which independent third-party regulators establish rates. In applying Statement 71, we capitalize certain costs and benefits as regulatory assets and liabilities, respectively, in order to 'rovide for recovery from or refund to utility customers in future periods.

Our regulatory assets are recoverable through either rate riders or base rates specifically authorized by a state regulatory commission. Base rates are designed to provide both a recovery of cost and a return on investment during the period the rates are in effect. As such, all of our regulatory assets are subject to review by the respective state regulatory commission during any future rate proceedings. In the event that the provisions of Statement 71 were no longer applicable, we would recognize a write-off of net regulatory assets (regulatory assets less regulatory liabilities) that would result in a change to net income. However, although the natural gas distribution industry is becoming increasingly competitive, our utility operations continue to recover their costs through cost-based rates established by the state regulatory commissions. As a result, we believe that the accounting prescribed under Statement 71 remains appropriate. It is also our opinion that all regulatory assets are recoverable in future rate proceedings, and therefore we have not recorded any regulatory assets that are recoverable but are not yet included in base rates or contemplated in a future rate recovery proceeding.

Regulatory assets and liabilities in the consolidated balance sheets as of October 31, 2006 and 2005, are as follows.

	2006	2005
	In thousands	
Regulatory Assets:		
Unamortized debt expense	$ 11,306	$ 4,822
Amounts due from customers	89,635	52,161
Environmental costs*	3,812	4,085
Demand-side management costs*	3,554	4,387
Deferred operations and maintenance expenses*	9,234	9,219
Deferred integration costs of acquisition*	681	1,021
Deferred pension and other retirement benefits costs*	8,748	6,480
Regulatory cost of removal asset	12,086	—
Other*	4,412	3,671
Total	$ 143,468	$ 85,846
Regulatory Liabilities:		
Regulatory cost of removal obligations	$ 310,989	$ 288,989
Amounts due to customers	123	17,124
Deferred income taxes	25,134	25,992
Environmental liability due customers*	772	1,157
Total	$ 337,018	$ 333,262

*

Regulatory assets are included in "Other" in "Investments, Deferred Charges and Other Assets" and regulatory liabilities are included in "Other" in "Deferred Credits and Other Liabilities" in the consolidated balance sheets.

As of October 31, 2006, we had regulatory assets totaling $4.4 million on which we do not earn a return during the recovery ɜriod. The original amortization periods for these assets range from 3 to 15 years and, accordingly, $3.3 million will be fully amortized by 2008, $.2 million will be fully amortized by 2010 and the remaining $.9 million will be fully amortized by 2018.

C. *Utility Plant and Depreciation.*

Utility plant is stated at original cost, including direct labor and materials, allocable overhead charges and an allowance for borrowed and equity funds used during construction (AFUDC). For the years ended October 31, 2006, 2005 and 2004, AFUDC totaled $3.9 million, $3.1 million and $2.6 million, respectively. The portion of AFUDC attributable to equity funds is included in "Other Income (Expense)" and the portion attributable to borrowed funds is shown as a reduction of "Utility Interest Charges" in the consolidated statements of income. The costs of property retired are removed from utility plant and charged to accumulated depreciation.

We compute depreciation expense using the straight-line method over periods ranging from 4 to 88 years. The composite weighted-average depreciation rates were 3.46% for 2006, 3.46% for 2005 and 3.51% for 2004.

Depreciation rates for utility plant are approved by our regulatory commissions. In North Carolina, we are required to conduct a depreciation study every five years and propose new depreciation rates for approval. No such five-year requirement exists in South Carolina or Tennessee; however, we periodically propose revised

ates in those states based on depreciation studies. The approved depreciation rates are comprised of two components, one based on average service life and one based on cost of removal. Through depreciation expense, we accrue estimated non-legal costs of removal on any depreciable asset that includes cost of removal in its depreciation rates. The related costs of removal accrual is reflected in "Cost of removal obligations" in the consolidated balance sheets. In the rate setting process, the liability for non-legal costs of removal is treated as a reduction to the net rate base upon which the regulated utility has the opportunity to earn its allowed rate of return.

On November 1, 2002, we adopted SFAS No. 143, "Accounting for Asset Retirement Obligations" (AROs) (Statement 143). Statement 143 addresses financial accounting and reporting for AROs associated with the retirement of long-lived assets that result from the acquisition, construction, development and operation of the asset. Statement 143 requires the recognition of the fair value of a liability for an ARO in the period in which the liability is incurred if a reasonable estimate of fair value can be made. We have determined that AROs exist for our underground mains and services.

In accordance with long-standing regulatory treatment, our depreciation rates are comprised of two components, one based on average service life and one based on cost of removal. We collect through rates the estimated costs of removal on certain regulated properties through depreciation expense, with a corresponding credit to accumulated depreciation. These removal costs are non-legal obligations as defined by Statement 143. Because these estimated removal costs meet the requirements of Statement 71, we have accounted for these non-legal asset removal obligations as a regulatory liability. We have reclassified the estimated non-legal asset removal obligations from "Accumulated depreciation" to "Cost of removal obligations" in "Deferred Credits and Other Liabilities" in our consolidated balance sheets.

In our fourth quarter of 2006, we applied FIN 47 requiring recognition of a liability for the fair value of a conditional asset retirement obligation when incurred if the liability can be reasonably estimated. We have recorded a liability on our distribution and transmission mains and services. For further discussion of asset retirement obligations, see Note 1.N to the consolidated financial statements.

The cost of removal obligations recorded in our consolidated balance sheets as of October 31, 2006 and 2005, are shown below.

	2006	2005
	In thousands	
Regulatory non-legal asset removal obligations	$ 310,989	$ 288,989
Conditional asset retirement obligations	19,115	—
Total cost of removal obligations	$ 330,104	$ 288,989

D. Trade Accounts Receivable and Allowance for Doubtful Accounts.

Trade accounts receivable consist of natural gas sales and transportation services, merchandise sales and service work. We maintain an allowance for doubtful accounts, which we adjust periodically, based on the aging of receivables and our historical and projected charge-off activity. Our estimate of recoverability could differ from actual experience based on customer credit issues, the level of natural gas prices and general economic conditions. Effective November 1, 2005 as approved in the November 3 order, the NCUC has allowed the recovery of all uncollected gas costs in North Carolina through the gas cost deferral account. As a result, only the portion of accounts written off relating to the non-gas costs, or margin, is included in base rates and, accordingly, only this portion is included in the provision for uncollectibles expense. Merchandise receivables due beyond one year are included in "Other" in "Investments, Deferred Charges and Other Assets" in the consolidated balance sheets.

A reconciliation of changes in the allowance for doubtful accounts for the years ended October 31, 2006, 2005 and 2004, is as follows.

	2006	2005	2004
		In thousands	
Balance at beginning of year	$ 1,188	$ 1,086	$ 2,743
Additions charged to uncollectibles expense	4,706	6,224	6,098
Accounts written off, net of recoveries	(4,655)	(6,122)	(7,755)
Balance at end of year	$ 1,239	$ 1,188	$ 1,086

E. Goodwill, Equity Method Investments and Long-Lived Assets.

All of our goodwill is attributable to the regulated utility segment. We evaluate goodwill for impairment annually on October 31, or more frequently if impairment indicators arise during the year. We recomputed the fair value of goodwill in 2006, and there is no impairment.

In our 2006 appraisal, we used a weighted average of the guideline company method of the market approach and the discounted cash flow method of the income approach on the premise of continued use. This method assumes that a buyer and seller contemplate the continued use of the reporting unit at its present location as part of current and future operations. The guideline company method of the market approach is based on market multiples of companies that are representative of our peers in the natural gas distribution industry. The discounted cash flow method of the income approach consists of estimating annual future cash flows and individually discounting them back to the present value. These calculations are dependent on several subjective factors, including the timing of future cash flows, future growth rates and the discount rate. The calculations also define the reporting unit as the domestic natural gas distribution business. An impairment charge would be recognized if the carrying value of the reporting unit, including goodwill, exceeded its fair value. No impairment has been recognized during the years ended October 31, 2006, 2005 and 2004.

We review our equity method investments and long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amounts may not be recoverable. There were no events or circumstances during the years ended October 31, 2006, 2005 and 2004, that resulted in any impairment charges. For further information on equity method investments, see Note 11 to the consolidated financial statements.

F. Unamortized Debt Expense.

Unamortized debt expense consists of costs, such as underwriting and broker dealer fees, discounts and commissions, legal fees, registration fees and rating agency fees, related to issuing long-term debt. We amortize debt expense on a straight-line basis, which approximates the effective interest method, over the life of the related debt which has lives ranging from 10 to 30 years.

G. Inventories.

We maintain gas inventories on the basis of average cost. Injections into storage are priced at the purchase cost at the time of injection and withdrawals from storage are priced at the weighted average purchase price in storage. The cost of gas in storage is recoverable under rate schedules approved by state regulatory commissions. Inventory activity is subject to regulatory review on an annual basis in gas cost recovery proceedings.

Materials, supplies and merchandise inventories are valued at the lower of average cost or market and removed from such inventory at average cost.

H. Deferred Purchased Gas Adjustments.

Rate schedules for utility sales and transportation customers include purchased gas adjustment (PGA) provisions that provide for the recovery of prudently incurred gas costs. With regulatory commission approval, we revise rates periodically without formal rate proceedings to reflect changes in the cost of gas. Under PGA provisions, charges to cost of gas are based on the gas cost amounts recoverable under approved rate schedules. By jurisdiction, differences between gas costs incurred and gas costs billed to customers are deferred and included in "Amounts due from customers" or "Amounts due to customers" in the consolidated balance sheets. We review gas costs and deferral activity periodically and, with regulatory commission approval, increase rates to collect under-recoveries or decrease rates to refund over-recoveries over a subsequent period.

I. Taxes.

Deferred income taxes are determined based on the estimated future tax effects of differences between the book and tax basis of assets and liabilities. Deferred taxes are primarily attributable to utility plant, equity method investments and revenues and cost of gas. We have provided valuation allowances to reduce the carrying amount of deferred tax assets to amounts that are more likely than not to be realized. To the extent that the establishment of deferred income taxes is different from the recovery of taxes through the ratemaking process, the differences are deferred pursuant to Statement 71, and a regulatory asset or liability is recognized for the impact of tax expenses or benefits that will be collected from or refunded to customers in different periods pursuant to rate orders. We amortize deferred investment tax credits to income over the estimated useful lives of the property to which the credits relate.

General taxes consist primarily of property taxes and payroll taxes. These taxes are not included in revenues.

J. Revenue Recognition.

Utility sales and transportation revenues are based on rates approved by state regulatory commissions. Base rates charged to jurisdictional customers may not be changed without formal approval by the regulatory commission in that jurisdiction; however, the wholesale cost of gas component of rates may be adjusted periodically under PGA provisions. A weather normalization adjustment (WNA) factor is included in rates charged to residential and commercial customers during the winter period November through March in all jurisdictions except EasternNC. The WNA is designed to offset the impact that warmer-than-normal or colder-than-normal weather has on customer billings during the winter season. Effective November 1, 2005, in North Carolina, through a general rate case proceeding, a Customer Utilization Tracker (CUT) eliminated the WNA that had previously been used. The CUT provides for the recovery of our approved margin per customer independent of both weather and other consumption patterns of residential and commercial customers.

Revenues are recognized monthly on the accrual basis, which includes estimated amounts for gas delivered to customers but not yet billed under the cycle-billing method from the last meter reading date to month end. The unbilled revenue estimate reflects factors requiring judgment related to estimated usage by customer class, changes in weather during the period and the impact of the WNA or CUT mechanisms, as applicable.

Secondary market, or wholesale, sales revenues are recognized when the physical sales are delivered based on contract or market prices.

K. Earnings Per Share.

We compute basic earnings per share using the weighted average number of shares of common stock outstanding during each period. A reconciliation of basic and diluted earnings per share for the years ended October 31, 2006, 2005 and 2004, is presented below.

	2006	2005	2004
	(In thousands except per share amounts)		
Net Income	$ 97,189	$ 101,270	$ 95,188
Average shares of common stock outstanding for basic earnings per share	75,863	76,680	74,359
Contingently issuable shares under the Executive Long-Term Incentive Plan	293	312	438
Average shares of dilutive stock	76,156	76,992	74,797
Earnings Per Share:			
Basic	$ 1.28	$ 1.32	$ 1.28
Diluted	$ 1.28	$ 1.32	$ 1.27

L. Statements of Cash Flows.

For purposes of reporting cash flows, we consider instruments purchased with an original maturity at date of purchase of three months or less to be cash equivalents.

M. Use of Estimates.

We make estimates and assumptions when preparing the consolidated financial statements. These estimates and assumptions affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities as of the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from estimates.

N. Recently Issued Accounting Standards.

In March 2005, the Financial Accounting Standards Board (FASB) issued Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations" (FIN 47), to clarify the term "conditional asset retirement" as used in SFAS 143, "Accounting for Asset Retirement Obligations." FIN 47 requires that a liability be recognized for the fair value of conditional AROs when incurred, if the fair value of the liability can be reasonably estimated. Uncertainty about the timing or method of settlement of a conditional asset retirement obligation would be factored into the measurement of the liability when sufficient information exists. This interpretation is effective no later than the end of fiscal years ending after December 15, 2005. As of October 31, 2006, we adopted FIN 47 and recorded an asset retirement cost of $7 million as part of "Utility Plant," a liability for the conditional asset retirement obligation of $19.1 million and a regulatory asset of $12.1 million. We received regulatory approval to establish a regulatory asset for the accumulated accretion expense and accumulated depreciation. Consequently, the adoption of FIN 47 did not have an impact on our results of operations or cash flows. Additionally, had FIN 47 been applied to the prior year presented with this report, the conditional ARO would have been $17.1 million and $18.1 million at November 1, 2004 and October 31, 2005, respectively. In accordance with FIN 47, such amounts are not reflected in the balance sheet as of October 31, 2005.

In June 2006, the FASB issued Interpretation 48, "Accounting for Uncertainty in Income Taxes" (FIN 48), to clarify the accounting for uncertain tax positions in accordance with SFAS 109, "Accounting for Income Taxes." FIN 48 defines a minimum recognition threshold that a tax position must meet to be recognized in an

nterprise's financial statements. Additionally, FIN 48 provides guidance on derecognition, measurement, classification, interim period accounting, disclosure and transition requirements in accounting for uncertain tax positions. This interpretation is effective the beginning of the first annual period commencing after December 15, 2006. We are currently assessing the impact FIN 48 may have on our consolidated financial statements; however, we believe the adoption of FIN 48 will not have a material impact on our financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" (Statement 157). Statement 157 provides enhanced guidance for using fair value to measure assets and liabilities and applies whenever other standards require (or permit) assets or liabilities to be measured at fair value, but does not expand the use of fair value in any new circumstances. Statement 157 establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data, for example, the reporting entity's own data. Under Statement 157, fair value measurements would be separately disclosed by level within the fair value hierarchy. Statement 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years, with earlier application encouraged. Accordingly, we will adopt Statement 157 no later than our first fiscal quarter in 2008. We believe the adoption of Statement 157 will not have a material effect on our financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans" (Statement 158). Statement 158 requires an employer to fully recognize the obligations associated with single-employer defined benefit pension, retiree healthcare and other postretirement plans in the financial statements by recognizing in its statement of financial position an asset for a plan's overfunded status or a liability for a plan's underfunded status rather than only disclosing the funded status in the footnotes to the financial statements. Statement 158 requires employers to recognize changes in the funded status of a defined benefit postretirement plan in the year in which the changes occur. Those changes will be reported in accumulated other comprehensive income (OCI) in the stockholders' equity section of the balance sheet. Statement 158 also requires that the company measure a plan's assets and its obligations that determine its funded status as of the end of the employer's fiscal year.

Statement 158 provides different effective dates for the recognition and related disclosure provisions and for the required change to a fiscal year-end measurement date. The requirement to recognize the funded status of a benefit plan and the related disclosure quirements initially will apply as of the end of the fiscal year ending after December 15, 2006. The requirement to measure plan assets and benefit obligations as of the date of the employer's fiscal year end statement of financial position will be effective for fiscal years ending after December 15, 2008, and will not be applied retrospectively. Accordingly, we will adopt the funded status portion of Statement 158 as of October 31, 2007. The measurement date portion of Statement 158 does not apply to us because our pension plan measurement date is already the same as our fiscal year end date. We believe the adoption of Statement 158 will not have a material effect on our financial position, results of operations or cash flows.

If Statement 158 had been adopted for the current year ended October 31, 2006, the effect on the consolidated balance sheets would have been a non-cash charge of $42.3 million as a regulatory asset of $25.6 million and deferred income taxes of $16.7 million with a reduction of $14.6 million to prepaid pension and an increase in accrued postretirement benefits of $27.7 million. The actual charge at October 31, 2007, could be substantially different depending on the discount rate, asset returns and plan population at that time. Based on a preliminary assessment of prior regulatory treatment of postretirement benefits, management believes that regulatory asset or liability treatment will be afforded to any regulatory asset or liability that would otherwise be recorded in accumulated OCI resulting from the implementation of Statement 158. We

ıtend to meet with our regulators in fiscal year 2007 to discuss the regulatory accounting and rate treatment of Statement 158.

2. Acquisitions

Effective at the close of business on September 30, 2003, we purchased 100% of the common stock of NCNG from Progress Energy, Inc. (Progress), for $417.5 million in cash plus $32.4 million for estimated working capital. We paid an additional $.3 million for actual working capital in our second quarter ended April 30, 2004. At the time of the acquisition, NCNG, a regulated natural gas distribution company, served 176,000 customers in eastern North Carolina, including 57,000 customers served by four municipalities who were wholesale customers of NCNG. NCNG was merged into Piedmont immediately following the closing.

We also purchased for $7.5 million in cash Progress' equity interest in EasternNC. At that time, EasternNC was a regulated utility with a certificate of public convenience and necessity to provide natural gas service to 14 counties in eastern North Carolina that previously were not served with natural gas. Progress' equity interest in EasternNC consisted of 50% of EasternNC's outstanding common stock and 100% of EasternNC's outstanding preferred stock.

We recorded the assets purchased on September 30, 2003, at fair value, except for utility plant, franchises and consents and miscellaneous intangible property that were recorded at book value in accordance with Statement 71. We recorded estimated goodwill at closing of $42.2 million for NCNG and $1.1 million for EasternNC. We finalized the purchase price allocation during our third quarter ended July 31, 2004, resulting in a decrease in goodwill of $2.7 million attributable to NCNG. This adjustment was primarily due to recording $5 million in deferred income taxes from book and tax basis differences of the purchase price, partially offset by unrecorded liabilities and the true-up of estimated working capital to actual. The goodwill attributable to EasternNC as of September 30, 2003, was not adjusted. We believe that approximately $31.4 million of the goodwill will be deductible for tax purposes.

On October 25, 2005, we purchased the remaining 50% interest in EasternNC for $1. EasternNC was merged into Piedmont immediately following the closing. The primary reason for the purchase of the remaining 50% interest was to integrate the rate structure of EasternNC into Piedmont's rate structure.

3. Regulatory Matters

Our utility operations are regulated by the North Carolina Utilities Commission (NCUC), the Public Service Commission of South Carolina (PSCSC) and the Tennessee Regulatory Authority (TRA) as to rates, service area, adequacy of service, safety ʿandards, extensions and abandonment of facilities, accounting and depreciation. We are also regulated by the NCUC as to the ˏsuance of securities.

In 1996, the NCUC ordered us to establish an expansion fund to enable the extension of natural gas service into unserved areas of North Carolina. The expansion fund was funded with supplier refunds, plus investment income earned, that would otherwise be refunded to customers. In accordance with a 2002 NCUC order, we no longer deposit supplier refunds in the expansion fund for our pre-NCNG acquisition operations; however, we continued to deposit supplier refunds attributable to NCNG operations in the expansion fund until an order was issued in the general rate case proceeding in 2005 discussed below. As of October 31, 2005, the balance of $13.1 million in our expansion fund held by the North Carolina State Treasurer was included in the consolidated balance sheet in "Restricted cash," with an offsetting liability included in "Amounts due to customers." In accordance with the order in the general rate case proceeding in 2005 discussed below, the restrictions on this cash were removed. We received $13.2 million in January 2006 from the North Carolina State Treasurer that was offset against "Amounts due to customers."

The PSCSC has approved a gas cost hedging plan for the purpose of cost stabilization for South Carolina customers. The plan targets 30% to 60% of annual normalized sales volumes for South Carolina and operates

sing historical pricing indices that are tied to future projected gas prices as traded on a national exchange. All properly accounted for costs incurred in accordance with the plan are deemed to be prudently incurred and are recovered in rates as a gas cost. Any benefits recognized are deemed to be reductions in gas cost and are refunded to South Carolina customers in rates.

We have a similar hedging plan in North Carolina. Recovery of costs associated with the hedging plan is not pre-approved by the NCUC and the costs are treated as gas costs subject to the annual gas cost prudence review. Any benefits or gain recognition are deemed to be reductions in gas costs and are refunded to North Carolina customers in rates. Through October 31, 2006, we have recovered 100% of the costs incurred under the North Carolina plan which is still under review for prudence.

In Tennessee, costs and benefits associated with hedging activities are recovered through the Actual Cost Adjustment (ACA) mechanism. The costs and benefits of financial instruments and all other gas costs incurred are components of the Tennessee Incentive Plan (TIP) mechanism approved by the TRA. The TIP mechanism replaced annual prudence reviews by benchmarking gas costs and secondary market activity performance against amounts determined by published market indices. In July 2005, in the order approving our 2004 TIP filing, the TRA established a separate docket to address issues raised by the Tennessee Consumer Advocate Staff and the TRA Staff related to the breadth of secondary market activities covered by the TIP, the method for selecting the independent consultant to review performance under the TIP, and the procedures utilized with respect to request for proposals. The TRA set a procedural schedule that included a hearing date of May 15, 2006. A series of settlement discussions followed leading to a September 2006 proposal that represented a reasonable balance between the respective roles of regulatory oversight and the alignment of ratepayer and shareholder interests inherent in the TIP to which the Tennessee Consumer Advocate Division and the TRA Staff have preliminarily agreed. Final approval of the settlement will be sought from the TRA and would maintain our annual incentive cap of gains and losses of $1.6 million which has been a key element of the TIP since its inception.

Due to the seasonal nature of our business and weather conditions during the winter period, we contract with customers in the secondary market to sell supply and capacity assets when available. In North Carolina and South Carolina, we operate under benefit-sharing mechanisms approved by the NCUC and the PSCSC for secondary market transactions (capacity release and off-system sales) whereby 75% of the benefit is refunded to jurisdictional customers in rates and 25% of the benefit is retained by us. In Tennessee, we operate under the TIP whereby gas purchase benchmarking benefits or losses are combined with secondary market transaction benefits or losses and shared by customers and us under a pre-approved formula. Our share of net gains or losses in Tennessee is subject to an overall annual cap of $1.6 million.

In March 2003, we, along with two other natural gas companies in Tennessee, filed a petition with the TRA requesting a declaratory order that the gas cost portion of uncollectible accounts be recovered through PGA procedures. The petition stated that to the extent that the gas cost portion of net write-offs for a fiscal year exceeds the gas cost portion of uncollectible accounts allowed in base rates, the unrecovered portion would be included in ACA filings for future recovery from customers. Conversely, to the extent that the gas cost portion of net write-offs for a fiscal year is less than the gas cost portion included in base rates, the difference would be refunded to customers through the ACA filings. In February 2004, the TRA approved the petition by modifying the formula in the PGA rules to allow for the recovery of uncollected gas cost on an experimental basis for one year, effective March 10, 2004. On April 4, 2005, the TRA extended the experimental period for one more year. On June 26, 2006, a motion was made to permanently approve the procedure. After receiving further comments, the TRA approved this motion on August 7, 2006. In conjunction with the approval, the TRA established a rulemaking to implement the formula.

The North Carolina General Assembly enacted the Clean Water and Natural Gas Critical Needs Act of 1998 which provided for the issuance of $200 million of general obligation bonds of the state for the purpose of providing grants, loans or other financing for the cost of constructing natural gas facilities in unserved areas

f North Carolina. In 2000, the NCUC issued an order awarding EasternNC an exclusive franchise to provide natural gas service to 14 counties in the eastern-most part of North Carolina that had not been able to obtain gas service because of the relatively small population of those counties and the resulting uneconomic feasibility of providing service. The order also granted $38.7 million in state bond funding. In 2001, the NCUC issued an order granting EasternNC an additional $149.6 million, for a total of $188.3 million.

During the fiscal year ended October 31, 2006, we were reimbursed $16 million in construction costs by the state, the remaining balance of the bond fund as of October 31, 2005. There was no remaining bond receivable as of October 31, 2006. As of October 31, 2005, we had receivables of $12 million related to the bond fund included in "Other receivables" in the consolidated balance sheets.

The NCUC had allowed EasternNC to defer its operations and maintenance expenses during the first eight years of operation or until the first rate case order, whichever occurred first, with a maximum deferral of $15 million. The deferred amounts accrued interest at a rate of 8.69% per annum. On December 1, 2003, the NCUC confirmed that these deferred expenses should be treated as a regulatory asset for future recovery from customers to the extent they are deemed prudent and proper. As a part of the general rate case proceeding discussed below, deferral ceased on October 31, 2005, and the balance in the deferred account as of June 30, 2005, $7.9 million, including accrued interest, is being amortized over 15 years beginning November 1, 2005. Amortization of amounts totaling $1.3 million that were deferred between July 1 and October 31, 2005, will be addressed in our next North Carolina general rate case.

On October 22, 2004, we filed a petition with the NCUC seeking deferred accounting treatment for certain pipeline integrity management costs to be incurred by us in compliance with the Pipeline Safety Improvement Act of 1992 and regulations of the United States Department of Transportation. The NCUC approved deferral treatment of these costs applicable to all incremental expenditures beginning November 1, 2004. As a part of the general rate case discussed below, the balance of $.4 million in the deferred account as of June 30, 2005, is being amortized over three years beginning November 1, 2005, and subsequent expenditures will continue to be deferred. Any unamortized balance at the end of the three years will be addressed in a future rate case.

On February 16, 2005, the Natural Gas Rate Stabilization Act of 2005 became effective in South Carolina. The law provides electing natural gas utilities, including Piedmont, with a mechanism for the regular, periodic and more frequent (annual) adjustment of rates which is intended to: (1) encourage investment by natural gas utilities, (2) enhance economic development efforts, (3) reduce the cost of rate adjustment proceedings and (4) result in smaller but more frequent rate changes for customers. If the utility elects to operate under the Act, the annual filing will provide that the utility's rate of return on equity will remain within a 50-basis points band ›ove or below the current allowed rate of return on equity. On April 26, 2005, we filed an election with the PSCSC to adopt this new mechanism.

On June 15, 2005, we filed with the PSCSC a quarterly monitoring report for the twelve months ended March 31, 2005, along with revenue deficiency calculations and proposed changes in our tariff rates. In the filing, we requested an increase in annual margin of $3.2 million. On October 21, 2005, the PSCSC issued an order approving an increase in annual margin of $2.6 million, effective November 1, 2005.

On June 15, 2006, we filed with the PSCSC a quarterly monitoring report for the twelve months ended March 31, 2006, along with revenue deficiency calculations and proposed changes in our tariff rates. In the filing, we requested an increase in annual margin of $10.4 million. On September 1, 2006, we, the Office of Regulatory Staff (ORS) and the South Carolina Energy Users Committee (SCEUC) filed a settlement agreement with the PSCSC addressing our proposed rate changes under the Natural Gas Rate Stabilization Act. On September 27, 2006, the PSCSC approved the settlement which will result in a $6.5 million increase in revenue based on 11.2% return on equity effective November 1, 2006.

On August 30, 2006, the PSCSC approved a settlement agreement between us, the ORS and the SCEUC accepting our purchased gas adjustment and finding our gas purchasing policies prudent. As part of this approved settlement effective November 1, 2006, we can recover uncollectible gas costs through the PGA mechanism in South Carolina.

On April 1, 2005, we filed a general rate case application with the NCUC requesting a consolidation of the respective rate bases, revenues and expenses of Piedmont, NCNG and EasternNC. In addition to a unified and uniform rate structure for all customers served by us in North Carolina, the application requested a general restructuring and increase in rates and charges for customers to produce an overall annual increase in margin of $36.7 million, a consolidation and/or amortization of certain deferred accounts, changes to cost allocations and rate design including an innovative tariff mechanism that decouples margin recovery from residential and commercial customer consumption, changes and unification of existing service regulations and tariffs, common depreciation rates for plant and recovery of uncollectible gas costs through the gas cost deferred account.

On November 3, 2005, the NCUC issued an order approving, among other things, an annual increase in margin of $20.2 million and authorizing new rates effective November 1, 2005. The order provided for the elimination of the weather normalization adjustment (WNA) mechanism in North Carolina and the establishment of a Customer Utilization Tracker (CUT) that decouples margin recovery from residential and commercial customer consumption. The CUT is experimental and can be effective for no more than three years, subject to review and approval in a future general rate case proceeding. The CUT provides for the recovery of our approved margin per customer independent of weather or other usage and consumption patterns of residential and commercial customers. The CUT tracks our margin earned monthly and will result in semi-annual rate adjustments to refund any over-collection or recover any under-collection. During the life of the CUT, the NCUC ordered us to contribute $500,000 per year toward conservation programs to assist residential and commercial customers. The conservation programs are subject to review and approval by the NCUC. On March 17, 2006, we made our first rate adjustment filing to collect, beginning April 1, $11.8 million attributable to the period ended January 31, 2006. On October 16, 2006, we made our second rate adjustment filing to collect, beginning November 1, 2006, $26.4 million attributable to the period ended August 31, 2006. Both of these rate adjustment filings have been approved by the NCUC.

Effective November 1, 2005 as approved in the November 3 order, the NCUC has allowed the recovery of all uncollected gas costs through the gas cost deferral account. As a result, only the portion of accounts written off relating to the non-gas costs, or margin, is included in base rates and, accordingly, only this portion is included in the provision for uncollectibles expense.

On January 3, 2006, the North Carolina Office of the Attorney General filed a notice of appeal in the general rate case proceeding challenging the lawfulness of the NCUC's authorization and approval of the CUT. On April 6, the Attorney General filed a Notice of Appeal and Exceptions to the NCUC's March 28, 2006, order approving the first adjustment filing under the CUT. On July 18, the Company and the Office of the Attorney General filed a settlement with the NCUC. As a result, the Attorney General withdrew both appeals. In the settlement, we agreed to share, in each of the three years the CUT is effective, the first $3 million of CUT dollars that are non-weather related. Annually, the first $3 million of non-weather related CUT amounts will be allocated 25% to customer rate reduction, 25% to energy conservation program funding and 50% to us. Accordingly, we recognized a $1.5 million liability with this settlement in our third quarter that was composed of an annual $750,000 to conservation programs (in addition to the $500,000 annual contribution in the rate case order) and an annual $750,000 to the reduction of customer rates during the same period. The NCUC approved the settlement on September 14, 2006.

The financial condition of the natural gas marketers and pipelines that supply and deliver natural gas to our distribution system can increase our exposure to supply and price fluctuations. We believe our risk exposure to the financial condition of the marketers and pipelines is not significant based on our receipt of the

roducts and services prior to payment and the availability of other marketers of natural gas to meet our firm supply needs if necessary.

We currently have commission approval in all three states that place additional credit requirements on the retail natural gas marketers that schedule gas into our system.

We filed a petition with the NCUC and the PSCSC on September 20, 2006, and with the TRA on September 29, 2006, for authorization to place certain ARO costs in deferred accounts so that the current regulatory treatment for these costs will not be altered due to our adoption of FIN 47. We requested that an order on these issues be made effective as of October 31, 2006. On October 16, 2006, the TRA approved the petition. On October 27, 2006, the NCUC approved the petition. On November 2, 2006, the PSCSC approved the petition.

4. Long-Term Debt

All of our long-term debt is unsecured. Long-term debt as of October 31, 2006 and 2005, is as follows.

	2006	2005
	In thousands	
Senior Notes:		
9.44%, due 2006	$ —	$ 35,000
8.51%, due 2017	35,000	35,000
Insured Quarterly Notes:		
6.25%, due 2036	200,000	—
Medium-Term Notes:		
7.35%, due 2009	30,000	30,000
7.80%, due 2010	60,000	60,000
6.55%, due 2011	60,000	60,000
5.00%, due 2013	100,000	100,000
6.87%, due 2023	45,000	45,000
8.45%, due 2024	40,000	40,000
7.40%, due 2025	55,000	55,000
7.50%, due 2026	40,000	40,000
7.95%, due 2029	60,000	60,000
6.00%, due 2033	100,000	100,000
Total	825,000	660,000
Less current maturities	—	35,000
Total	$ 825,000	$ 625,000

Current maturities for the next five years ending October 31 and thereafter are as follows.

	In thousands
2007	$ —
2008	—
2009	30,000
2010	60,000
2011	60,000
Thereafter	675,000
Total	$ 825,000

We have a shelf registration statement that can be used for either debt or equity securities filed with the Securities and Exchange Commission. On June 20, 2006, we sold $200 million of 6.25% insured quarterly notes under this shelf registration statement. The unsecured and unsubordinated insured quarterly notes are due on June 1, 2036. We have the option to redeem all or part of the notes before the stated maturity at any time on or after June 1, 2011, at 100% of their principal amount plus any accrued and unpaid interest to the date of redemption. We are obligated to redeem the notes in whole upon the occurrence of certain corporate transactions or failure to pay the premium under the insurance agreement. These quarterly notes were used to pay off $188 million of short-term debt on June 20 and to pay off a portion of the sinking fund of $35 million on the 9.44% Senior Notes due July 30. The remaining balance of unused long-term financing available under this shelf registration statement is $109.4 million.

The amount of cash dividends that may be paid on common stock is restricted by provisions contained in certain note agreements under which long-term debt was issued, with those for the senior notes being the most restrictive. We cannot pay or declare any dividends, make any other distribution on any class of stock or make any investments in subsidiaries, or permit any subsidiary to do any of the above (all of the foregoing being "restricted payments"), except out of net earnings available for restricted payments. As of October 31, 2006, we could make restricted payments totaling $558.4 million. Retained earnings as of this date were $348.8 million; therefore, our retained earnings were not restricted.

We are subject to default provisions related to our long-term debt. Failure to satisfy any of the default provisions would result in total outstanding issues of debt becoming due. There are cross-default provisions in all our debt agreements. As of October 31, 2006, we are in compliance with all default provisions.

5. Capital Stock and Accelerated Share Repurchase

Changes in common stock for the years ended October 31, 2004, 2005 and 2006, are as follows.

	Shares	Amount
	In thousands	
Balance, October 31, 2003	67,309	$ 372,651
Issued to participants in the Employee Stock Purchase Plan (ESPP)	45	853
Issued to the Dividend Reinvestment and Stock Purchase Plan (DRIP)	940	19,164
Issued to participants in the Executive Long-Term Incentive Plan (LTIP)	79	1,658
Sale of common stock, net of expenses	8,500	173,828
Shares repurchased under Common Stock Open Market Repurchase Plan	(203)	(4,487)
Balance, October 31, 2004	76,670	563,667
Issued to ESPP	43	904
Issued to DRIP	1,013	22,632
Issued to LTIP	77	1,796
Shares repurchased under Common Stock Open Market Repurchase Plan	(1,105)	(26,119)
Balance, October 31, 2005	76,698	562,880
Issued to ESPP	36	882
Issued to DRIP	735	17,496
Issued to LTIP	75	1,669
Shares repurchased under Common Stock Open Market Repurchase Plan	(1,080)	(25,871)
Shares repurchased under Accelerated Share Repurchase Plan (ASR)	(1,000)	(24,292)
Balance, October 31, 2006	75,464	$ 532,764

In June 2004, the Board of Directors approved a Common Stock Open Market Purchase Program that authorizes the repurchase of up to three million shares of currently outstanding shares of common stock. We implemented the program in September 2004. We utilize a broker to repurchase the shares on the open market and such shares are cancelled and become authorized but unissued shares available for issuance under the ESPP, DRIP and LTIP.

On December 16, 2005, the Board of Directors approved an increase in the number of shares in this program from three million to six million to reflect the stock split in 2004. The Board also approved the repurchase of up to four million additional shares of currently outstanding shares of common stock and amended the program to provide for repurchases to maintain our debt-to-equity capitalization ratios at target levels. These combined actions increased the total authorized share repurchases from three million to ten million shares.

On April 7, 2006, we entered into an accelerated share repurchase program whereby we purchased and retired 1 million shares of our common stock from an investment bank at the closing price that day of $23.87 per share. Total consideration paid to purchase the shares of $23.9 million, including $30,000 in commissions and other fees, was recorded in "Stockholders' equity" as a reduction in "Common stock."

As part of the accelerated share repurchase, we simultaneously entered into a forward sale contract with the investment bank that was expected to mature in approximately 50 trading days. Under the terms of the forward sale contract, the investment bank was required to purchase, in the open market, 1 million shares of our common stock during the term of the contract to fulfill its obligation related to the shares it borrowed from third parties and sold to us. At settlement, we, at our option, were required to either pay cash or issue registered or unregistered shares of our common stock to the investment bank if the investment bank's weighted average purchase price was higher than the April 7, 2006, closing price. The investment bank was required to pay us either cash or shares of our common stock, at our option, if the investment bank's weighted average price for the shares purchased was lower than the April 7, 2006, closing price. At settlement on June 6, we paid cash of $.4 million to the investment bank and recorded this amount in "Stockholders' equity" as a reduction in "Common stock." The $.4 million was the difference between the investment bank's weighted average purchase price of $24.26 and the April 7, 2006, closing price of $23.87 per share multiplied by 1 million shares.

As of October 31, 2006, 2.8 million shares of common stock were reserved for issuance as follows.

	In thousands
ESPP	141
DRIP	1,489
LTIP	1,148
Total	2,778

6. Financial Instruments and Related Fair Value

On April 24, 2006, we replaced our expiring $250 million 364-day committed lines of credit with a new senior five-year credit facility that includes renewal options. This new credit facility provides a committed line of credit of $350 million with the ability to expand up to $600 million, for which we pay an annual fee of $35,000 plus six basis points for any unused amount up to $350 million. This new credit facility also provides a line of credit for letters of credit of $5 million. The credit facility bears interest based on the 30-day LIBOR rate plus from .15% to .35%, based on our credit ratings.

As of October 31, 2006 and 2005, outstanding borrowings under the lines are included in "Notes payable" in the consolidated balance sheets, and consisted of $170 million and $158.5 million, respectively, in LIBOR cost-plus loans at a weighted average interest rate of 5.57% and 4.28%, respectively. Our credit facility's

nancial covenants require us to maintain a ratio of total debt to total capitalization of no greater than 70%, and actual was 53% at October 31, 2006. As of October 31, 2006, the unused committed lines of credit totaled $180 million.

As of October 31, 2006, we had $1.2 million in letters of credit issued and outstanding. These letters of credit are used to guarantee claims from self-insurance under our general liability policies.

Our principal business activity is the distribution of natural gas. As of October 31, 2006, our trade accounts receivable consisted of gas receivables of $85.7 million and merchandise and jobbing receivables of $4.8 million, net of an allowance for doubtful accounts of $1.2 million. We believe that we have provided an adequate allowance for any receivables which may not be ultimately collected.

In connection with the sale in January 2004 of our propane interests, we received 37,244 common units of Energy Transfer Partners, LP. The market value of these units as of October 31, 2004, was included in "Marketable securities" in the consolidated balance sheet. In February 2005, we sold all of the common units with proceeds of $2.4 million, resulting in a pre-tax gain of $1.5 million. For further information on this transaction, see Note 11 to the consolidated financial statements.

The carrying amounts in the consolidated balance sheets of cash and cash equivalents, restricted cash, receivables, notes payable and accounts payable approximate their fair values due to the short-term nature of these financial instruments. Based on quoted market prices of similar issues having the same remaining maturities, redemption terms and credit ratings, the estimated fair value amounts of long-term debt as of October 31, 2006 and 2005, including current portion, were as follows.

	2006		2005	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	In thousands			
Long-term debt	$ 825,000	$ 913,739	$ 660,000	$ 753,267

The use of different market assumptions or estimation methodologies could have a material effect on the estimated fair value amounts. The fair value amounts do not reflect principal amounts that we will ultimately be required to pay.

We purchase natural gas for our regulated operations for resale under tariffs approved by the state regulatory commissions having jurisdiction over the service area where the customer is located. We recover the cost of gas purchased for regulated operations through purchased gas cost recovery mechanisms. We structure the pricing, quantity and term provisions of our gas supply contracts to maximize flexibility and minimize cost and risk for our customers. Our risk management policies allow us to use financial struments for limited trading purposes and to hedge risks. We have a management-level Energy Risk Management Committee that monitors risks in accordance with our risk management policies.

We have purchased and sold financial options for natural gas in all three states for our gas purchase portfolios. The gains or losses on financial derivatives utilized in the regulated utility segment ultimately will be included in our rates to customers. Current period changes in the assets and liabilities from these risk management activities are recorded as a component of gas costs in amounts due customers in accordance with Statement 71. Accordingly, there is no earnings impact on the regulated utility segment as a result of the use of these financial derivatives. As of October 31, 2006 and 2005, the total fair value of gas purchase options included in the consolidated balance sheets was $3.1 million and $22.8 million, respectively.

7. Leases, Unconditional Purchase Obligations and Legal Obligations

We lease certain buildings, land and equipment for use in our operations under noncancelable operating leases. For the years ended October 31, 2006, 2005 and 2004, operating lease payments were $7.2 million,

6.9 million and $5.7 million, respectively. During 2005, we sold our corporate office building and entered into a ten-year lease on new office space beginning November 1, 2005.

Future minimum lease obligations for the next five years ending October 31 and thereafter are as follows.

	In thousands
2007	$ 6,316
2008	5,317
2009	4,721
2010	3,972
2011	3,839
Thereafter	17,462
Total	$ 41,627

We routinely enter into long-term commodity purchase commitments and agreements that commit future cash flows to acquire services we need in our business. These commitments include pipeline and storage capacity contracts and gas supply contracts to provide service to our customers and telecommunication and information technology contracts and other purchase obligations. The time periods for pipeline and storage capacity contracts range from one to nineteen years. The time periods for gas supply contracts range from one to three years. The time periods for the telecommunications and technology contracts providing maintenance fees for hardware and software applications, usage fees, local and long-distance data costs, frame relay, cell phone and pager usage fees range from one to five years. Other purchase obligations consist primarily of commitments for pipeline products, vehicles and contractors.

As of October 31, 2006, future unconditional purchase obligations for the next five years ending October 31 and thereafter are as follows.

	Pipeline and Storage Capacity	Gas Supply	and Information Technology	Other	Total
			In thousands		
2007	$ 124,454	$ 29,539	$ 20,337	$ 28,406	$ 202,736
2008	133,649	848	24,242	—	158,739
2009	134,914	285	24,751	—	159,950
2010	133,579	15	25,271	—	158,865
2011	133,722	—	25,801	—	159,523
Thereafter	580,802	—	—	—	580,802
Total	$ 1,241,120	$ 30,687	$ 120,402	$ 28,406	$ 1,420,615

From time to time, we conduct business with natural gas marketers who act as agents for various industrial customers of ours or who purchase natural gas directly for their own account. We previously had such an arrangement with National Gas Distributors LLC (NGD), which filed a voluntary bankruptcy petition on January 20, 2006. The bankruptcy trustee for this petition claimed that certain amounts paid by NGD to us for gas supply constitute preference payments, and sought their return. We have disputed these claims and vigorously defended our position on the matter. In October 2006, we agreed to settle with the NGD bankruptcy trustee in order to avoid protracted litigation and the expense thereof. The settlement has been submitted to the bankruptcy court for approval. During the fourth quarter, we recorded our estimated liability under the settlement, which does not have a material adverse impact on our financial position, results of operations or cash flows.

. **Employee Benefit Plans**

We have a defined-benefit pension plan for the benefit of eligible full-time employees. An employee becomes eligible on the January 1 or July 1 following either the date on which he or she attains age 30 or attains age 21 and completes 1,000 hours of service during the 12-month period commencing on the employment date. Plan benefits are generally based on credited years of service and the level of compensation during the five consecutive years of the last ten years prior to retirement during which the participant received the highest compensation. Our policy is to fund the plan in an amount not in excess of the amount that is deductible for income tax purposes.

We provide certain postretirement health care and life insurance benefits (OPEB) to eligible full-time employees. The liability associated with such benefits is funded in irrevocable trust funds that can only be used to pay the benefits. Employees are first eligible to retire and receive these benefits at age 55 with ten or more years of service after the age of 45. Employees who met this requirement in 1993 or who retired prior to 1993 are in a "grandfathered" group for whom we pay the full cost of the retiree's coverage and the retiree pays the full cost of dependent coverage. Employees not in the grandfathered group have 80% of the cost of retiree coverage paid by us, subject to certain annual contribution limits. Retirees not in the grandfathered group pay 20% of the cost of their coverage plus the full cost of dependent coverage.

In connection with the acquisition of NCNG, we acquired certain pension and OPEB obligations of former employees of NCNG. In February 2004, Progress transferred $34 million attributable to the accrued pension benefits for this group as of September 30, 2003, to the trust fund for this separate "frozen" plan. Progress transferred an additional $.2 million on November 19, 2004, as a result of updated employee information. The transferred active pension plan participants began accruing benefits under the Piedmont pension plan as of October 1, 2003. The OPEB obligation of $9.7 million as of September 30, 2003, for former employees of NCNG was recorded as a liability at closing. No assets attributable to this liability were transferred from Progress. We intend to merge the "frozen" qualified NCNG pension plan with the Piedmont pension plan as of December 31, 2006.

As a result of the Medicare Prescription Drug Improvement and Modernization Act of 2003, we amended our postretirement benefit plan on August 1, 2005, to eliminate prescription drug coverage beginning January 1, 2006, for retirees who are Medicare eligible. This prescription drug benefit was replaced by a defined dollar benefit to pay the premiums for Medicare Part D.

In connection with the acquisition of NCNG, we acquired certain pension liabilities related to a supplemental executive retirement plan (SERP) for 10 former retirees or directors of NCNG. The nonqualified SERP provides for a defined benefit payment to the former employee, director or their surviving spouse. There are no assets related to the plan, and no additional benefits accrue to the participants. Payments to the participants are made from operating funds during the year.

In addition, there is a nonqualified retirement plan for non-employee directors which provides retirement benefits to directors of the Company who were elected on or prior to August 20, 2003. Both of these nonqualified plans are presented below.

We also have a SERP covering all officers at the vice president level and above. It provides supplemental retirement income for officers whose benefits under the Company's qualified retirement plan are limited by tax code provisions. The level of insurance benefit and target retirement income benefits intended to be provided under the SERP depend upon the position of the officer. The SERP is funded by life insurance policies covering each officer, and the policy is owned exclusively by each officer. Premiums on these policies paid and expensed by us, as grossed up for taxes to the individual officer, totaled $.7 million in 2006, $1 million in 2005 and $86,000 in 2004.

Piedmont Natural Gas Company, Inc.

Notes to Consolidated Financial Statements — (Continued)

A reconciliation of changes in the plans' benefit obligations and fair value of assets for the years ended October 31, 2006 and 2005, and a statement of the funded status as recorded in the consolidated balance sheets as of October 31, 2006 and 2005, are presented below.

	Qualified Pension		Nonqualified Pension		Other Benefits	
	2006	2005	2006	2005	2006	2005
	In thousands					
Change in benefit obligation:						
Obligation at beginning of year	$ 236,608	$ 226,315	$ 4,484	$ 4,698	$ 30,732	$ 38,874
Service cost	10,972	11,278	66	61	1,134	1,391
Interest cost	13,436	12,816	239	255	1,747	2,151
Plan amendments	—	—	—	—	—	(5,934)
Actuarial (gain) loss	(190)	(1,792)	84	(9)	3,816	(3,260)
Benefit payments	(24,497)	(12,009)	(531)	(521)	(3,177)	(2,490)
Obligation at end of year	$ 236,329	$ 236,608	$ 4,342	$ 4,484	$ 34,252	$ 30,732
Change in fair value of plan assets:						
Fair value at beginning of year	$ 199,159	$ 181,244	$ —	$ —	$ 15,275	$ 14,045
Actual return on plan assets	22,681	13,121	—	—	1,740	964
Employer contributions	15,100	17,300	531	521	2,962	2,721
Administrative expenses	(517)	(497)	—	—	—	—
Benefit payments	(24,497)	(12,009)	(531)	(521)	(3,177)	(2,455)
Fair value at end of year	$ 211,926	$ 199,159	$ —	$ —	$ 16,800	$ 15,275
Funded status:						
Funded status at end of year	$ (24,403)	$ (37,449)	$ (4,342)	$ (4,484)	$ (17,452)	$ (15,459)
Unrecognized transition obligation	—	—	—	—	4,669	5,336
Unrecognized prior-service cost	4,395	5,327	—	—	—	—
Unrecognized actuarial (gain) loss	34,615	40,462	220	136	(1,553)	(4,996)
Accrued benefit asset (liability)	$ 14,607	$ 8,340	$ (4,122)	$ (4,348)	$ (14,336)	$ (15,119)
Amounts recognized in the consolidated balance sheets consist of:						
Prepaid benefit cost	$ 14,607	$ 8,340	$ —	$ —	$ —	$ —
Accrued benefit liability	—	—	(4,342)	(4,484)	(14,336)	(15,119)
Intangible asset	—	—	—	—	—	—
Accumulated other comprehensive income	—	—	220	136	—	—
Net amount recognized at year end	$ 14,607	$ 8,340	$ (4,122)	$ (4,348)	$ (14,336)	$ (15,119)

Other comprehensive income attributable to change in additional minimum pension liability recognition	$ —	$ (4,526)	$ 84	$ (9)	$ —	$ —

Net periodic benefit cost for the years ended October 31, 2006, 2005 and 2004, includes the following components.

	Qualified Pension			Nonqualified Pension			Other Benefits		
	2006	2005	2004	2006	2005	2004	2006	2005	2004
	In thousands								
Service cost	$ 10,972	$ 11,278	$ 9,698	$ 66	$ 61	$ 53	$ 1,134	$ 1,391	$ 1,338
Interest cost	13,436	12,816	12,084	239	255	282	1,747	2,151	2,547
Expected return on plan assets	(17,112)	(16,593)	(16,220)	—	—	—	(1,151)	(1,030)	(922)
Amortization of transition obligation	—	—	—	—	—	—	667	879	879
Amortization of prior service cost	933	933	931	—	—	—	—	1,285	1,030
Amortization of actuarial (gain) loss	604	378	—	—	—	—	(218)	—	280
Total	$ 8,833	$ 8,812	$ 6,493	$ 305	$ 316	$ 335	$ 2,179	$ 4,676	$ 5,152

In determining the market-related value of plan assets, we use the following methodology. The asset gain or loss is determined each year by comparing the fund's actual return to the expected return, based on the disclosed expected return on investment assumption. Such asset gain or loss is then recognized ratably over a five-year period. Thus, the market-related value of assets as of year end is determined by adjusting the market value of assets by the portion of the prior five years' gains or losses that has not yet been recognized. This method has been applied consistently in all years presented in the consolidated financial statements. The discount rate can vary from plan year to plan year. October 31 is the measurement date for the plans.

The discount rate has been separately determined for each plan by projecting the plan's cash flows and developing a zero-coupon spot rate yield curve using non-arbitrage pricing and Moody's AA or better-rated non-callable bonds that produces similar results to a hypothetical bond portfolio. As of October 31, 2006, the benchmark was 5.78% for the Piedmont pension plan and the NCNG pension plan, 5.65% for the NCNG SERP, 5.69% for the directors' SERP and 5.74% for OPEB.

We amortize unrecognized prior-service cost over the average remaining service period for active employees. We amortize the unrecognized transition obligation over the average remaining service period for active employees expected to receive benefits under the plan as of the date of transition. We amortize gains and losses in excess of 10% of the greater of the benefit obligation and the market-related value of assets over the average remaining service period for active employees. The method of amortization in all cases is straight-line.

The weighted average assumptions used in the measurement of the benefit obligation as of October 31, 2006 and 2005, are presented below.

	Qualified Pension		Nonqualified Pension		Other Benefits	
	2006	2005	2006	2005	2006	2005
Discount rate	5.78 %	6.00 %	5.67 %	5.75 %	5.74 %	5.89 %
Rate of compensation increase	4.01 %	4.05 %	N/A	N/A	4.01 %	4.05 %

The weighted average assumptions used to determine the net periodic benefit cost as of October 31, 2006, 2005 and 2004, are presented below.

	Qualified Pension			Nonqualified Pension			Other Benefits		
	2006	2005	2004	2006	2005	2004	2006	2005	2004
Discount rate	6.00 %	5.75 %	6.25 %	5.75 %	5.75 %	6.25 %	5.89 %	5.75 %	6.25 %
Expected long-term rate of return on plan assets	8.50 %	8.50 %	8.50 %	N/A	N/A	N/A	8.50 %	8.50 %	8.50 %
Rate of compensation increase	4.05 %	3.97 %	3.97 %	N/A	N/A	N/A	N/A	N/A	N/A

The weighted-average asset allocations by asset category for the two pension plans and the OPEB plan as of October 31, 2006 and 2005, are presented below.

	Pension Benefits		Other Benefits	
	2006	2005	2006	2005
Equity securities	68 %	63 %	48 %	45 %
Debt securities	32 %	37 %	52 %	55 %
Total	100 %	100 %	100 %	100 %

We have long-term target allocations for the pension and OPEB plans by asset category of 60% for equity securities and 40% for debt securities. Our primary investment objective is to generate sufficient assets to meet plan liabilities. The plans' assets will therefore be invested to maximize long-term returns consistent with the plans' liabilities, cash flow requirements and risk tolerance. The plans' liabilities are primarily defined in terms of participant salaries. Given the nature of these liabilities, and recognizing the long-term benefits of investing in equity securities, we invest in a diversified portfolio which includes a significant exposure to equity securities.

Specific financial targets include:

- Achieve full funding over the longer term,
- Control fluctuation in pension expense from year to year,
- Achieve satisfactory performance relative to other similar pension plans, and
- Achieve positive returns in excess of inflation over short to intermediate time frames.

To develop the expected long-term rate of return on assets assumption, we considered historical returns and future expectations for returns for each asset class, as well as target asset allocation of the pension and OPEB portfolios. We intend to use 8.5% as the expected long-term rate of return on the pension and OPEB plans for 2007.

We estimate that we will contribute $16.5 million to the qualified pension plans, $.6 million to the nonqualified pension plans and $3 million to the OPEB plan in 2007.

The Pension Protection Act of 2006 (PPA) was signed into law by the President of the United States on August 17, 2006. While the PPA will have some effect on specific plan provisions in our retirement programs, the primary effect will be to change the minimum funding requirements for plan years beginning in 2008. The PPA has directed the United States Department of the Treasury to develop a new yield curve to discount pension obligations for determining the funded status of a plan when calculating funding requirements. Until regulations are issued by the Department of the Treasury, we are unable to determine the effect on our consolidated financial statements.

Because we believe that our plans are well funded, we expect the PPA to reduce our contributions to the pension plan that would otherwise have been required to be made beginning in 2008, deferring them to a later year. However, the amount of future year-by-year contributions is not expected to be materially different from our current projections.

Benefit payments, which reflect expected future service, as appropriate, are expected to be paid for the next ten years ending October 31 as follows.

	Qualified Pension	Nonqualified Pension	Other Benefits
		In thousands	
2007	$ 14,774	$ 495	$ 2,785
2008	11,239	459	2,705
2009	12,184	443	2,711
2010	15,003	443	2,768
2011	14,415	417	2,762
2012 - 2016	76,294	1,836	14,661

The assumed health care cost trend rates used in measuring the accumulated OPEB obligation for the medical plans for all participants as of October 31, 2006 and 2005, are presented below.

	2006	2005
Health care cost trend rate assumed for next year	9.00 %	9.75 %
Rate to which the cost trend is assumed to decline (the ultimate trend rate)	5.00 %	5.00 %
Year that the rate reaches the ultimate trend rate	2012	2012

In the past, information for participants aged less than 65 and those aged greater than 65 was maintained separately for calculating the heath care cost trend rate; however, actual experience and trend guidelines were indicating that post-age 65 medical trends were lower than pre-65 medical trends and prescription drug trends for both groups were at about the same level. Since post-age 65 participants have more prescription claims as a group, the trends are nearly equal. The change in trend rates did not have a material effect on the accumulated OPEB obligation.

The health care cost trend rate assumptions could have a significant effect on the amounts reported. A change of 1% would have the following effects.

	1% Increase	1% Decrease
	In thousands	
Effect on total of service and interest cost components of net periodic postretirement health care benefit cost for the year ended October 31, 2006	$ 85	$ (106)
Effect on the health care cost component of the accumulated postretirement benefit obligation as of October 31, 2006	1,277	(1,272)

We maintain salary investment plans which are profit-sharing plans under Section 401(a) of the Internal Revenue Code of 1986, as amended (the Tax Code), which include qualified cash or deferred arrangements under Tax Code Section 401(k). The salary investment plans are subject to the provisions of the Employee Retirement Income Security Act. Full-time employees who have completed 30 days of continuous service and have attained age 18 are eligible to participate. Participants may defer a portion of their base salary to the plans and we match a portion of their contributions. Employee contributions vest immediately and company contributions vest after six months of service. For the years ended October 31, 2006, 2005 and 2004, our matching contributions totaled $3.3 million, $3.2 million and $2.9 million, respectively. There are several investment options available to enable participants to diversify their accounts. Participants may invest in Piedmont stock up to a maximum of 20% of their account.

As a result of a plan merger effective in 2001, participants' accounts in our employee stock ownership plan (ESOP) were transferred into our salary investment plans. Former ESOP participants may remain invested in Piedmont common stock in their salary investment plan or may sell the common stock at any time and

einvest the proceeds in other available investment options. The tax benefit of any dividends paid on ESOP shares still in participants' accounts is reflected in the consolidated statement of stockholders' equity as an increase in retained earnings.

9. Employee Share-Based Plans

Under the LTIP, the Board of Directors has awarded units to eligible officers and other participants. Depending upon the levels of performance targets achieved by Piedmont during multi-year performance periods, distribution of those awards may be made in the form of shares of common stock and cash withheld for payment of applicable taxes on the compensation. The LTIP requires that a minimum threshold performance be achieved in order for any award to be distributed. For the years ended October 31, 2006, 2005 and 2004, we recorded compensation expense for the LTIP of $5.4 million, $4 million and $3.1 million, respectively. Shares of common stock to be issued under the LTIP are contingently issuable shares and are included in our calculation of fully diluted earnings per share.

We have four awards under the LTIP with three-year performance periods ending October 31, 2006, October 31, 2007, October 31, 2008 and October 31, 2009. Fifty percent of the units awarded will be based on achievement of a target annual compounded increase in basic earnings per share (EPS). For this 50% portion, an EPS performance of 80% of target will result in an 80% payout, an EPS performance of 100% of target will result in a 100% payout and an EPS performance of 120% of target will result in a maximum 120% payout, and EPS performance levels between these levels will be subject to mathematical interpolation. EPS performance below 80% of target will result in no payout of this portion. The other 50% of the units awarded will be based on the achievement of a target total annual shareholder return in comparison to the A. G. Edwards Large Natural Gas Distribution Index industry peer group (Peer Group) total shareholder return (increase in the registrant's common stock price plus dividends paid over the specified period of time). The total shareholder return performance measure will be the registrant's percentile ranking in relationship to the Peer Group. For this 50% portion, a ranking below the 25th percentile will result in no payout, a ranking between the 25th and 39th percentile will result in an 80% payout, a ranking between the 40th and 49th percentile will result in a 90% payout, a ranking between the 50th and 74th percentile will result in a 100% payout, a ranking between the 75th and 89th percentile will result in a 110% payout, and a ranking at or above the 90th percentile will result in a maximum 120% payout.

We have one additional award with a five-year performance period that ended October 31, 2006, for a group of retired employees with 75% of the units awarded being based on achievement of a target cumulative increase in net income and 25% of the units awarded based on achievement of a target total annual shareholder return in comparison to the Peer Group discussed above and the same percentile rankings. The payout under this award will occur over a three-year period.

As of October 31, 2006 and 2005, we have accrued $11.4 million and $9.3 million for these awards. The accrual is based on the fair market value of our stock at the end each quarter. The liability is re-measured to market value at the settlement date.

On September 1, 2006, the Board of Directors approved a grant under our Incentive Compensation Plan (ICP) to our President and Chief Executive Officer of 65,000 restricted shares of our common stock with a value at the date of grant of $1.7 million, based on the average closing price of our stock during the period July 1-30, 2006. The restricted shares shall vest and be payable on the following schedule only if he is an employee on the vesting date for each tranche:

- 20% on September 1, 2009,
- 30% on September 1, 2010, and
- 50% on September 1, 2011.

During the vesting period, any dividends paid on these shares will be accrued and converted into additional shares at the closing price on the date of the dividend payment. The additional shares will vest according to the vesting schedule above. As of October 31, 2006, we have recorded $.06 million as compensation expense. We are recording compensation under the ICP on the straight-line method.

On a quarterly basis, we issue shares of common stock under the ESPP and have accounted for the issuance as an equity transaction. On November 1, 2005, we amended our plan to lower the discount from 10% to 5%. The purchase price on the purchase date is 95% of the average closing price as recorded on the New York Stock Exchange for the last month of the payroll contribution period.

As discussed in Note 5, we repurchase shares on the open market and such shares are then cancelled and become authorized but unissued shares available for issuance under our employee plans, including the ESPP, LTIP and ICP.

10. Income Taxes

The components of income tax expense for the years ended October 31, 2006, 2005 and 2004, are as follows.

	2006		2005		2004	
	Federal	State	Federal	State	Federal	State
	In thousands					
Charged to operating income:						
Current	$ 27,470	$ 4,977	$ 19,073	$ 3,880	$ 18,414	$ 9,298
Deferred	14,775	3,855	24,006	5,462	24,880	(557)
Amortization of investment tax credits	(534)	—	(541)	—	(550)	—
Total	41,711	8,832	42,538	9,342	42,744	8,741
Charged to other income (expense):						
Current	9,052	1,427	15,588	2,966	11,293	2,236
Deferred	1,107	301	(6,407)	(1,701)	(2,582)	(385)
Total	10,159	1,728	9,181	1,265	8,711	1,851
Total	$ 51,870	$ 10,560	$ 51,719	$ 10,607	$ 51,455	$ 10,592

A reconciliation of income tax expense at the federal statutory rate to recorded income tax expense for the years ended October 31, 2006, 2005 and 2004, is as follows.

	2006	2005	2004
		In thousands	
Federal taxes at 35%	$ 55,867	$ 57,258	$ 55,032
State income taxes, net of federal benefit	6,864	6,894	6,885
Amortization of investment tax credits	(534)	(541)	(550)
Sale of propane interests	—	(1,624)	—
Other, net	233	339	680
Total	$ 62,430	$ 62,326	$ 62,047

As of October 31, 2006 and 2005, deferred income taxes consisted of the following temporary differences.

	2006	2005
	In thousands	
Utility plant	$ 226,866	$ 208,947
Equity method investments	15,419	12,114
Revenues and cost of gas	25,356	25,273
Other, net	(7,145)	(10,156)
Net deferred income tax liabilities	$ 260,496	$ 236,178

As of October 31, 2006 and 2005, total deferred income tax liabilities were $281.8 million and $261.6 million and total net deferred income tax assets were $21.3 million and $25.4 million, respectively. Total net deferred income tax assets as of October 31, 2006 and 2005, were net of a valuation allowance of $.6 million, respectively, for net operating loss carryforwards that we believed were more likely than not to expire before we could use them. Piedmont and its wholly owned subsidiaries file a consolidated federal income tax return. Prior to October 25, 2005, EasternNC filed a separate federal income tax return as we did not own the prerequisite 80% share of EasternNC to allow EasternNC to participate in our consolidated federal return. With Piedmont's acquisition of the remaining 50% interest in EasternNC, EasternNC became a member of Piedmont's consolidated group on October 25, 2005, and was immediately merged into Piedmont. As of the acquisition date, EasternNC had federal and state net operating loss carryforwards of $7.5 million that expire from 2017 through 2025. Piedmont may use the EasternNC federal loss carryforwards to offset taxable income, subject to an annual limitation of $.3 million.

A reconciliation of changes in the deferred tax valuation allowance for the years ended October 31, 2006, 2005 and 2004, is as follows.

	2006	2005	2004
		In thousands	
Balance at beginning of year	$ 583	$ 1,245	$ 1,073
Charged (credited) to income tax expense	(15)	(662)	172
Balance at end of year	$ 568	$ 583	$ 1,245

During the years ended October 31, 2004 and October 31, 2006, the Internal Revenue Service finalized its audit of our returns for the tax years ended October 31, 2001 and 2002, respectively. The audit results, which did not have a material effect on our financial position or results of operations, have been reflected in the consolidated financial statements. The Internal Revenue Service is auditing our tax returns for the tax years ended October 31, 2003 through October 31, 2005. We believe the results of the audit will not have a material effect on our financial position or results of operations.

11. Equity Method Investments

The consolidated financial statements include the accounts of wholly owned subsidiaries whose investments in joint venture, energy-related businesses are accounted for under the equity method. Our ownership interest in each entity is included in "Equity method investments in non-utility activities" in the consolidated balance sheets. Earnings or losses from equity method investments are included in "Income from equity method investments" in the consolidated statements of income.

As of October 31, 2006, there were no amounts that represented undistributed earnings of our 50% or less owned equity method investments in our retained earnings.

Cardinal Pipeline Company, L.L.C.

We own 21.48% of the membership interests in Cardinal Pipeline Company, L.L.C., a North Carolina limited liability company. The other members are subsidiaries of The Williams Companies, Inc., and SCANA Corporation. Cardinal owns and operates an intrastate natural gas pipeline in North Carolina and is regulated by the NCUC. Cardinal has firm service agreements with local distribution companies for 100% of the firm transportation capacity on the pipeline, of which Piedmont subscribes to approximately 38%. Cardinal is dependent on the Williams-Transco pipeline system to deliver gas into its system for service to its customers. Cardinal's long-term debt is secured by Cardinal's assets and by each member's equity investment in Cardinal.

We have related party transactions as a transportation customer of Cardinal, and we record in cost of gas the transportation costs charged by Cardinal. For each of the years ended October 31, 2006, 2005 and 2004, these gas costs were $4.7 million. As of October 31, 2006 and 2005, we owed Cardinal $.1 million and $.4 million, respectively.

Summarized financial information provided to us by Cardinal for 100% of Cardinal as of September 30, 2006 and 2005, and for the twelve months ended September 30, 2006, 2005 and 2004, is presented below.

	2006	2005	2004
		In thousands	
Current assets	$ 8,717	$ 7,270	
Non-current assets	85,933	88,250	
Current liabilities	4,458	3,294	
Non-current liabilities	35,520	37,440	
Revenues	15,524	15,525	$ 15,567
Gross profit	15,524	15,525	15,567
Income before income taxes	8,785	8,368	8,102

Pine Needle LNG Company, L.L.C.

We own 40% of the membership interests in Pine Needle LNG Company, L.L.C., a North Carolina limited liability company. The other members are the Municipal Gas Authority of Georgia and subsidiaries of The Williams Companies, Inc., SCANA Corporation and Hess Corporation. Pine Needle owns an interstate liquefied natural gas (LNG) storage facility in North Carolina and regulated by the Federal Energy Regulatory Commission (FERC). Pine Needle has firm service agreements for 100% of the storage capacity of the facility, of which Piedmont subscribes to approximately 64%.

Pine Needle enters into interest-rate swap agreements to modify the interest characteristics of its long-term debt. Our share of movements in the market value of these agreements are recorded as a hedge in "Accumulated other comprehensive income (loss)" in the consolidated balance sheets. Pine Needle's long-term debt is secured by Pine Needle's assets and by each member's equity investment in Pine Needle.

We have related party transactions as a customer of Pine Needle, and we record in cost of gas the storage costs charged by Pine Needle. For the years ended October 31, 2006, 2005 and 2004, these gas costs were $12.7 million, $12.4 million and $12.3 million, respectively. As of October 31, 2006 and 2005, we owed Pine Needle $1.1 million.

Summarized financial information provided to us by Pine Needle for 100% of Pine Needle as of September 30, 2006 and 2005, and for the twelve months ended September 30, 2006, 2005 and 2004, is presented below.

	2006	2005	2004
		In thousands	
Current assets	$ 10,823	$ 8,653	
Non-current assets	88,879	92,255	
Current liabilities	8,208	6,752	
Non-current liabilities	34,835	40,251	
Revenues	19,231	19,870	$ 19,357
Gross profit	19,231	19,870	19,357
Income before income taxes	10,047	9,480	9,372

US Propane, L.P.

Prior to January 20, 2004, we owned 20.69% of the membership interests in US Propane, L.P. The other members were subsidiaries of TECO Energy, Inc., AGL Resources, Inc. and Atmos Energy Corporation. US Propane owned all of the general partnership interest and approximately 26% of the limited partnership interest in Heritage Propane Partners, L.P. (Heritage Propane), a marketer of propane through a nationwide retail distribution network. In January 2004, we, along with the other members, completed the sale of US Propane's general and limited partnership interests in Heritage Propane for $130 million.

In connection with the sale, the former members of US Propane formed TAAP, LP, a limited partnership, to receive the approximately 180,000 common units of Heritage Propane retained in the sale. On May 21, 2004, TAAP distributed to us 37,244 common units of Energy Transfer Partners, LP (formerly Heritage Propane), as our share of the retained units. The market value of these units as of October 31, 2004, was included in "Marketable securities" in the consolidated balance sheet. On February 1, 2005, we sold 18,622 of the units and on February 2, 2005, we sold the remaining 18,622 units for total cash proceeds of $2.4 million. We recorded a pre-tax gain of $1.5 million in the consolidated statement of income for the year ended October 31, 2005.

SouthStar Energy Services LLC

We own 30% of the membership interests in SouthStar Energy Services LLC, a Delaware limited liability company. Under the terms of the Amended and Restated Limited Liability Company Agreement (Restated Agreement) effective January 1, 2004, earnings and losses are allocated 25% to us and 75% to the other member, Georgia Natural Gas Company (GNGC), a subsidiary of AGL Resources, Inc. SouthStar primarily sells natural gas to residential, commercial and industrial customers in the southeastern United States; however, SouthStar conducts most of its business in the unregulated retail gas market in Georgia.

Contained in the SouthStar Restated Agreement mentioned above between us and GNGC, there are provisions providing for the disposition of ownership interests between members, including a provision granting three options to GNGC to purchase our ownership interest in SouthStar. By November 1, 2007, with the option effective on January 1, 2008 (2008 option), GNGC has the option to purchase one-third of our 30% interest in SouthStar. With the same notice in the following years, GNGC has the option to purchase 50% of our interest to be effective on January 1, 2009 (2009 option), and 100% of our interest to be effective on January 1, 2010. The purchase price would be based on the market value of SouthStar as defined in the Restated Agreement.

If GNGC exercises either the 2008 option or the 2009 option, we, at our discretion, may cause GNGC to purchase our entire ownership interest.

For further information on this provision, please see the Restated Agreement that was filed with the Securities and Exchange Commission (SEC) as Exhibit 10.1 in our Form 10-Q for the quarter ended April 30, 2004.

SouthStar's business is seasonal in nature as variations in weather conditions generally result in greater revenue and earnings during the winter months when weather is colder. Also, because SouthStar is not a rate-regulated company, the timing of its earnings can be affected by changes in the wholesale price of natural gas. While SouthStar uses financial contracts to moderate the effect of price changes on the timing of its earnings, wholesale price volatility can cause variations in the timing of the recognition of earnings.

These financial contracts, in the form of futures, options and swaps, are considered to be derivatives and fair value is based on selected market indices. Our share of movements in the market value of these contracts are recorded as a hedge in "Accumulated other comprehensive income (loss)" in the consolidated balance sheets.

We have related party transactions as we sell wholesale gas supplies to SouthStar, and we record in operating revenues the amounts billed to SouthStar. For the years ended October 31, 2006, 2005 and 2004, these operating revenues were $21.6 million, $10.3 million and $2.7 million, respectively. As of October 31, 2006 and 2005, SouthStar owed us $.8 million and $.9 million, respectively.

Summarized financial information provided to us by SouthStar for 100% of SouthStar as of September 30, 2006 and 2005, and for the twelve months ended September 30, 2006, 2005 and 2004, is presented below.

	2006	2005	2004
		In thousands	
Current assets	$ 195,893	$ 208,537	
Non-current assets	11,136	15,497	
Current liabilities	69,438	109,111	
Non-current liabilities	870	—	
Revenues	1,053,770	861,091	$ 790,288
Gross profit	155,416	148,885	122,811
Income before income taxes	88,765	91,200	72,056

Hardy Storage Company LLC

Piedmont Hardy Storage Company, LLC (Piedmont Hardy), a wholly-owned subsidiary of Piedmont, owns 50% of the membership interests in Hardy Storage Company, LLC (Hardy Storage), a West Virginia limited liability company. The other owner is a subsidiary of Columbia Gas Transmission Corporation, a subsidiary of NiSource Inc. Hardy Storage is constructing an underground interstate natural gas storage facility located in Hardy and Hampshire Counties, West Virginia, that it intends to own and operate. The storage facility is expected to be in service in April 2007. On June 29, 2006, Hardy Storage signed a note purchase agreement for interim notes and a revolving equity bridge facility for up to a total of $173.1 million for funding during the construction period. Once in service and after the satisfaction of certain conditions in the note purchase agreement, the two members of Hardy Storage will pay off 30% of the construction financing with their equity contributions and the remaining 70% debt will convert to a fifteen-year mortgage-style debt instrument without recourse to the members. The other member of Hardy Storage will contribute assets and cash as part of its share of the 30% owner contributions, and we will contribute cash as our share.

The members of Hardy Storage have each agreed to guarantee 50% of the construction financing. The guaranty was executed by Piedmont Energy Partners, Inc. (PEP), a wholly owned subsidiary of Piedmont and a sister company of Piedmont Hardy. Our share of the guaranty is capped at $111.5 million. Depending upon

ıe facility's performance over the first three years after the in-service date, there could be additional construction requiring debt of up to $10 million, of which PEP will guarantee 50%.

Securing PEP's guaranty is a pledge of intercompany notes issued by Piedmont held by non-utility subsidiaries of PEP. Should Hardy Storage be unable to perform its payment obligation under the construction financing, PEP will call on Piedmont for the payment of the notes, plus accrued interest, for the amount of the guaranty. Also pledged is our membership interests in Hardy Storage.

As we are in the formation stage of the joint venture, we are recording a liability at fair value for this guaranty based on the present value of 50% of the construction financing outstanding at the end of each quarter, with a corresponding increase to our investment account in the venture. As our risk in the project changes, the fair value of the guaranty is adjusted accordingly through a quarterly evaluation.

As of October 31, 2006, $65.1 million was outstanding under the construction financing, and we have recorded a guaranty liability of $1.8 million.

On November 1, 2005, the FERC issued an order granting a certificate of public convenience and necessity to Hardy Storage authorizing it to construct and operate the proposed project. In December 2005, two intervenors filed for rehearing with the FERC contesting the inclusion of income tax allowances in Hardy Storage's rates. This issue was settled subsequently with the intervenors with no material effect on the project.

On October 26, 2006, Hardy Storage filed an application with the FERC for an amendment to its certificate of public convenience and necessity for approval of a settlement that establishes revised initial rates based on updated cost estimates. This application also requested expedited treatment for an order to be issued no later than February 28, 2007. The estimated cost of the project as refiled with the FERC is $164 million, an increase of $43 million from the original application of $121 million, due to higher costs for skilled labor, material and equipment for the project. The project sponsors continue to pursue the construction of the project with an anticipated in-service date of April 2007.

Summarized financial information provided to us by Hardy Storage for 100% of Hardy Storage as of October 31, 2006 and 2005, and for the twelve months ended October 31, 2006 and 2005, is presented below.

	2006	2005	2004
	In thousands		
Current assets	$ 12,807	$ 8,107	n/a
Non-current assets	88,194	9,914	
Current liabilities	39,873	2,644	
Non-current liabilities	2,922	2,756	
Revenues	*	*	
Gross profit	*	*	
Income before income taxes	2,023	123	

* Hardy Storage is not "in service" during the periods presented. The income above is related to AFUDC associated with the financing and construction activities of the storage facilities, and is recorded in accordance with regulatory guidelines.

12. Business Segments

We have two reportable business segments, regulated utility and non-utility activities. These segments were identified based on products and services, regulatory environments and our current corporate organization and business decision-making activities. Operations of our regulated utility segment are conducted by the parent company and, through October 25, 2005, by EasternNC. Operations of our non-utility activities segment are comprised of our equity method investments in joint ventures.

Operations of the regulated utility segment are reflected in operating income in the consolidated statements of income. Operations of the non-utility activities segment are included in the consolidated statements of income in "Income from equity method investments."

We evaluate the performance of the regulated utility segment based on margin, operations and maintenance expenses and operating income. We evaluate the performance of the non-utility activities segment based on earnings from the ventures. All of our operations are within the United States. No single customer accounts for more than 10% of our consolidated revenues.

Operations by segment for the years ended October 31, 2006, 2005 and 2004, and as of October 31, 2006 and 2005, are presented below.

	Regulated Utility	Non-Utility Activities	Total
		In thousands	
2006			
Revenues from external customers	$ 1,924,628	$ —	$ 1,924,628
Margin	523,479	—	523,479
Operations and maintenance expenses	219,353	503	219,856
Depreciation	89,696	4	89,700
Income from equity method investments	—	29,917	29,917
Interest expense	52,310	50	52,360
Operating income (loss) before income taxes	181,292	(623)	180,669
Income before income taxes and minority interest	130,730	28,889	159,619
Total assets	2,600,411	75,877	2,676,288
Equity method investments in non-utility activities	—	75,330	75,330
Construction expenditures	196,730	551	197,281
2005			
Revenues from external customers	$ 1,761,091	$ —	$ 1,761,091
Margin	499,139	—	499,139
Operations and maintenance expenses	206,983	214	207,197
Depreciation	85,169	—	85,169
Income from equity method investments	—	27,664	27,664
Interest expense	44,256	52	44,308
Operating income (loss) before income taxes	177,180	(403)	176,777
Income before income taxes and minority interest	135,758	28,440	164,198
Total assets	2,527,993	71,520	2,599,513
Equity method investments in non-utility activities	—	71,520	71,520
Construction expenditures	157,883	—	157,883
2004			
Revenues from external customers	$ 1,529,739	$ —	$ 1,529,739
Margin	488,369	—	488,369
Operations and maintenance expenses	200,282	172	200,454
Depreciation	82,276	—	82,276
Income from equity method investments	—	27,381	27,381
Interest expense	47,364	48	47,412
Operating income (loss) before income taxes	178,800	(234)	178,566
Income before income taxes and minority interest	125,044	32,239	157,283
Construction expenditures	103,187	—	103,187

Reconciliations to the consolidated financial statements for the years ended October 31, 2006, 2005 and 2004, and as of October 31, 2006 and 2005, are as follows.

	2006	2005	2004
		In thousands	
Operating Income:			
Segment operating income before income taxes	$ 180,669	$ 176,777	$ 178,566
Utility income taxes	(50,543)	(51,880)	(51,485)
Non-utility activities before income taxes	623	403	234
Total	$ 130,749	$ 125,300	$ 127,315
Net Income:			
Income before income taxes and minority interest for reportable segments	$ 159,619	$ 164,198	$ 157,283
Income taxes	(62,430)	(62,326)	(62,047)
Less minority interest	—	(602)	(48)
Total	$ 97,189	$ 101,270	$ 95,188
Consolidated Assets:			
Total assets for reportable segments	$ 2,676,288	$ 2,599,513	
Eliminations/Adjustments	57,651	2,977	
Total	$ 2,733,939	$ 2,602,490	

13. Environmental Matters

Our three state regulatory commissions have authorized us to utilize deferral accounting in connection with environmental costs. Accordingly, we have established regulatory assets for actual environmental costs incurred and for estimated environmental liabilities recorded.

Several years ago, we entered into a settlement with a third party with respect to nine manufactured gas plant (MGP) sites that e have owned, leased or operated and paid an amount, charged to the estimated environmental liability, that released us from any investigation and remediation liability. Although no such claims are pending or, to our knowledge, threatened, the settlement did not cover any third-party claims for personal injury, death, property damage and diminution of property value or natural resources. Three other MGP sites that we also have owned, leased or operated were not included in the settlement. In addition to these sites, we acquired the liability for an MGP site located in Reidsville, North Carolina, in connection with the acquisition in 2002 of certain assets and liabilities of North Carolina Gas Services, a division of NUI Utilities, Inc.

As of October 31, 2006, our undiscounted environmental liability totaled $3.3 million, and consisted of $2.9 million for the four MGP sites and $.4 million for underground storage tanks not yet remediated. We increased the liability in 2006 by $.1 million and in 2005 by $.2 million to reflect the impact of inflation based on the consumer price index.

As of October 31, 2006, our regulatory assets for unamortized environmental costs totaled $3.8 million. The portion of the regulatory assets representing actual costs incurred, including the settlement payment to the third party, is being amortized as recovered in rates from customers.

Further evaluations of the MGP sites and the underground storage tank sites could significantly affect recorded amounts; however, we believe that the ultimate resolution of these matters will not have a material adverse effect on our financial position, cash flows or results of operations.

In connection with the acquisition in 2003 of NCNG, several MGP sites owned by NCNG were transferred to a wholly owned subsidiary of Progress prior to closing. Progress has complete responsibility for performing all of NCNG's remediation obligations to conduct testing and clean-up at these sites, including both the cost of such testing and clean-up and the implementation of any affirmative remediation obligations that NCNG has related to the sites. Progress' responsibility does not include any third-party claims for personal injury, death, property damage and diminution of property value or natural resources. We know of no such pending or threatened claims.

On October 30, 2003, in connection with the 2003 NCNG general rate case proceeding, the NCUC ordered an environmental regulatory liability of $3.5 million be established for refund to customers over the three-year period beginning November 1, 2003. This liability resulted from a payment made to NCNG by its insurers prior to our acquisition. As a part of the 2005 NCUC general rate case proceeding discussed in Note 3 to the consolidated financial statements, the NCUC ordered a new three-year amortization period for the unamortized balance as of June 30, 2005, beginning November 1, 2005.

On July 26, 2005, we were notified by the North Carolina Department of Environment and Natural Resources that we were named as a potentially responsible party for alleged environmental problems associated with an underground storage tank site. We owned this site for less than two years several years ago in connection with a non-utility venture. There have been at least four owners of the site. We contractually transferred any clean-up costs to the new owner of the site when we sold this venture. Our current estimate of the cost to remediate the site is approximately $124,800. It is unclear how many of the former owners may ultimately be held liable for this site; however, based on the uncertainty of the ultimate liability, we established a non-regulated environmental liability for $31,200, one-fourth of the estimated cost.

14. Restructuring

On April 13, 2006, we announced plans to restructure our management group at an estimated one-time cost of $7 to $8 million. The restructuring plans were a part of an ongoing, larger effort aimed at streamlining business processes, capturing operational and organizational efficiencies and improving customer service. The restructuring began with an offer of early retirement for 23 employees in our management group, and eventually included the further consolidation and reorganization of management positions and functions that was completed in July 2006.

Since April, we have recognized a liability and expense of $7.9 million, which was included in operations and maintenance expense for the cost of the restructuring program. This liability included early retirement for 22 employees of the management group and severance for 17 additional employees through further consolidation. Due to the short discount period, the liability for the program was recorded at its gross value.

A reconciliation of activity to the liability is as follows:

	In thousands
Costs incurred and expensed	$ 7,982
Costs paid	(6,748)
Adjustment to accruals	(79)
Ending liability, October 31, 2006	$ 1,155

15. Subsequent Events

On November 7, 2006, we entered into an accelerated share repurchase program whereby we purchased and retired 1 million shares of our common stock from an investment bank at the closing price that day of $26.48 per share. Total consideration paid to purchase the shares of $26.6 million, including $118,800 in commissions and other fees, was recorded in "Stockholders' equity" as a reduction in "Common stock." As

art of the accelerated share repurchase, we simultaneously entered into a forward sale contract with the investment bank that is expected to mature in approximately 50 trading days. Under the terms of the forward sale contract, the investment bank is required to purchase, in the open market, 1 million shares of our common stock during the term of the contract to fulfill its obligation related to the shares it borrowed from third parties and sold to us. At settlement, we, at our option, are required to either pay cash or issue registered or unregistered shares of our common stock to the investment bank if the investment bank's weighted average purchase price is higher than the November 7, 2006, closing price. The investment bank is required to pay us either cash or shares of our common stock, at our option, if the investment bank's weighted average price for the shares purchased is lower than the November 7, 2006, closing price.

* * * * *

Selected Quarterly Financial Data (In thousands except per share amounts)

	Operating Revenues	Margin	Operating Income (Loss)	Net Income (Loss)	Earnings (Loss) per Share of Common Stock Basic	Earnings (Loss) per Share of Common Stock Diluted
Fiscal Year 2006						
January 31	$ 921,347	$ 209,372	$ 81,161	$ 71,997	$ 0.94	$ 0.94
April 30	483,198	154,010	44,200	43,742	0.57	0.57
July 31	237,874	72,982	(1,026)	(12,389)	(0.16)	(0.16)
October 31	282,209	87,115	6,414	(6,161)	(0.08)	(0.08)
Fiscal Year 2005						
January 31	$ 680,556	$ 202,620	$ 78,919	$ 71,277	$ 0.93	$ 0.93
April 30	508,035	140,657	40,914	39,632	0.52	0.52
July 31	232,912	76,616	2,984	(4,666)	(0.06)	(0.06)
October 31	339,588	79,246	2,483	(4,973)	(0.06)	(0.06)

The pattern of quarterly earnings is the result of the highly seasonal nature of the business as variations in weather conditions generally result in greater earnings during the winter months. Basic earnings per share are calculated using the weighted average number of shares outstanding during the quarter. The annual amount may differ from the total of the quarterly amounts due to changes in the number of shares outstanding during the year.

Item 9. ***Changes in and Disagreements with Accountants on Accounting and Financial Disclosure***

None.

Controls and Procedures

Management's Evaluation of Disclosure Controls and Procedures

Management, including the President and Chief Executive Officer and the Senior Vice President and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures. Such disclosure controls and procedures are designed to ensure that all information required to be disclosed in our reports filed with the SEC is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Based on our evaluation process, the Chief Executive Officer and the Chief Financial Officer have concluded that we have effective disclosure controls and procedures as of October 31, 2006. Management's report on internal control over financial reporting and the attestation report of our independent registered public accounting firm are on Page 70 and Page 71, respectively. There were no changes in our internal control over financial reporting during the fourth quarter that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

January 12, 2007

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal ɔntrol over financial reporting as that term is defined in Rules 13a-15(f) under the Securities Exchange Act of 1934 is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. The Company's internal control over financial reporting is supported by a program of internal audits and appropriate reviews by management, written policies and guidelines, careful selection and training of qualified personnel and a written Code of Business Conduct and Ethics adopted by the Company's Board of Directors and applicable to all Company Directors, officers and employees.

Because of the inherent limitations, any system of internal control over financial reporting, no matter how well designed, may not prevent or detect misstatements due to the possibility that a control can be circumvented or overridden or that misstatements due to error or fraud may occur that are not detected. Also, projections of the effectiveness to future periods are subject to the risk that the internal controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies and procedures included in such controls may deteriorate.

We have conducted an evaluation of the effectiveness of our internal control over financial reporting based upon the framework in "Internal Control — Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based upon such evaluation, our management concluded that as of October 31, 2006, our internal control over financial reporting was effective.

Management's assessment of the effectiveness of our internal control over financial reporting as of October 31, 2006, has been audited by Deloitte and Touche LLP, an independent registered public accounting firm. Their attestation report is on Page 71.

Piedmont Natural Gas Company, Inc.

/s/ Thomas E. Skains

Thomas E. Skains
Chairman, President and Chief Executive Officer

/s/ David J. Dzuricky
David J. Dzuricky
Senior Vice President and Chief Financial Officer

/s/ Jose M. Simon
Jose M. Simon
Vice President and Controller

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Piedmont Natural Gas Company, Inc.

We have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that Piedmont Natural Gas Company Inc. and subsidiaries ("Piedmont") maintained effective internal control over financial reporting as of October 31, 2006, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Piedmont's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of Piedmont's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Piedmont maintained effective internal control over financial reporting as of October 31, 2006, is fairly stated, in all material respects, based on the criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also in our opinion, Piedmont maintained, in all material respects, effective internal control over financial reporting as of October 31, 2006, based on the criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements of Piedmont as of and for the year ended October 31, 2006, and our report dated January 12, 2007 expressed an unqualified opinion on those financial statements.

/s/ Deloitte & Touche LLP
Charlotte, North Carolina
January 12, 2007

Other Information

None.

PART III

Directors and Executive Officers of the Registrant

Information concerning our executive officers and directors is set forth in the sections entitled "Information Regarding the Board of Directors" and "Executive Officers" in our Proxy Statement for the 2007 Annual Meeting of Shareholders, which sections are incorporated in this annual report on Form 10-K by reference. Information concerning compliance with Section 16(a) of the Securities Exchange Act of 1934, as amended, is set forth in the section entitled "Section 16(a) Beneficial Ownership Reporting Compliance" in our Proxy Statement for the 2007 Annual Meeting of Shareholders, which section is incorporated in this annual report on Form 10-K by reference.

Information concerning our Audit Committee and our Audit Committee financial experts is set forth in the section entitled "Committees of the Board" in our Proxy Statement for the 2007 Annual Meeting of Shareholders, which section is incorporated in this annual report on Form 10-K by reference.

We have adopted a Code of Business Conduct and Ethics that is applicable to all our directors, officers and employees, including our principal executive officer, principal financial officer and principal accounting officer. The Code of Business Conduct and Ethics was filed as Exhibit 14.1 to our annual report on Form 10-K for the year ended October 31, 2003, and is available on our website at www.piedmontng.com . If we amend the Code of Business Conduct and Ethics or grant a waiver, including an implicit waiver, from the Code of Business Conduct and Ethics, we will disclose the amendment or waiver on our website within four business days of such amendment or waiver.

Executive Compensation

Information for this item is set forth in the sections entitled "Executive Compensation and Other Information," "Directors' Compensation Policy," "Compensation Committee Interlocks and Insider Participation," "Compensation Committee Report on Executive Compensation" and "Comparisons of Cumulative Total Shareholder Returns" in our Proxy Statement for the 2007 Annual Meeting of Shareholders, which sections are incorporated in this annual report on Form 10-K by reference.

Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Item 12.

Information for this item is set forth in the section entitled "Security Ownership of Management and Certain Beneficial Owners" in our Proxy Statement for the 2007 Annual Meeting of Shareholders, which section is incorporated in this annual report on Form 10- by reference.

We know of no arrangement, or pledge, which may result in a change in control. Information describing any material changes to the procedures for recommending nominees to the Board is set forth in the section entitled "Commonly Asked Questions" in our Proxy Statement for the 2007 Annual Meeting of Shareholders, which section is incorporated in this annual report on Form 10-K by reference.

Information concerning securities authorized for issuance under our equity compensation plans is set forth in the section entitled "Long-Term Incentive Plan Awards — Awards in Last Fiscal Year" in our Proxy Statement for the 2007 Annual Meeting of Shareholders, which section is incorporated in this annual report on Form 10-K by reference.

Certain Relationships and Related Transactions

Information for this item is set forth in the section entitled "Certain Relationships and Related Transactions" in our Proxy Statement for the 2007 Annual Meeting of Shareholders, which section is incorporated in this annual report on Form 10-K by reference.

Principal Accounting Fees and Services

Information for this item is set forth in the section entitled "Fees For Services" in "Proposal B — Ratification of Deloitte & Touche As Independent Registered Public Accounting Firm For Fiscal Year 2007" in our Proxy Statement for the 2007 Annual Meeting of Shareholders, which section is incorporated in this annual report on Form 10-K by reference.

PART IV

Exhibits, Financial Statement Schedules

(a) 1. *Financial Statements*

The following consolidated financial statements for the year ended October 31, 2006, are included in Item 8 of this report as follows:

	Page
Consolidated Balance Sheets — October 31, 2006 and 2005	33
Consolidated Statements of Income — Years Ended October 31, 2006, 2005 and 2004	34
Consolidated Statements of Cash Flows — Years Ended October 31, 2006, 2005 and 2004	35
Consolidated Statements of Stockholders' Equity — Years Ended October 31, 2006, 2005 and 2004	36
Notes to Consolidated Financial Statements	37

(a) 2. *Supplemental Consolidated Financial Statement Schedules*

None

Schedules and certain other information are omitted for the reason that they are not required or are not applicable, or the required information is shown in the consolidated financial statements or notes thereto.

(a) 3. *Exhibits*

Where an exhibit is filed by incorporation by reference to a previously filed registration statement or report, such registration statement or report is identified in parentheses. Upon written request of a shareholder, we will provide a copy of the exhibit at a nominal charge.

The exhibits numbered 10.1 through 10.26 are management contracts or compensatory plans or arrangements.

3 .1 Articles of Incorporation of the Company as of March 3, 2006, filed in the Department of State of the State of North Carolina (Exhibit 4.1, Form S-8 Registration Statement No. 333-132738).

3 .2 Copy of Certificate of Merger (New York) and Articles of Merger (North Carolina), each dated March 1, 1994, evidencing merger of Piedmont Natural Gas Company, Inc., with and into PNG Acquisition Company, with PNG Acquisition Company being renamed "Piedmont Natural Gas Company, Inc." (Exhibits 3.2 and 3.1, Registration Statement on Form 8-B, dated March 2, 1994).

3 .3 By-Laws, dated February 27, 2004 (Exhibit 3.1, Form 10-Q for the quarter ended April 30, 2004).

4 .1 Note Agreement, dated as of September 21, 1992, between Piedmont and Provident Life and Accident Insurance Company (Exhibit 4.30, Form 10-K for the fiscal year ended October 31, 1992).

4 .2 Indenture, dated as of April 1, 1993, between Piedmont and Citibank, N.A., Trustee (Exhibit 4.1, Form S-3 Registration Statement No. 33-59369).

4 .3 Medium-Term Note, Series A, dated as of July 23, 1993 (Exhibit 4.7, Form 10-K for the fiscal year ended October 31, 1993).

4 .4 Medium-Term Note, Series A, dated as of October 6, 1993 (Exhibit 4.8, Form 10-K for the fiscal year ended October 31, 1993).

4 .5 First Supplemental Indenture, dated as of February 25, 1994, between PNG Acquisition Company, Piedmont Natural Gas Company, Inc., and Citibank, N.A., Trustee (Exhibit 4.2, Form S-3 Registration Statement No. 33-59369).

4 .6 Medium-Term Note, Series A, dated as of September 19, 1994 (Exhibit 4.9, Form 10-K for the fiscal year ended October 31, 1994).

4 .7 Pricing Supplement of Medium-Term Notes, Series B, dated October 3, 1995 (Exhibit 4.10, Form 10-K for the fiscal year ended October 31, 1995).

4 .8 Pricing Supplement of Medium-Term Notes, Series B, dated October 4, 1996 (Exhibit 4.11, Form 10-K for the fiscal year ended October 31, 1996).

4 .9 Rights Agreement, dated as of February 27, 1998, between Piedmont and Wachovia Bank, N.A., as Rights Agent, including the Rights Certificate (Exhibit 10.1, Form 8-K dated February 27, 1998).

4 .10 Agreement of Substitution and Amendment of Common Shares Rights Agreement, dated as of December 18, 2003, between Piedmont and American Stock Transfer and Trust Company, Inc. (Exhibit 4.10, Form S-3 Registration Statement No. 333-111806).

4 .11 Form of Master Global Note, executed September 9, 1999 (Exhibit 4.4, Form S-3 Registration Statement No. 333-26161).

4 .12 Pricing Supplement of Medium-Term Notes, Series C, dated September 15, 1999 (Rule 424(b)(3) Pricing Supplement to Form S-3 Registration Statement Nos. 33-59369 and 333-26161).

4 .13 Pricing Supplement of Medium-Term Notes, Series C, dated September 15, 1999 (Rule 424(b)(3) Pricing Supplement to Form S-3 Registration Statement Nos. 33-59369 and 333-26161).

4 .14 Pricing Supplement No. 3 of Medium-Term Notes, Series C, dated September 26, 2000 (Rule 424(b)(3) Pricing Supplement to Form S-3 Registration Statement No. 333-26161).

4 .15 Form of Master Global Note, executed June 4, 2001 (Exhibit 4.4, Form S-3 Registration Statement No. 333-62222).

4 .16 Pricing Supplement No. 1 of Medium-Term Notes, Series D, dated September 18, 2001 (Rule 424(b)(3) Pricing Supplement to Form S-3 Registration Statement No. 333-62222).

4 .17 Second Supplemental Indenture, dated as of June 15, 2003, between Piedmont and Citibank, N.A., Trustee (Exhibit 4.3, Form S-3 Registration Statement No. 333-106268).

4 .18 Form of 5% Medium-Term Note, Series E, dated as of December 19, 2003 (Exhibit 99.1, Form 8-K, dated December 23, 2003).

4 .19 Form of 6% Medium-Term Note, Series E, dated as of December 19, 2003 (Exhibit 99.2, Form 8-K, dated December 23, 2003).

4 .20 Third Supplemental Indenture, dated as of June 20, 2006, between Piedmont Natural Gas Company, Inc. and Citibank, N.A., as trustee (Exhibit 4.1, Form 8-K dated June 20, 2006).

4 .21 Form of 6.25% Insured Quarterly Note Series 2006, Due 2036 (Exhibit 4.2 (as included in Exhibit 4.1), Form 8-K dated June 20, 2006).

Compensatory Contracts:

10 .1 Form of Director Retirement Benefits Agreement with outside directors, dated September 1, 1999 (Exhibit 10.54, Form 10-K for the fiscal year ended October 31, 1999).

10 .2 Resolution of Board of Directors, September 2, 2005, establishing compensation for non-management directors (Exhibit 10.1, Form 8-K dated September 9, 2005).

10 .3 Executive Long-Term Incentive Plan, dated February 27, 2004 (Exhibit 10.2, Form 10-Q for quarter ended April 30, 2004).

10 .4 Establishment of Measures for Long-Term Incentive Plan #10 (filed in Form 8-K dated October 20, 2006, as Item 1.01).

10 .5 Form of Award Agreement under Executive Long-Term Incentive Plan.

10 .6 Employment Agreement with David J. Dzuricky, dated December 1, 1999 (Exhibit 10.37, Form 10-K for the fiscal year ended October 31, 1999).

10 .7 Employment Agreement with Thomas E. Skains, dated December 1, 1999 (Exhibit 10.40, Form 10-K for the fiscal year ended October 31, 1999).

10 .8 Employment Agreement with Franklin H. Yoho, dated March 18, 2002 (Exhibit 10.23, Form 10-K for the fiscal year ended October 31, 2002).

10 .9 Employment Agreement with Michael H. Yount, dated May 1, 2006 (Exhibit 10.1, Form 10-Q for the quarter ended April 30, 2006).

10 .10 Employment Agreement with Kevin M. O'Hara, dated May 1, 2006 (Exhibit 10.2, Form 10-Q for the quarter ended April 30, 2006).

10 .11 Severance Agreement with David J. Dzuricky, dated December 1, 1999 (Exhibit 10.41, Form 10-K for the fiscal year ended October 31, 1999).

10 .12 Severance Agreement with Thomas E. Skains, dated December 1, 1999 (Exhibit 10.44, Form 10-K for the fiscal year ended October 31, 1999).

10 .13 Severance Agreement with Franklin H. Yoho, dated March 18, 2002 (Exhibit 10.28, Form 10-K for the fiscal year ended October 31, 2002).

10 .14 Severance Agreement with Michael H. Yount, dated May 1, 2006 (Exhibit 10.3, Form 10-Q for the quarter ended April 30, 2006).

10 .15 Severance Agreement with Kevin M. O'Hara, dated May 1, 2006 (Exhibit 10.4, Form 10-Q for the quarter ended April 30, 2006).

10 .16 Severance Agreement with June B. Moore, dated May 1, 2006 (Exhibit 10.5, Form 10-Q for the quarter ended April 30, 2006).

10 .17 Severance Agreement with Jane R. Lewis-Raymond, dated May 1, 2006 (Exhibit 10.6, Form 10-Q for the quarter ended April 30, 2006).

10 .18 Piedmont Natural Gas Company, Inc. Supplemental Executive Benefit Plan (Amended and Restated as of November 1, 2004) (Exhibit 10.1, Form 8-K dated December 10, 2004).

10 .19 Form of Participation Agreement under the Piedmont Natural Gas Company, Inc. Supplemental Executive Benefit Plan (Amended and Restated as of November 1, 2004) (with supplemental retirement benefit) (Exhibit 10.14, Form 10-K for the fiscal year ended October 31, 2004).

10 .20 Form of Participation Agreement under the Piedmont Natural Gas Company, Inc. Supplemental Executive Benefit Plan (Amended and Restated as of November 1, 2004) (without supplemental retirement benefit) (Exhibit 10.15, Form 10-K for the fiscal year ended October 31, 2004).

10 .21 Piedmont Natural Gas Company, Inc. Short-Term Incentive Plan (STIP) (effective November 1, 2003) (Exhibit 10.16, Form 10-K for the fiscal year ended October 31, 2004).

10 .22 Form of Participation Agreement under the Piedmont Natural Gas Company, Inc. Short-Term Incentive Plan (STIP).

10 .23 Establishment of Measures for 2007 Short-Term Incentive Plan (filed in Form 8-K dated October 20, 2006, as Item 1.01).

10 .24 Jerry W. Amos Engagement Letter dated January 3, 2005 (Exhibit 10.1, Form 8-K filed January 6, 2005) (Exhibit 10.18, Form 10-K for the fiscal year ended October 31, 2004).

10 .25 Piedmont Natural Gas Company, Inc. Incentive Compensation Plan (Exhibit 10.1, Form 8-K dated March 3, 2006).

10 .26 Restricted Stock Award Agreement between Piedmont Natural Gas Company, Inc. and Thomas E. Skains, dated September 1, 2006.

Other Contracts:

10 .27 Amended and Restated Limited Liability Company Agreement of SouthStar Energy Services LLC, effective January 1, 2004, between Piedmont Energy Company and Georgia Natural Gas Company (Exhibit 10.1, Form 10-Q for the quarter ended April 30, 2004).

10 .28 First Amendment to Amended and Restated Limited Liability Company Agreement of SouthStar Energy Services LLC, dated as of July 31, 2006, between Piedmont Energy Company and Georgia Natural Gas Company.

10 .29 Amendment by Written Consent to Amended and Restated Limited Liability Company Agreement of SouthStar Energy Services LLC, dated as of August 28, 2006, between Piedmont Energy Company and Georgia Natural Gas Company.

10 .30 Amendment by Written Consent to Amended and Restated Limited Liability Company Agreement of SouthStar Energy Services LLC, dated as of September 20, 2006, between Piedmont Energy Company and Georgia Natural Gas Company.

10 .31 Equity Contribution Agreement, dated as of November 12, 2004, between Columbia Gas Transmission Corporation and Piedmont Natural Gas Company (Exhibit 10.1, Form 8-K dated November 16, 2004).

10 .32 Construction, Operation and Maintenance Agreement by and Between Columbia Gas Transmission Corporation and Hardy Storage Company, LLC, dated November 12, 2004 (Exhibit 10.2, Form 8-K dated November 16, 2004).

10 .33 Operating Agreement of Hardy Storage Company, LLC, dated as of November 12, 2004 (Exhibit 10.3, Form 8-K dated November 16, 2004).

10 .34 Guaranty of Principal dated as of June 29, 2006, by Piedmont Energy Partners, Inc. in favor of U.S. Bank National Association, as agent (Exhibit 10.1, Form 8-K dated July 5, 2006).

10 .35 Residual Guaranty dated as of June 29, 2006, by Piedmont Energy Partners, Inc. in favor of U.S. Bank National Association, as agent (Exhibit 10.2, Form 8-K dated July 5, 2006).

12 Computation of Ratio of Earnings to Fixed Charges.

21 List of Subsidiaries.

23 .1 Consent of Independent Registered Public Accounting Firm.

31 .1 Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 of the Chief Executive Officer.

31 .2 Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 of the Chief Financial Officer.

32 .1 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 of the Chief Executive Officer.

32 .2 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 of the Chief Financial Officer.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Piedmont Natural Gas Company, Inc.
(Registrant)

By: /s/ Thomas E. Skains

Thomas E. Skains
Chairman of the Board, President
and Chief Executive Officer

Date: January 12, 2007

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ Thomas E. Skains Thomas E. Skains	Chairman of the Board, President and Chief Executive Officer (Principal Executive Officer)	January 12, 2007
/s/ David J. Dzuricky David J. Dzuricky	Senior Vice President and Chief Financial Officer (Principal Financial Officer)	January 12, 2007
/s/ Jose M. Simon Jose M. Simon	Vice President and Controller (Principal Accounting Officer)	January 12, 2007

Signature	Title	Date
/s/ Jerry W. Amos :rry W. Amos	Director	January 12, 2007
/s/ E. James Burton E. James Burton	Director	January 12, 2007
/s/ D. Hayes Clement D. Hayes Clement	Director	January 12, 2007
/s/ Malcolm E. Everett III Malcolm E. Everett III	Director	January 12, 2007
/s/ John W. Harris John W. Harris	Director	January 12, 2007
/s/ Aubrey B. Harwell, Jr. Aubrey B. Harwell, Jr.	Director	January 12, 2007
/s/ Muriel W. Sheubrooks luriel W. Sheubrooks	Director	January 12, 2007
/s/ Frank B. Holding, Jr. Frank B. Holding, Jr.	Director	January 12, 2007
/s/ Minor M. Shaw Minor M. Shaw	Director	January 12, 2007
/s/ David E. Shi David E. Shi	Director	January 12, 2007
/s/ Vicki McElreath Vicki McElreath	Director	January 12, 2007

Piedmont Natural Gas Company, Inc.
Form 10-K
For the Fiscal Year Ended October 31, 2006
Exhibits

10 .5 Form of Award Agreement under Executive Long-Term Incentive Plan

10 .22 Form of Participation Agreement under the Piedmont Natural Gas Company, Inc. Short-Term Incentive Plan (STIP)

10 .26 Restricted Stock Award Agreement between Piedmont Natural Gas Company, Inc. and Thomas E. Skains, dated September 1, 2006

10 .28 First Amendment to Amended and Restated Limited Liability Company Agreement of SouthStar Energy Services LLC, dated as of July 31, 2006, between Piedmont Energy Company and Georgia Natural Gas Company

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32 .1 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 of the Chief Executive Officer

32 .2 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 of the Chief Financial Officer

Exhibit 10.5

AGREEMENT

THIS AGREEMENT, made and entered into this the ______ day of ____________, 20___, by and between Piedmont Natural Gas ompany, Inc. (the "Company") and ________________________ (the "Participant").

WITNESSETH:

WHEREAS, the Company's Executive Long-Term Incentive Plan was adopted by the Company's Board of Directors on August 22, 2003, approved by the Shareholders of the Company at the Annual Meeting of Shareholders held on February 27, 2004 and amended by the Company's Board of Directors on February 27, 2004 (the 2003 Long-Term Incentive Plan, as amended, being referred to herein as the "Plan"); and

WHEREAS, the Company's Board of Directors on ____________, 20___, established a three-year performance period under the Plan beginning November 1, 20___ (the "Performance Period"), and the Company's Board of Directors accepted the recommendation of its Compensation Committee (the "Committee") as to the Unit awards for the ____________ Performance Period; and

WHEREAS, the Participant has been awarded ____________ (____________) Units, as defined in Section 2.1 of the Plan, for the ____________ Performance Period.

NOW, THEREFORE, in consideration of these premises and the mutual promises contained herein, the parties hereto hereby agree as follows:

1. Except as otherwise provided in this Agreement, the Participant's award shall only be distributed at the end of the Performance Period. The percentage of the Units awarded to the Participant that shall be distributed to the Participant shall depend on the levels of financial

performance and other performance achieved during the Performance Period as set forth on Exhibit A attached hereto. No distributions of Units shall be made with respect to a particular measure of performance if the minimum percentage of the applicable measure of performance is not achieved for the Performance Period as set forth on Exhibit A . The financial performance levels achieved for each Performance Period and the percentage of Units to be distributed shall be conclusively determined by the Board of Directors.

2. The percentage of Units awarded to the Participant which the Participant shall become entitled to receive based on the levels of performance (the "Retained Units") shall be distributed in the form of a combination of shares and cash consisting of a number of the Company's common shares ("Shares") equal to fifty percent (50%) of the number of Retained Units and cash equal in value to fifty percent (50%) of the number of Retained Units, with the Participant having the option to elect a greater percent distribution in Shares. The Units awarded but which the Participant does not become entitled to receive shall be cancelled. At the end of the Performance Period the Participant shall receive payment for any Retained Units in the form of a lump sum distribution of Shares and cash in accordance with the provisions of the Plan. Such lump sum distribution of Shares and cash shall be paid within 2.5 months of the end of the Performance Period.

3. No award of Units to the Participant shall entitle the Participant to any right as a stockholder of the Company.

4. In case of the death of the Participant prior to the end of the Performance Period, the Units awarded under this Plan shall be paid in accordance with Section 5.1 of the Plan. In the event a Participant terminates employment prior to the end of any Performance Period under circumstances entitling the Participant to a retirement pension or benefit under the Company's

defined benefit pension plan or any other plan substituted for or supplementing said plan, the number of Units awarded for the Performance Period shall be prorated to the end of the month in which such termination occurs and distributed at the end of the Performance Period based upon the Company's performance for such Performance Period. Absence of the Participant prior to the end of any Performance Period under circumstances entitling the Participant to Sickness Allowance and/or Long Term Disability Benefits under the Company's plan, or to a benefit of a similar type substituted under or for or supplementing any such plan, or a benefit under a plan which the Company determines to be comparable, shall not affect Units previously granted under the Plan.

5. In the event of any other termination of employment or leave of absence prior to the end of any Performance Period, all Units awarded to the Participant with respect to such Performance Period shall be immediately forfeited and cancelled.

6. All Units awarded to the Participant and not previously distributed in accordance with the Plan shall be forfeited and cancelled in their entirety if the Participant is discharged for cause or, without the consent of the Company, becomes associated with, employed by, renders services to, consults with, acquires ownership of more than five percent (5%) of any class of stock of, or acquires beneficial ownership of more than five percent (5%) of the earnings or profits of any corporation, partnership, proprietorship, trust, or other entity which in the judgment of the Company's Board of Directors competes directly or through any affiliate with the Company or any subsidiary in any of their lines of business.

7. In the event of involuntary termination of employment of the Participant in connection with, or at any time following, any Change of Control of the Company, the Participant shall be entitled to the number of Units awarded for the Performance Period, reduced

in proportion to the number of months remaining in the Performance Period after the date of termination. In connection with this Agreement, the term "Change of Control" shall mean (a) the adoption of a plan of merger or consolidation of the Company with any ·ther corporation or business association of any type as a result of which the holders of the voting capital stock of the Company as a oup would receive less than 50% of the voting capital stock of the surviving or resulting corporation; and (b) the acquisition of more than 20% of the voting capital stock of the Company by any Person within the meaning of Section 13(d)(3) of the Securities Exchange Act of 1934, as amended. The term "Person" means any individual or a corporation, partnership, trust, limited liability company, association, joint venture, pool, syndicate, sole proprietorship, unincorporated organization or any other form of entity not specifically listed herein.

8. The Participant's award under the Plan may not be assigned or alienated.

9. Neither the Plan, nor this Agreement, nor any action taken under the Plan or this Agreement shall be construed as giving to the Participant the right to be retained in the employ of the Company.

10. The Company shall have the right to deduct from any distribution or payment in cash under the Plan, and the Participant shall be required to pay to the Company, any federal, state or local taxes required by law to be withheld with respect to such distribution or payment. The number of Shares to be distributed to the Participant may be reduced by the number of Shares equivalent in value to the cash necessary to pay any withholding tax where the cash to be distributed is not sufficient to pay such tax, or the Participant may deliver to the Company cash sufficient to pay such taxes.

11. Any distribution of Shares may be delayed until the requirements of any applicable laws or regulations or any stock exchange requirements are satisfied. The Shares

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distributed to the Participant shall be subject to such restrictions and conditions on disposition as counsel for the Company shall determine to be desirable or necessary under applicable law.

12. Notwithstanding any other provision of the Plan, no distributions of Units shall be made if, at the time a distribution would herwise have been made (a) the regular quarterly dividend on any outstanding common or preferred Shares of the Company has been omitted and not subsequently paid or there exists any default in payment of dividends on any such outstanding Shares; (b) estimated consolidated net income for the Company for the twelve (12) month period preceding the month the distribution would otherwise have been made is less than the sum of the amount of the awards eligible for distribution under the Plan in that month plus all dividends applicable to such period on an accrual basis, either paid, declared or accrued at the most recently paid rate, on all outstanding preferred and common Shares of the Company; or (c) the distribution would result in a default in any agreement by which the Company is bound.

13. The Participant may designate a beneficiary or beneficiaries to receive all or part of the Units to be distributed to him/her under the Plan in case of death of the Participant. Any such Units awarded under this Plan shall be distributed to the beneficiary (ies) designated in Exhibit B that is incorporated herein for all purposes. If no beneficiary (ies) is designated, such Units shall be paid to the estate of the Participant.

14. The Participant acknowledges that the award of Units to him/her under the Plan is governed by the terms of the Plan, as amended from time to time, and the terms of the Plan as they exist on the date of this Agreement are incorporated into this Agreement in their entirety and made a part hereof by reference. Unless otherwise defined herein, capitalized

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terms used herein shall have the meaning set forth in the Plan. In the event of any conflict between the terms of the Plan and this Agreement, the terms of the Plan shall control.

15. Any claim under the Plan by the Participant or anyone claiming through the Participant shall be presented to the Committee in ;cordance with Section 11.0 of the Plan.

16. The Board of Directors shall have authority to administer and interpret the Plan and to establish rules for its administration.

17. If any provision or provisions of the Plan or this Award Agreement would cause any amount to be includible in gross income of the Participant prior to the Company's scheduled payment of such amount to the Participant provided for herein or subject such Participant to penalties or interest under Section 409A of the Internal Revenue Code of 1986, as amended, such provision or provisions shall be interpreted or modified to the extent necessary so that no such amount will be included in such Participant's gross income prior to its scheduled payment by the Company provided for herein and no such penalties or interest will be incurred.

18. This Agreement shall be governed by the laws of the State of North Carolina to the extent not preempted by applicable federal law.

IN WITNESS WHEREOF, the parties hereto have executed or caused this Agreement to be executed in duplicate as of the date first above written.

PIEDMONT NATURAL GAS COMPANY, INC.

By: ________________________________

Chairman, President and Chief Executive Officer

____

Participant

Exhibit 10.22

PARTICIPATION AGREEMENT
UNDER THE
PIEDMONT NATURAL GAS COMPANY, INC.
SHORT-TERM INCENTIVE PLAN (STIP)

Piedmont Natural Gas Company, Inc. (the "Company") and ___________ ("Participant") hereby enter into this Participation Agreement as of ___________, 20___ under the Piedmont Natural Gas Company, Inc. Short-Term Incentive Plan (STIP) for the fiscal year 20___, approved by the Board of Directors on ___________, 20___.

1. Designation as a Participant. You have been designated as a Participant under the Plan for the fiscal year 20___. Exhibit A attached hereto identifies the target award applicable to you. The award is a cash payment. Subject to Stock Ownership Guidelines, a participant who does not meet their stock ownership goal due to stock sales will be required to use a minimum of 25% (net of applicable taxes) of any short-term incentive award to purchase Piedmont stock until the applicable ownership level is achieved. As a participant, you shall be subject to all the terms and conditions of the Plan, which are hereby incorporated by reference, and this Participation Agreement.

2. Performance Period. The fiscal year 20___ Plan performance period begins November 1, 20___ and ends October 31, 20___.

3. Performance Goals. The fiscal year 20___ Plan performance goals are established by the Board of Directors. The table below identifies the performance/payment relationship for the fiscal year 20___ Plan.

Performance Against EPS Goal	Payout as a Percent of Incentive Opportunity
> = 105% of Goal (> = $x.xx)	150%
100% of Goal ($x.xx)	100%
95% of Goal ($x.xx)	50%
< 95% of Goal (< = $x.xx)	0%

Payouts for performance between 95% and 105% of goal will be subject to mathematical interpolation.

4. Tax Withholding. The Company will withhold any required taxes for any target awards distributed to you in compliance with tax withholding regulations.

5. Change of Employment Status. Changes in position during fiscal year 20___ which create revised target awards, or hires/promotion to STIP participation will be prorated based on the number of months of actual participation.

Unless otherwise determined by the Board, any resignation or termination of the participant prior to the end of the fiscal year 20___performance period immediately terminates participation and causes a forfeiture and cancellation of all Plan benefits and wards.

In the event of a participant's death, disability or retirement prior to the date the award is paid, the following shall apply: (i) In the event of the participant's death or disability before the end of the performance period, the Company will be assumed to have achieved a target performance level for the performance period in which the death or disability occurs for purposes of determining the award. In the event of the participant's death or disability after the end of the performance period, but before the date the award is paid, the participant's award shall be payable based on the actual performance criteria for the entire period. (ii) In the event of a participant's retirement, the participant's award shall be determined and payable following the end of the performance period based on the actual performance criteria for the entire period. (iii) The amount of the award shall be prorated as necessary to reflect the period of time during which the individual was employed in the performance period.

This Notice of participation is subject to all terms and conditions of the Short-Term Incentive Plan as interpreted by the Company's Board of Directors.

IN WITNESS WHEREOF, the parties have executed this Agreement as of the day and year written above.

Piedmont Natural Gas Company, Inc.

By ______________________________

____

Participant

Exhibit 10.26

Piedmont Natural Gas Company, Inc.
Restricted Stock Award Agreement

Piedmont Natural Gas Company, Inc. hereby grants you, Thomas E. Skains (the "Employee"), a grant of time-vested restricted stock pursuant to and subject to the provisions of the Piedmont Natural Gas Company, Inc. Incentive Compensation Plan (the "Plan") and to the terms and conditions set forth on the following pages. The intention of this grant is to support the Company's strategy to retain the current Chairman, President and Chief Executive Officer. This grant of restricted stock is not intended to replace any current benefit or incentive programs in which the Employee currently participates.

The date of this Restricted Stock Award Agreement (this "Agreement") is September 1, 2006 (the "Grant Date").

The initial grant of Restricted Stock is **65,000** shares of Common Stock of the Company (the "Shares").

The Shares shall vest and no longer be subject to forfeiture or restriction in accordance with the following schedule:

Year	Number of Vested Shares
September 1, 2007	0
September 1, 2008	0
September 1, 2009	13,000
September 1, 2010	19,500
September 1, 2011	32,500

During the period when the Shares are not vested (the "Vesting Period") but prior to vesting or forfeiture of the Shares, any dividends paid on the Shares will be accrued and converted into additional Shares which additional Shares will be subject to the same restrictions on transferability and forfeitability as the original Shares with respect to which they were distributed.

Your signature below indicates your agreement and understanding to the terms and conditions of this Agreement.

Piedmont Natural Gas Company, Inc.

/s/ John W. Harris
John W. Harris
Chair, Compensation Committee
Board of Directors

Employee

/s/ Thomas E. Skains
Thomas E. Skains
Chairman, President and CEO

TERMS AND CONDITIONS OF RESTRICTED STOCK GRANT

1. Definitions. Capitalized terms used herein and not otherwise defined shall have the meaning assigned to such terms in the Plan.
`. Grant. The Company hereby grants to the Employee, subject to all of the terms and conditions set forth in the Plan and in this greement, the Shares indicated on Page 1.
3. Shares Held in Escrow. As of the Grant Date, the Shares will be issued in the name of the Employee and held by the Secretary of the Company as escrow agent (the " Escrow Agent "), and will not be sold, transferred or otherwise disposed of, and will not be pledged or otherwise hypothecated until the Shares are vested in accordance with this Agreement. The Company may instruct the transfer agent for its Common Stock to place a legend on the certificates representing the Shares or otherwise note its record as to the restrictions on transfer set forth in this Agreement. Subject to Section 15, at the time the Shares have vested and all other terms and conditions in this Agreement have been satisfied, the certificate or certificates representing such Shares will be delivered by the Escrow Agent to the Employee.
4. Vesting Schedule. As of the Grant Date, the Shares shall be "Unvested Shares" and fully forfeitable. Except as provided in Section 5, and subject to Section 6, the Unvested Shares shall become " Vested Shares " in accordance with the vesting schedule specified on page 1. Vesting actually will occur only if the Company or a Subsidiary employs the Employee through the applicable vesting date.
5. Board Discretion on Vesting. The Board, in its discretion, may accelerate the vesting of the balance, or some lesser portion of the balance, of the Unvested Shares at any time. If so accelerated, such Shares will be considered as having vested as of the date specified by the Board.
6. Forfeiture. Notwithstanding any contrary provision of this Agreement, if the Employee's employment with the Company terminates for any reason prior to the Unvested Shares becoming Vested Shares in accordance with Section 4 or Section 5, Employee shall forfeit all of Employee's right, title and interest in and to the Unvested Shares as of the date of Employee's termination of employment, and such Unvested Shares shall automatically revert to the Company at no cost to the Company immediately following the event of forfeiture. The Employee hereby appoints the Escrow Agent with full power of substitution, as the Employee's true and lawful attorney-in-fact with irrevocable power and authority in the name and on behalf of the Employee to take any action and execute all documents and instruments, including, without limitation, stock powers which may be necessary to transfer the certificate or certificates evidencing such Unvested Shares to the Company upon such forfeiture.
7. Death of Employee. Any distribution or delivery to be made to the Employee under this Agreement will, if the Employee is then deceased, be made to the Employee's designated beneficiary, or if no beneficiary survives the Employee, to the administrator or executor of the Employee's estate. Any such transferee must furnish the Company with (a) written notice of his or her status as ansferee, and (b) evidence satisfactory to the Company to establish the validity

of the transfer and compliance with any laws or regulations pertaining to said transfer.
8. Payment and Withholding of Taxes. Notwithstanding any contrary provision of this Agreement, no certificate representing the Shares may be released from the escrow established pursuant to Section 3 unless and until satisfactory arrangements (as determined by the Committee) have been made by the Employee with respect to the payment of income and employment taxes which the Company determines must be withheld with respect to such Shares. The Committee, in its sole discretion and pursuant to such procedures as it may specify from time to time, may permit the Employee to satisfy such tax withholding obligation, in whole or in part by (a) electing to have the Company withhold otherwise deliverable Vested Shares, or (b) delivering to the Company already vested and owned shares of Company stock having a Fair Market Value equal to the minimum amount required to be withheld.
9. Rights as Stockholder. The Employee, as beneficial owner of the Shares, shall have all of the rights and privileges of a stockholder of the Company in respect of any Shares deliverable hereunder at the time certificates representing such Shares have been issued, recorded on the records of the Company or its transfer agents or registrars, and delivered to the Employee or the Escrow Agent. During the Vesting Period, any dividends paid on the Shares shall be treated as described on the first page of this Agreement.
10. No Effect on Employment. The Employee's employment with the Company and its Subsidiaries is on an at-will basis only. Accordingly, the terms of the Employee's employment with the Company and its Subsidiaries will be determined from time to time by the Company or the Subsidiary employing the Employee (as the case may be), and the Company or the Subsidiary will have the right, which is hereby expressly reserved, to terminate or change the terms of the employment of the Employee at any time for any reason whatsoever, with or without good cause, subject to the terms of the employment agreement between the Employee and the Company dated December 1, 1999.
11. Changes in Shares. In the event of any merger, reorganization, consolidation, recapitalization, separation, liquidation, stock dividend, split-up, share combination, or other change in the corporate structure of the Company that affects the Shares, the Shares will be increased, reduced or otherwise changed to the extent the Board deems any such change necessary or appropriate to put the Employee in the same economic position as he was in immediately before such event. If the Employee receives rights or warrants with respect to any Shares, such rights or warrants may be held or exercised by the Employee, provided that until such exercise any such rights or warrants and after such exercise any shares or other securities acquired by the exercise of such rights or warrants will be considered to be Shares and will be subject to all of the conditions and restrictions applicable to Shares pursuant to this Agreement.
12. Address for Notices. Any notice to be given to the Company under the terms of this Agreement will be addressed to the Company, in care of Vice President — General Counsel, Corporate Secretary and Chief Compliance Officer at Piedmont Natural Gas Company, Inc., 4720 Piedmont Row Drive, Charlotte, NC 28210, or at such other address as the Company may hereafter designate in writing.

13. Grant is Not Transferable. Except to the limited extent provided in Section 7 above, this grant and the rights and privileges conferred hereby will not be transferred, assigned, pledged or hypothecated in any way (whether by operation of law or otherwise) and will not be subject to sale under execution, attachment or similar process. Upon any attempt to transfer, assign, pledge, hypothecate or otherwise dispose of this grant, or any right or privilege conferred hereby, or upon any attempted sale under any execution, attachment or similar process, this grant and the rights and privileges conferred hereby immediately will become null and void.
14. Binding Agreement. Subject to the limitation on the transferability of this grant contained herein, this Agreement will be binding upon and inure to the benefit of the heirs, legatees, legal representatives, successors and assigns of the parties hereto.
15. Additional Conditions to Release from Escrow. If at any time the Company determines, in its discretion, that the listing, registration or qualification of the Shares upon any securities exchange or under any state or federal law, or the consent or approval of any governmental regulatory authority is necessary or desirable as a condition to the release of such Shares from the escrow established pursuant to Section 3, such release will not occur unless and until such listing, registration, qualification, consent or approval will have been effected or obtained free of any conditions not acceptable to the Company. The Company will make all reasonable efforts to meet the requirements to any such state or federal law or securities exchange and to obtain any such consent or approval of any such governmental authority.
16. Committee Authority. The Compensation Committee of the Board, with approval from the Board, will have the power and discretion to interpret this Agreement and to adopt such rules for the administration, interpretation and application of the Agreement as are consistent herewith and to interpret or revoke any such rules (including, but not limited to, the determination of whether or not any Shares have vested). All actions taken and all interpretations and determinations made by the Committee in good faith will be final and binding upon the Employee, the Company and all other interested persons. No member of the Committee will be personally liable for any action, determination or interpretation made in good faith with respect to this Agreement.
17. Captions. Captions provided herein are for convenience only and are not to serve as a basis for interpretation or construction of this Agreement.
18. Agreement Severable. In the event that any provision in this Agreement will be held invalid or unenforceable, such provision will be severable from, and such invalidity or unenforceability will not be construed to have any effect on, the remaining provisions of this Agreement.
19. Modifications to the Agreement. This Agreement constitutes the entire understanding of the parties on the subjects covered. The Employee expressly warrants that he is not accepting this Agreement in reliance on any promises, representations, or inducements other than those contained herein. Modifications to this Agreement can be made only in an express written contract executed by a duly authorized officer of the Company.

20. Notice of Governing Law. Except to the extent superceded by the laws of the United States, this Agreement will be governed by, and construed in accordance with, the laws of the State of North Carolina without regard to principles of conflict of laws.

21. Additional Actions. The parties will execute such further instruments and take such further action as may reasonably be necessary carry out the intent of this Agreement.

Exhibit 10.28

**First Amendment to Amended and Restated
Limited Liability Company Agreement of
Southstar Energy Services LLC**

This FIRST AMENDMENT (the "Amendment") TO AMENDED AND RESTATED LIMITED LIABILITY COMPANY AGREEMENT (the "LLC Agreement") of SOUTHSTAR ENERGY SERVICES LLC, a Delaware limited liability company (the "Company"), is made as of this 31st day of July, 2006, by and between Georgia Natural Gas Company and Piedmont Energy Company, as the current Members of the Company.

WITNESSETH

WHEREAS, the Members have entered into the Agreement as of January 1, 2004, and now, to reflect changed circumstances, desire to amend the Agreement, as set forth herein.

NOW THEREFORE, in consideration of the sum of Ten and No/100 Dollars ($10.00) and other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the Members agree as follows:

1. All capitalized terms not otherwise defined in this Amendment shall have the same meaning as set forth in the Agreement.

2. Section 4.1(e) of the Agreement is hereby amended by deleting the word "*audited*" therefrom.

3. Section 4.3(d) of the Agreement is hereby amended by deleting the word "*audited*" and the clause "*prepared by a national CPA firm selected by the Executive Committee* " therefrom.

4. The Members agree that, other the specific amendments set forth herein, the Agreement remains unaltered and in full force and effect.

5. This Amendment may be executed in counterparts, which, when assembled, shall constitute one and the same counterpart.

[Signatures on following page]

In witness whereof, the Members have caused their authorized officers to execute this Amendment as of the date and year first written above.

GEORGIA NATURAL GAS COMPANY

By: /s/ Brett Stovern

Name: Brett Stovern

Title: Vice President

PIEDMONT ENERGY COMPANY

By: /s/ David J. Dzuricky

Name: David J. Dzuricky

Title: Vice President

Exhibit 10.29

SouthStar Energy Services LLC

Certified Resolutions

RESOLVED, that Exhibit D of the LLC Agreement be amended to include a 70% Allocable Share for Georgia Natural Gas Company and a 30% Allocable Share for Piedmont Energy Company for income derived from the Ohio market, based on a proper allocation of the Company's cost of conducting business in the Ohio market versus its other current markets.

****

I, Michael A. Braswell, President of SouthStar Energy Services LLC, do hereby certify that the foregoing is a full, true and complete extract from the Written Consent of the Executive Committee of SouthStar Energy Services LLC dated as of August 28, 2006.

IN WITNESS WHEREOF, I have hereunto set my hand and affixed the Corporate Seal of SouthStar Energy Services LLC, this the 20th day of November, 2006.

By: /s/ Michael A. Braswell

Michael A. Braswell — President

Exhibit 10.30

SouthStar Energy Services LLC

Certified Resolutions

ESOLVED, that Exhibit D of the LLC Agreement be amended to include a 70% Allocable Share for Georgia Natural Gas Company and a 30% Allocable Share for Piedmont Energy Company for income derived from the Florida market, based on a proper allocation of the Company's cost of conducting business in the Florida market versus its other current markets.

****

I, Michael A. Braswell, President of SouthStar Energy Services LLC, do hereby certify that the foregoing is a full, true and complete extract from the Written Consent of the Executive Committee of SouthStar Energy Services LLC dated as of September 20, 2006.

IN WITNESS WHEREOF, I have hereunto set my hand and affixed the Corporate Seal of SouthStar Energy Services LLC, this the 20th day of November, 2006.

By: /s/ Michael A. Braswell

Michael A. Braswell — President

Exhibit 12

PIEDMONT NATURAL GAS COMPANY, INC. AND SUBSIDIARIES
Computation of Ratio of Earnings to Fixed Charges
For Fiscal Years Ended October 31, 2002 through 2006
(in thousands except ratio amounts)

	2006	2005	2004	2003	2002
Earnings:					
Pre-tax income from continuing operations	$ 122,525	$ 131,235	$ 123,894	$ 105,189	$ 82,091
Distributed income of equity investees	57,410	24,344	26,291	10,188	22,143
Fixed charges	58,445	49,709	52,436	43,491	44,251
Preferred security dividend, net of tax	—	—	(1,379)	(276)	—
Total Adjusted Earnings	$ 238,380	$ 205,288	$ 201,242	$ 158,592	$ 148,485
Fixed Charges:					
Interest	$ 55,959	$ 47,336	$ 48,973	$ 41,401	$ 42,250
Amortization of debt expense	561	439	429	365	366
One-third of rental expense	1,925	1,934	1,655	1,449	1,635
Preferred security dividend, net of tax	—	—	1,379	276	—
Total Fixed Charges	$ 58,445	$ 49,709	$ 52,436	$ 43,491	$ 44,251
Ratio of Earnings to Fixed Charges	4.08	4.13	3.84	3.65	3.36

Exhibit 21

List of Subsidiaries
October 31, 2006

Name	State of Incorporation	Identity of Business Unit
Subsidiaries of Piedmont Natural Gas Company, Inc.:		
Piedmont Energy Partners, Inc.	North Carolina	Holding Company
Piedmont Hardy Storage Company, LLC	North Carolina	Member of Hardy Storage Company, LLC
Piedmont ENCNG Company, LLC	North Carolina	Member of Piedmont Hardy Storage Company, LLC
Subsidiaries of Piedmont Energy Partners, Inc.:		
Piedmont Propane Company	North Carolina	Dormant
Piedmont Interstate Pipeline Company	North Carolina	Member of Pine Needle LNG Company, L.L.C.
Piedmont Intrastate Pipeline Company	North Carolina	Member of Cardinal Pipeline Company, L.L.C.
Piedmont Energy Company	North Carolina	Member of SouthStar Energy Services, LLC

Exhibit 23.1

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Ve consent to the incorporation by reference in Registration Statement Nos. 333-106268 and 333-111806 on Form S-3, and in egistration Statement Nos. 33-61093, 333-34433, 333-34435, 333-76138, 333-76140, and 333-132738 on Form S-8 of our reports dated January 12, 2007, relating to the financial statements of Piedmont Natural Gas Company, Inc., and management's report on the effectiveness of internal control over financial reporting, appearing in this Annual Report on Form 10-K of Piedmont Natural Gas Company, Inc. for the year ended October 31, 2006.

/s/ Deloitte & Touche LLP
Charlotte, North Carolina
January 12, 2007

Exhibit 31.1

CERTIFICATIONS PURSUANT TO
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Thomas E. Skains, certify that:

1. I have reviewed this Annual Report on Form 10-K of Piedmont Natural Gas Company, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: January 12, 2007

/s/ Thomas E. Skains
Thomas E. Skains
Chairman of the Board, President and Chief Executive Officer
(Principal Executive Officer)

Exhibit 31.2

CERTIFICATIONS PURSUANT TO
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, David J. Dzuricky, certify that:

1. I have reviewed this Annual Report on Form 10-K of Piedmont Natural Gas Company, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: January 12, 2007

/s/ David J. Dzuricky
David J. Dzuricky
Senior Vice President and Chief Financial Officer
(Principal Financial Officer)

Exhibit 32.1

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO SECTION 906
OF THE SARBANES-OXLEY
ACT OF 2002

In connection with the Annual Report of Piedmont Natural Gas Company, Inc. (the "Company"), on Form 10-K for the period ended October 31, 2006, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Thomas E. Skains, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

January 12, 2007

/s/ Thomas E. Skains

Thomas E. Skains
President and Chief Executive Officer

A signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

Exhibit 32.2

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO SECTION 906
OF THE SARBANES-OXLEY
ACT OF 2002

In connection with the Annual Report of Piedmont Natural Gas Company, Inc. (the "Company"), on Form 10-K for the period ended October 31, 2006, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, David J. Dzuricky, Senior Vice President and Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

January 12, 2007

/s/ David J. Dzuricky

David J. Dzuricky
Senior Vice President and Chief Financial Officer

A signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

Created by 10KWizard www.10KWizard.comSource: PIEDMONT NATURAL GAS, 10-K, January 12, 2007

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

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2006

OR

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

For the transition period from to

Commission File Number 1-14174

AGL RESOURCES INC.

(Exact name of registrant as specified in its charter)

Georgia (State or other jurisdiction of incorporation or organization)	**58-2210952** (I.R.S. Employer Identification No.)
Ten Peachtree Place NE, Atlanta, Georgia 30309 (Address and zip code of principal executive offices)	**404-584-4000** (Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of Class	Name of each exchange on which registered
Common Stock, $5 Par Value	**New York Stock Exchange**
8% Trust Preferred Securities	**New York Stock Exchange**

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 under the Securities Act. Yes ☑ No ☐

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Securities Act. Yes ☐ No ☑

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, and (2) has been subject to such filing requirements for the past 90 days. Yes ☑ No ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer.
Large accelerated filer ☑ Accelerated filer ☐ Non-accelerated filer ☐

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

The aggregate market value of the registrant's voting and non-voting common equity held by non-affiliates of the registrant, computed by reference to the price at which the registrant's common stock was last sold as of the last business day of the registrant's most recently completed second fiscal quarter, was $2,971,414,431

The number of shares of the registrant's common stock outstanding as of January 31, 2007 was 77,752,515.

DOCUMENTS INCORPORATED BY REFERENCE:

Portions of the Proxy Statement for the 2007 Annual Meeting of Shareholders ("Proxy Statement") to be held May 2, 2007, are incorporated by reference in Part III.

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GLOSSARY OF KEY TERMS

Atlanta Gas Light	Atlanta Gas Light Company
AGL Capital	AGL Capital Corporation
AGL Networks	AGL Networks, LLC
Bcf	Billion cubic feet
Chattanooga Gas	Chattanooga Gas Company
Credit Facility	Credit agreement supporting our commercial paper program
Deregulation Act	1997 Natural Gas Competition and Deregulation Act
Dominion Ohio	Dominion East of Ohio, a Cleveland, Ohio based natural gas company; a subsidiary of Dominion Resources, Inc.
EBIT	Earnings before interest and taxes, a non-GAAP measure that includes operating income, other income, equity in SouthStar's income, minority interest in SouthStar's earnings, donations and gain on sales of assets and excludes interest and tax expense; as an indicator of our operating performance, EBIT should not be considered an alternative to, or more meaningful than, operating income or net income as determined in accordance with GAAP
Energy Act	Energy Policy Act of 2005
ERC	Environmental remediation costs
FASB	Financial Accounting Standards Board
FERC	Federal Energy Regulatory Commission
Florida Commission	Florida Public Service Commission
GAAP	Accounting principles generally accepted in the United States of America
Georgia Commission	Georgia Public Service Commission
LNG	Liquefied natural gas
LOCOM	Lower of weighted average cost or current market price
Maryland Commission	Maryland Public Service Commission
Marketers	Marketers selling retail natural gas in Georgia and certificated by the Georgia Commission
Medium-term notes	Notes issued by Atlanta Gas Light with scheduled maturities between 2012 and 2027 bearing interest rates ranging from 6.6% to 9.1%
MGP	Manufactured gas plant
New Jersey Commission	New Jersey Board of Public Utilities
NYMEX	New York Mercantile Exchange, Inc.
OCI	Other comprehensive income
Operating margin	A non-GAAP measure of income, calculated as revenues minus cost of gas, that excludes operation and maintenance expense, depreciation and amortization, taxes other than income taxes, and the gain or loss on the sale of our assets; these items are included in our calculation of operating income as reflected in our statements of consolidated income. Operating margin should not be considered an alternative to, or more meaningful than, operating income or net income as determined in accordance with GAAP
Jefferson Island	Jefferson Island Storage & Hub, LLC
Piedmont	Piedmont Natural Gas
Pivotal Propane	Pivotal Propane of Virginia, Inc.
Pivotal Utility	Pivotal Utility Holdings, Inc., doing business as Elizabethtown Gas, Elkton Gas and Florida City Gas
PGA	Purchased gas adjustment
PRP	Pipeline replacement program
SEC	Securities and Exchange Commission
Sequent	Sequent Energy Management, L.P.
SFAS	Statement of Financial Accounting Standards
SouthStar	SouthStar Energy Services LLC
Tennessee Commission	Tennessee Regulatory Authority
Virginia Natural Gas	Virginia Natural Gas, Inc.
Virginia Commission	Virginia State Corporation Commission

REFERENCED ACCOUNTING STANDARDS

APB 25	APB Opinion No. 25, "Accounting for Stock Issued to Employees"
EITF 98-10	Emerging Issues Task Force (EITF) Issue No. 98-10, "Accounting for Contracts Involved in Energy Trading and Risk Management Activities"
EITF 99-02	EITF Issue No. 99-02, "Accounting for Weather Derivatives"
EITF 02-03	EITF Issue No. 02-03, "Issues Involved in Accounting for Contracts under EITF Issue No. 98-10, 'Accounting for Contracts Involved in Energy Trading and Risk Management Activities'"
EITF 06-3	EITF Issue No. 06-3, "How Taxes Collected from Customers and Remitted to Governmental Authorities Should be Presented in the Income Statements"
FIN 46 & FIN 46R	FASB Interpretation No. (FIN) 46, "Consolidation of Variable Interest Entities"
FIN 47	FIN 47, "Accounting for Conditional Asset Retirement Obligations, an interpretation of FASB Statement No. 143"
FIN 48	FIN 48, "Accounting for Uncertainty in Income Taxes, an interpretation of SFAS Statement No. 109"
SFAS 5	Statement of Financial Accounting Standards (SFAS) No. 5, "Accounting for Contingencies"
SFAS 13	SFAS No. 13, "Accounting for Leases"
SFAS 71	SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation"
SFAS 87	SFAS No. 87, "Employers' Accounting for Pensions"
SFAS 106	SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions"
SFAS 109	SFAS No. 109, "Accounting for Income Taxes"
SFAS 123 & SFAS 123R	SFAS No. 123, "Accounting for Stock-Based Compensation"
SFAS 131	SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information"
SFAS 133	SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities"
SFAS 141	SFAS No. 141, "Business Combinations"
SFAS 142	SFAS No. 142, "Goodwill and Other Intangible Assets"
SFAS 148	SFAS No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure"
SFAS 149	SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities"
SFAS 154	SFAS No. 154, "Accounting Changes and Error Corrections"
SFAS 157	SFAS No. 157, "Fair Value Measurements"
SFAS 158	SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans"

PART I

ITEM 1. BUSINESS

Nature of Our Business

Unless the context requires otherwise, references to "we," "us," "our," the "company," and "AGL Resources" are intended to mean consolidated AGL Resources Inc. and its subsidiaries.

We are a Fortune 1000 energy services holding company whose principal business is the distribution of natural gas in six states – Florida, Georgia, Maryland, New Jersey, Tennessee and Virginia. We generate nearly all our operating revenues through the sale, distribution, transportation and storage of natural gas. Our six utilities serve more than 2.2 million end-use customers, making us the largest distributor of natural gas in the southeastern and mid-Atlantic regions of the United States based on customer count. We are involved in several related and complementary businesses, including retail natural gas marketing to end-use customers primarily in Georgia; natural gas asset management and related logistics activities for each of our utilities as well as for nonaffiliated companies; natural gas storage arbitrage and related activities; and the development and operation of high-deliverability natural gas storage assets. We also own and operate a small telecommunications business that constructs and operates conduit and fiber infrastructure within select metropolitan areas.

We manage these businesses through four operating segments, as described below, and a nonoperating corporate segment.

Distribution Operations – The distribution operations segment is the largest component of our business and includes utilities in six states - Florida, Georgia, Maryland, New Jersey, Tennessee and Virginia. These utilities are subject to regulation and oversight by state agencies in each state that we serve. These agencies approve natural gas rates designed to provide us the opportunity to generate revenues to recover the cost of natural gas delivered to our customers and our fixed and variable costs such as depreciation, interest, maintenance and overhead costs. These agencies also are charged with establishing mechanisms by which our utilities can earn a reasonable return for our shareholders.

With the exception of our Atlanta Gas Light Company (Atlanta Gas Light) subsidiary in Georgia, earnings in our Distribution Operations segment can be affected by customer consumption patterns that are a function of weather conditions and price levels for natural gas. Atlanta Gas Light charges rates to its customers primarily as monthly fixed charges. Our non-Georgia jurisdictions have various regulatory mechanisms to provide us with a reasonable opportunity to recover our costs, but they are not direct offsets to the potential impacts on earnings of weather and customer consumption.

Retail Energy Operations – Our retail energy operations segment consists of SouthStar Energy Services LLC (SouthStar), the largest marketer of natural gas in Georgia. SouthStar's operations also are sensitive to customer consumption patterns similar to those affecting our utility operations. SouthStar uses a variety of hedging strategies, such as futures, options, swaps, weather derivative instruments and other risk management tools, to mitigate the potential effect of these issues on its operations.

Wholesale Services – Our wholesale services segment, which consists of Sequent Energy Management, L.P. (Sequent), takes advantage of arbitrage opportunities within the gas supply, storage and transportation markets to generate earnings, and its profitability is correlated to volatility in these markets. Market volatility results from a number of factors, such as weather fluctuations or the change in supply of, or demand for, natural gas in different regions of the country. Sequent seeks to capture value from the price disparity among geographic locations and various time horizons created by this volatility. In doing so, Sequent also seeks to mitigate the risks associated with this volatility and protect its margin through a variety of risk management and hedging activities.

Energy Investments – Our energy investments segment includes a number of businesses that are related and complementary to our primary business. The most significant of these businesses is our natural gas storage business, which develops, acquires and operates high-deliverability salt-dome storage assets in the Gulf Coast region of the United States. While this business also can generate additional revenue during times of peak market demand for natural gas storage services, the majority of our storage services are covered under medium to long-term contracts at a fixed market rate.

For additional information on our segments, see Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" under the caption "Results of Operations" and "Note 11, Segment Information," set forth in Item 8, "Financial Statements and Supplementary Data." Operating revenues, operating margin and earnings before interest and taxes (EBIT) for each of our segments are presented in the following table for the years ended December 31, 2006, 2005 and 2004.

In millions	Operating revenues	Operating margin (1)	EBIT (1)
2006			
Distribution operations	$1,624	$807	$310
Retail energy operations	930	156	63
Wholesale services	182	139	90
Energy investments	41	36	10
Corporate (2)	(156)	1	(9)
Consolidated	$2,621	$1,139	$464
2005			
Distribution operations	$1,753	$814	$299
Retail energy operations	996	146	63
Wholesale services	95	92	49
Energy investments	56	40	19
Corporate (2)	(182)	-	(11)
Consolidated	$2,718	$1,092	$419
2004			
Distribution operations	$1,111	$640	$247
Retail energy operations	827	132	52
Wholesale services	54	53	24
Energy investments	25	13	7
Corporate (2)	(185)	(1)	(16)
Consolidated	$1,832	$837	$314

(1) These are non-GAAP measurements. A reconciliation of operating margin and EBIT to our operating income and net income is contained in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations."
(2) Includes the elimination of intercompany revenues and intercompany cost of gas.

In 2006, we derived approximately 80% of our EBIT from our regulated natural gas distribution business and the sale of natural gas to end-use customers primarily in Georgia through SouthStar. This statistic is significant because it represents the portion of our earnings that directly results from the underlying business of supplying natural gas to retail customers. Although SouthStar is not subject to the same regulatory framework as our utilities, it is an integral part of the retail framework for providing gas service to end-use customers in the state of Georgia.

The remaining 20% of our EBIT was principally derived from businesses that are complementary to our natural gas distribution business. We engage in natural gas asset management and the operation of high-deliverability natural gas underground storage as ancillary activities to our utility franchises. These businesses allow us to be opportunistic in capturing incremental value at the wholesale level, provide us with deepened business insight about natural gas market dynamics and facilitate our ability, in the case of asset management, to provide transparency to regulators as to how that value can be captured to benefit our utility customers through profit-sharing arrangements. Given the volatile and changing nature of the natural gas resource base in North America and globally, we believe that participation in these related businesses strengthens our business.

Natural Gas Demand

During 2006 we experienced a decline in per-household natural gas use, resulting in operating margin erosion. This decline was largely due to warmer weather – which was on average 14% warmer than in the prior year based on heating degree days - and higher than historical natural gas prices. The higher natural gas prices resulted in an average 34% increase in our residential customers' natural gas bills. The higher prices were primarily the result of market concerns about the sufficiency of the supply of natural gas due to disruptions in the availability of natural gas supplies caused by hurricanes Katrina and Rita in 2005. Additionally, our underlying business of supplying natural gas to retail customers continues to be negatively impacted by the addition of newer, more energy-efficient housing and efficiency improvements in natural gas appliances. The decline in natural gas usage has been somewhat offset by the growing trend toward larger homes that require more energy to heat despite the use of more efficient appliances.

In 2006, these factors contributed to lower volumes of natural gas deliveries to our customers as a result of customer conservation from the combination of both warmer weather and the reaction to the high prices for natural gas. The higher natural gas prices also resulted in higher bad debt expense. These factors negatively affected our EBIT.

Natural gas prices as of January 1, 2007 were approximately 44% lower than the same date in 2006 and are expected to be lower during the remainder of the current heating season (January – March). To the extent these lower natural gas prices are reflected in lower natural gas prices to our customers, the impact of conservation experienced during the prior heating season may be lessened. Additionally, the lower prices could result in a return to normalized consumption and a return to normalized bad debt expense. If this occurs, we would expect that our operating margins and EBIT would be positively impacted relative to what we experienced in the November 2005 through March 2006 heating season.

Seasonality

The operating revenues and EBIT of our distribution operations, retail energy operations and wholesale services segments are seasonal. During the heating season, natural gas usage and operating revenues are generally higher because more customers are connected to our distribution systems and natural gas usage is higher in periods of colder weather than in periods of warmer weather. Approximately 66% of these segments' operating revenues and 68% of

these segments' EBIT for the year ended December 31, 2006 were generated during the five-month heating season and are reflected in our statements of consolidated income for the quarters ended March 31, 2006 and December 31, 2006. Our base operating expenses, excluding cost of gas, interest expense and certain incentive compensation costs, are incurred relatively equally over any given year. Thus, our operating results vary significantly from quarter to quarter as a result of seasonality. Seasonality also affects the comparison of certain balance sheet items such as receivables, unbilled revenue, inventories and short-term debt across quarters. However, these items are comparable when reviewing our annual results.

Available Information

Detailed information about us is contained in our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, proxy statements and other reports, and amendments to those reports, that we file with or furnish to the Securities and Exchange Commission (SEC). These reports are available free of charge at our website, www.aglresources.com, as soon as reasonably practicable after we electronically file such reports with or furnish such reports to the SEC. We will furnish copies of such reports free of charge upon written request to our Investor Relations department. You can contact our Investor Relations department at:

AGL Resources Inc.
Investor Relations - Dept. 1071
P.O. Box 4569
Atlanta, GA 30309-4569
404-584-3801

In Part III of this Form 10-K, we incorporate by reference certain information from our Proxy Statement for our 2007 annual meeting of shareholders. We expect to file that Proxy Statement with the SEC on or about March 19, 2007, and we will promptly make it available on our website. Please refer to the Proxy Statement when it is available.

Additionally, our corporate governance guidelines, code of ethics, code of business conduct and the charters of each of our Board of Directors committees are available on our website. We will furnish copies of such information free of charge upon written request to our Investor Relations department.

ITEM 1A. RISK FACTORS

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

Certain expectations and projections regarding our future performance referenced in this report, in other materials we file with the SEC or otherwise release to the public, and on our website are forward-looking statements. Senior officers may also make verbal statements to analysts, investors, regulators, the media and others that are forward-looking. Forward-looking statements involve matters that are not historical facts, such as statements in "Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations" and elsewhere regarding our future operations, prospects, strategies, financial condition, economic performance (including growth and earnings), industry conditions and demand for our products and services. We have tried, whenever possible, to identify these statements by using words such as "anticipate," "assume," "believe," "can," "could," "estimate," "expect," "forecast," "future," "goal," "indicate," "intend," "may," "outlook," "plan," "potential," "predict," "project," "seek," "should," "target," "will," "would," and similar expressions.

You are cautioned not to place undue reliance on our forward-looking statements. Our forward-looking statements are not guarantees of future performance and are based on currently available competitive, financial and economic data along with our operating plans. While we believe that our expectations for the future are reasonable in view of the currently available information, our expectations are subject to future events, risks and inherent uncertainties, as well as potentially inaccurate assumptions, and there are numerous factors - many beyond our control - that could cause results to differ significantly from our expectations. Such events, risks and uncertainties include, but are not limited to those set forth below and in the other documents that we file with the SEC. We note these factors for investors as permitted by the Private Securities Litigation Reform Act of 1995. There also may be other factors that we cannot anticipate or that are not described in this report, generally because we do not perceive them to be material, that could cause results to differ significantly from our expectations.

Forward-looking statements are only as of the date they are made, and we do not undertake any obligation to update these statements to reflect subsequent circumstances or events. You are advised, however, to review any further disclosures we make on related subjects in our Form 10-Q and Form 8-K reports to the SEC.

Risks Related to Our Business

Risks related to the regulation of our businesses could affect the rates we are able to charge, our costs and our profitability.

Our businesses are subject to regulation by federal, state and local regulatory authorities. In particular, at the federal level our distribution businesses are regulated by the Federal Energy Regulatory Commission (FERC) under the Energy Policy Act of 2005 (Energy Act). At the state level, our distribution businesses are regulated by the Georgia Public Service Commission (Georgia Commission), the Tennessee Regulatory Authority (Tennessee Commission), the New Jersey Board of Public Utilities (New Jersey Commission), the Florida Public Service Commission (Florida Commission), the Virginia State Corporation Commission (Virginia Commission) and the Maryland Public Service Commission (Maryland Commission). These authorities regulate many aspects of our distribution operations, including construction and maintenance of facilities, operations, safety, rates that we charge customers, rates of return, the authorized cost of capital, recovery of pipeline replacement and environmental remediation costs, relationships with our affiliates, and carrying costs we charge marketers selling retail natural gas in Georgia and certificated by the Georgia Commission (Marketers) for gas held in storage for their customer accounts. Our ability to obtain rate increases and rate supplements to maintain our current rates of return depends on regulatory discretion, and there can be no assurance that we will be able to obtain rate increases or rate supplements or continue receiving our currently authorized rates of return.

Deregulation in the natural gas industry is the separation of the provision and pricing of local distribution gas services into discrete components. Deregulation typically focuses on the separation of the gas distribution business from the gas sales business and is intended to cause the opening of the formerly regulated sales business to alternative unregulated suppliers of gas sales services.

In 1997, the Georgia legislature enacted the Natural Gas Competition and Deregulation Act (Deregulation Act). To date, Georgia is the only state in the nation that has fully deregulated gas distribution operations, which ultimately resulted in Atlanta Gas Light exiting the retail natural gas sales business while retaining its gas distribution operations. Marketers then assumed the retail gas sales responsibility at deregulated prices. The deregulation process required Atlanta Gas Light to completely reorganize its operations and personnel at significant expense. It is possible that the legislature could reverse the deregulation process and require or permit Atlanta Gas Light to provide retail gas sales service once again or require our retail energy operations segment, SouthStar, to change the nature of how it provides natural gas to certain customers. In addition, the Georgia Commission has statutory authority on an emergency basis to order Atlanta Gas Light to temporarily provide the same retail gas service that it provided prior to deregulation. If any of these events were to occur, we would incur costs to reverse the restructuring process or potentially lose the earnings opportunity embedded within the current marketing framework. Furthermore, the Georgia Commission has authority to change the terms under which we charge Marketers for certain supply-related services, which could also affect our future earnings.

A significant portion of our accounts receivable are subject to collection risks, due in part to a concentration of credit risk in Georgia and at Sequent.

We have an accounts receivable collection risk in Georgia due to a concentration of credit risk related to the provision of natural gas services to Marketers. At September 30, 1998 (prior to deregulation), Atlanta Gas Light had approximately 1.5 million end-use customers in Georgia. In contrast, at December 31, 2006, Atlanta Gas Light had only 11 certificated and active Marketers in Georgia, four of which (based on customer count and including SouthStar) accounted for approximately 36% of our consolidated operating margin for 2006. As a result, Atlanta Gas Light now depends on a concentrated number of customers for revenues. The failure of these Marketers to pay Atlanta Gas Light could adversely affect Atlanta Gas Light's business and results of operations and expose it to difficulties in collecting Atlanta Gas Light's accounts receivable. The provisions of Atlanta Gas Light's tariff allow it to obtain security support in an amount equal to a minimum of two times a Marketer's highest month's estimated bill. Additionally, SouthStar markets directly to end-use customers and has periodically experienced credit losses as a result of severe cold weather or high prices for natural gas that increase customers' bills and, consequently, impair a customers' ability to pay.

Sequent often extends credit to its counterparties. Despite performing credit analyses prior to extending credit and seeking to effectuate netting agreements, Sequent is exposed to the risk that it may not be able to collect amounts owed to it. If the counterparty to such a transaction fails to perform and any collateral Sequent has secured is inadequate, Sequent could experience material financial losses. Further, Sequent has a concentration of credit risk which

could subject a significant portion of its credit exposure to collection risks. Approximately 57% of Sequent's credit exposure is concentrated in 20 counterparties. Although most of this concentration is with counterparties that are either load-serving utilities or end-use customers and that have supplied some level of credit support, default by any of these counterparties in their obligations to pay amounts due Sequent could result in credit losses that would negatively impact our wholesale services segment.

We face increasing competition, and if we are unable to compete effectively, our revenues, operating results and financial condition will be adversely affected and may limit our ability to grow our business.

The natural gas business is highly competitive, and we are facing increasing competition from other companies that supply energy, including electric companies, oil and propane providers and, in some cases, energy marketing and trading companies. In particular, the success of our investment in SouthStar is affected by the competition SouthStar faces from other energy marketers providing retail natural gas services in the Southeast. Natural gas competes with other forms of energy. The primary competitive factor is price. Changes in the price or availability of natural gas relative to other forms of energy and the ability of end-users to convert to alternative fuels affect the demand for natural gas. In the case of commercial, industrial and agricultural customers, adverse economic conditions, including higher gas costs, could also cause these customers to bypass or disconnect from our systems in favor of special competitive contracts with lower per-unit costs.

Our wholesale services segment competes with national and regional full-service energy providers, energy merchants and producers and pipelines for sales based on our ability to aggregate competitively priced commodities with transportation and storage capacity. Some of our competitors are larger and better capitalized than we are and have more national and global exposure than we do. The consolidation of this industry and the pricing to gain market share may affect our margins. We expect this trend to continue in the near term, and the increasing competition for asset management deals could result in downward pressure on the volume of transactions and the related margins available in this portion of Sequent's business.

The asset management arrangements between Sequent and our local distribution companies, and between Sequent and its nonaffiliated customers, may not be renewed or may be renewed at lower levels, which could have a significant impact on Sequent's business.

Sequent currently manages the storage and transportation assets of our affiliates Atlanta Gas Light, Elizabethtown Gas, Elkton Gas, Virginia Natural Gas, Inc. (Virginia Natural Gas), Florida City Gas and Chattanooga Gas Company (Chattanooga Gas) and shares profits it earns from the management of those assets with those customers and their respective customers, except at Elizabethtown Gas and Elkton Gas where Sequent is assessed an annual fixed-fee of approximately $4 million payable in monthly installments. Entry into and renewal of these agreements are subject to regulatory approval. In addition, Sequent has asset management agreements with certain nonaffiliated customers. Sequent's results could be significantly impacted if these agreements are not renewed or are amended or renewed with less favorable terms.

Our infrastructure improvement and customer growth may be restricted by the capital-intensive nature of our business.

We must construct additions to our natural gas distribution system to continue the expansion of our customer base. We may also need to construct expansions of our existing natural gas storage facilities or develop and construct new natural gas storage facilities. The cost of this construction may be affected by the cost of obtaining government approvals, development project delays or unexpected changes in project costs. Weather, general economic conditions and the cost of funds to finance our capital projects can materially alter the cost, and projected construction schedule and completion timeline of a project. Our cash flows may not be fully adequate to finance the cost of this construction. As a result, we may be required to fund a portion of our cash needs through borrowings or the issuance of common stock, or both. For our distribution operations segment, this may limit our ability to expand our infrastructure to connect new customers due to limits on the amount we can economically invest, which shifts costs to potential customers and may make it uneconomical for them to connect to our distribution systems. For our natural gas storage business, this may significantly reduce our earnings and return on investment from what would be expected for this business, or may impair our ability to complete the expansions or development projects.

Changes in weather conditions may affect our earnings.

Weather conditions and other natural phenomena can have a large impact on our earnings. Severe weather conditions can impact our suppliers and the pipelines that deliver gas to our distribution system. Extended mild weather, during either the winter period or summer period, can have a significant impact on demand for and cost of natural gas.

We have a weather normalization adjustment (WNA) mechanism for Elizabethtown Gas and Chattanooga Gas that partially offsets the impact of unusually cold or warm weather on residential and commercial customer billings and margin. Additionally, Virginia Natural Gas has a WNA mechanism for its residential customers that partially offsets the impact of unusually cold or warm weather. The WNA is most effective in a reasonable temperature range relative to normal weather using historical averages. The protection afforded by the WNA depends on continued regulatory approval. The loss of this continued regulatory approval could make us more susceptible to weather-related earnings fluctuations.

Changes in weather conditions may also impact SouthStar's earnings. As a result, SouthStar uses a variety of weather derivative instruments to mitigate the impact on its margins in the event of warmer than normal weather in the winter months. However, these instruments do not full protect SouthStar's earnings from the effects of unusually warm weather.

Our business is subject to environmental regulation in all jurisdictions in which we operate, and our costs to comply are significant. Any changes in existing environmental regulation could negatively affect our results of operations and financial condition.

Our operations and properties are subject to extensive environmental regulation pursuant to a variety of federal, state and municipal laws and regulations. Such environmental legislation imposes, among other things, restrictions, liabilities and obligations in connection with storage, transportation, treatment and disposal of hazardous substances and waste and in connection with spills, releases and emissions of various substances into the environment. Environmental legislation also requires that our facilities, sites and other properties associated with our operations be operated, maintained, abandoned and reclaimed to the satisfaction of applicable regulatory authorities. Our current costs to comply with these laws and regulations are significant to our results of operations and financial condition. Failure to comply with these laws and regulations and failure to obtain any required permits and licenses may expose us to fines, penalties or interruptions in our operations that could be material to our results of operations.

In addition, claims against us under environmental laws and regulations could result in material costs and liabilities. Existing environmental regulations could also be revised or reinterpreted, new laws and regulations could be adopted or become applicable to us or our facilities, and future changes in environmental laws and regulations could occur. With the trend toward stricter standards, greater regulation, more extensive permit requirements and an increase in the number and types of assets operated by us subject to environmental regulation, our environmental expenditures could increase in the future, particularly if those costs are not fully recoverable from our customers. Additionally, the discovery of presently unknown environmental conditions could give rise to expenditures and liabilities, including fines or penalties, which could have a material adverse effect on our business, results of operations or financial condition.

We could incur additional material costs for the environmental condition of some of our assets, including former manufactured gas plants.

We are generally responsible for all on-site and certain off-site liabilities associated with the environmental condition of the natural gas assets that we have operated, acquired or developed, regardless of when the liabilities arose and whether they are or were known or unknown. In addition, in connection with certain acquisitions and sales of assets, we may obtain, or be required to provide, indemnification against certain environmental liabilities. Before natural gas was widely available, we manufactured gas from coal and other fuels. Those manufacturing operations were known as manufactured gas plants (MGP) which we ceased operating in the 1950s.

We have identified ten sites in Georgia and three in Florida where we own all or part of an MGP site. We are required to investigate possible environmental contamination at those MGP sites and, if necessary, clean up any contamination. As of December 31, 2006, the soil and sediment remediation program was complete for all Georgia sites, although groundwater cleanup continues. As of December 31, 2006, projected costs associated with the MGP sites were $27 million. For elements of the MGP program where we still cannot provide engineering cost estimates, considerable variability remains in future cost estimates.

In addition, we are associated with former sites in New Jersey, North Carolina and other states that we

assumed with our acquisition of NUI Corporation (NUI) in November 2004. Material cleanups of these sites have not been completed nor are precise estimates available for future cleanup costs. For the New Jersey sites, cleanup cost estimates range from $60 million to $118 million. Costs have been estimated for only one of the non-New Jersey sites, for which current estimates range from $10 million to $17 million.

Our profitability may decline if the counterparties to Sequent's asset management transactions fail to perform in accordance with Sequent's agreements.

Sequent focuses on capturing the value from idle or underutilized energy assets, typically by executing transactions that balance the needs of various markets and time horizons. Sequent is exposed to the risk that counterparties to our transactions will not perform their obligations. Should the counterparties to these arrangements fail to perform, we might be forced to enter into alternative hedging arrangements, honor the underlying commitment at then-current market prices or return a significant portion of the consideration received for gas under a long-term contract. In such events, we might incur additional losses to the extent of amounts, if any, already paid to or received from counterparties.

We are exposed to market risk and may incur losses in wholesale services and retail energy operations.

The commodity, storage and transportation portfolios at Sequent and the commodity and storage portfolios at SouthStar consist of contracts to buy and sell natural gas commodities, including contracts that are settled by the delivery of the commodity or cash. If the values of these contracts change in a direction or manner that we do not anticipate, we could experience financial losses from our trading activities. Value at risk (VaR) is defined as the maximum potential loss in portfolio value over a specified time period that is not expected to be exceeded within a given degree of probability. Based on a 95% confidence interval and employing a 1-day holding period for all positions, Sequent's and SouthStar's portfolio of positions as of December 31, 2006 had a 1-day holding period VaR of $1 million and $0.1 million, respectively.

Our accounting results may not be indicative of the risks we are taking or the economic results we expect for wholesale services.

Although Sequent enters into various contracts to hedge the value of our energy assets and operations, the timing of the recognition of profits or losses on the hedges does not always correspond to the profits or losses on the item being hedged. The difference in accounting can result in volatility in Sequent's reported results, even though the expected profit margin is essentially unchanged from the date the transactions were consummated.

Inflation and increased gas costs could adversely impact our ability to control operating expenses, increase our level of indebtedness and adversely impact our customer base.

Inflation has caused increases in certain operating expenses which have required us to replace assets at higher costs. We attempt to control costs in part through implementation of best practices and business process improvements, many of which are facilitated through investments in information systems and technology. We have a process in place to continually review the adequacy of our utility gas rates in relation to the increasing cost of providing service and the inherent regulatory lag in adjusting those gas rates. Historically, we have been able to budget and control operating expenses and investments within the amounts authorized to be collected in rates, and we intend to continue to do so. However, any inability by us to reasonably control our expenses would adversely influence our future results.

Rapid increases in the price of purchased gas cause us to experience a significant increase in short-term debt because we must pay suppliers for gas when it is purchased, which can be significantly in advance of when these costs may be recovered through the collection of monthly customer bills for gas delivered. Increases in purchased gas costs also slow our utility collection efforts as customers are more likely to delay the payment of their gas bills, leading to higher-than-normal accounts receivable. This situation results in higher short-term debt levels and increased bad debt expense. Should the price of purchased gas increase significantly during the upcoming heating season, we would expect increases in our short-term debt, accounts receivable and bad debt expense during 2007.

Finally, higher costs of natural gas in recent years have already caused many of our utility customers to conserve in the use of our gas services and could lead to even more customers utilizing such conservation methods or switching to other more efficient competing products. The higher costs have also allowed competition from products utilizing alternative energy sources for applications that have traditionally used natural gas, encouraging some customers to move away from natural gas fired equipment to equipment fueled by other energy sources.

A decrease in the availability of adequate pipeline transportation capacity could reduce our revenues and profits.

Our gas supply depends on the availability of adequate pipeline transportation and storage capacity. We purchase a substantial portion of our gas supply from interstate sources. Interstate pipeline companies transport the gas to our system. A decrease in interstate pipeline capacity available to us or an increase in competition for interstate pipeline transportation and storage service could reduce our normal interstate supply of gas.

The cost of providing pension and postretirement health care benefits to eligible employees and qualified retirees is subject to changes in pension fund values and changing demographics and may have a material adverse effect on our financial results.

We have a defined benefit pension plan for the benefit of substantially all full-time employees and qualified retirees. The cost of providing these benefits to eligible current and former employees is subject to changes in the market value of our pension fund assets and changing demographics, including longer life expectancy of beneficiaries and an expected increase in the number of eligible former employees over the next five years.

Any sustained declines in equity markets and reductions in bond yields may have a material adverse effect on the value of our pension funds. In these circumstances, we may be required to recognize an increased pension expense or a charge to our statement of consolidated income to the extent that the pension fund values are less than the total anticipated liability under the plans.

Transporting and storing natural gas involves numerous risks that may result in accidents and other operating risks and costs.

Our gas distribution activities involve a variety of inherent hazards and operating risks, such as leaks, accidents and mechanical problems, which could cause substantial financial losses. In addition, these risks could result in loss of human life, significant damage to property, environmental pollution and impairment of our operations, which in turn could lead to substantial losses to us. In accordance with customary industry practice, we maintain insurance against some, but not all, of these risks and losses. The location of pipelines and storage facilities near populated areas, including residential areas, commercial business centers and industrial sites, could increase the level of damages resulting from these risks. The occurrence of any of these events not fully covered by insurance could adversely affect our financial position and results of operations.

Natural disasters, terrorist activities and the potential for military and other actions could adversely affect our businesses.

Natural disasters may damage our assets. The threat of terrorism and the impact of retaliatory military and other action by the United States and its allies may lead to increased political, economic and financial market instability and volatility in the price of natural gas that could affect our operations. In addition, future acts of terrorism could be directed against companies operating in the United States, and companies in the energy industry may face a heightened risk of exposure to acts of terrorism. These developments have subjected our operations to increased risks. The insurance industry has also been disrupted by these events. As a result, the availability of insurance covering risks against which we and our competitors typically insure may be limited. In addition, the insurance we are able to obtain may have higher deductibles, higher premiums and more restrictive policy terms.

Risks Related to Our Corporate and Financial Structure

We depend on our ability to successfully access the capital and financial markets. Any inability to access the capital or financial markets may limit our ability to execute our business plan or pursue improvements that we may rely on for future growth.

We rely on access to both short-term money markets (in the form of commercial paper and lines of credit) and long-term capital markets as a source of liquidity for capital and operating requirements not satisfied by the cash flow from our operations. If we are not able to access financial markets at competitive rates, our ability to implement our business plan and strategy will be affected. Certain market disruptions may increase our cost of borrowing or affect our ability to access one or more financial markets. Such market disruptions could result from;

- adverse economic conditions
- adverse general capital market conditions
- poor performance and health of the utility industry in general
- bankruptcy or financial distress of unrelated energy companies or Marketers
- significant decrease in the demand for natural gas

- adverse regulatory actions that affect our local gas distribution companies and our natural gas storage business
- terrorist attacks on our facilities or our suppliers
- extreme weather conditions

The use of derivative contracts in the normal course of our business could result in financial losses that negatively impact our results of operations.

We use derivatives, including futures, forwards and swaps, to manage our commodity and financial market risks. We could recognize financial losses on these contracts as a result of volatility in the market values of the underlying commodities or if a counterparty fails to perform under a contract. In the absence of actively quoted market prices and pricing information from external sources, the valuation of these financial instruments can involve management's judgment or use of estimates. As a result, changes in the underlying assumptions or use of alternative valuation methods could adversely affect the value of the reported fair value of these contracts.

We are vulnerable to interest rate risk with respect to our debt, which could lead to changes in interest expense and adversely affect our earnings.

We are subject to interest rate risk in connection with the issuance of fixed-rate and variable-rate debt. In order to maintain our desired mix of fixed-rate and variable-rate debt, we use interest rate swap agreements and exchange fixed-rate and variable-rate interest payment obligations over the life of the arrangements, without exchange of the underlying principal amounts. See Item 7A, "Quantitative and Qualitative Disclosures About Market Risk." We cannot ensure that we will be successful in structuring such swap agreements to effectively manage our risks. If we are unable to do so, our earnings may be reduced. In addition, higher interest rates, all other things equal, reduce the earnings that we derive from transactions where we capture the difference between authorized returns and short-term borrowings.

If we breach any of the financial covenants under our various, credit facilities, our debt service obligations could be accelerated.

Our existing credit facility and the SouthStar line of credit contain financial covenants. If we breach any of the financial covenants under these agreements, our debt repayment obligations under them could be accelerated. In such event, we may not be able to refinance or repay all our indebtedness, which would result in a material adverse effect on our business, results of operations and financial condition.

As a result of cross-default provisions in our borrowing arrangements, we may be unable to satisfy all our outstanding obligations in the event of a default on our part.

Our credit agreement supporting our commercial paper program (Credit Facility) and our indentures under which our debt is issued contain cross-default provisions. Accordingly, should an event of default occur under some of our debt agreements, we face the prospect of being in default under other of our debt agreements, obliged in such instance to satisfy a large portion of our outstanding indebtedness and unable to satisfy all our outstanding obligations simultaneously.

A downgrade in our credit rating could negatively affect our ability to access capital.

Standard & Poor's Ratings Services (S&P), Moody's Investor Service (Moody's) and Fitch Ratings (Fitch) currently assign our senior unsecured debt a rating of BBB+, Baa1 and A-, respectively. Our commercial paper currently is rated A2, P2 and F2 by S&P, Moody's and Fitch, respectively. If the rating agencies downgrade our ratings, particularly below investment grade, it may significantly limit our access to the commercial paper market and our borrowing costs would increase. In addition, we would likely be required to pay a higher interest rate in future financings and our potential pool of investors and funding sources would likely decrease.

Additionally, if our credit rating by either S&P or Moody's falls to non-investment grade status, we will be required to provide additional support for certain customers of our wholesale business. As of December 31, 2006, if our credit rating had fallen below investment grade, we would have been required to provide collateral of approximately $10 million to continue conducting our wholesale services business with certain counterparties.

ITEM 1B. UNRESOLVED STAFF COMMENTS

We do not have any unresolved comments from the SEC staff regarding our periodic or current reports under the Securities Exchange Act of 1934, as amended.

ITEM 2. PROPERTIES

Distribution Operations As of December 31, 2006, the properties of our distribution operations segment represented approximately 90% of the net property, plant and equipment in our consolidated balance sheet. This property primarily includes assets used for the distribution of natural gas to our customers in our service areas, including more than 43,000 miles of distribution and transmission mains. We have approximately 7.35 billion cubic feet (Bcf) of liquefied natural gas (LNG) storage capacity in five LNG plants located in Georgia, New Jersey and Tennessee. In addition, we own three propane storage facilities in Virginia and Georgia that have a combined storage capacity of approximately 4.5 million gallons. These LNG plants and propane facilities supplement the gas supply during peak usage periods.

Energy Investments The properties in our energy investments segment are primarily investments that are complementary to our distribution operations or provide services consistent with our core enterprises, including a natural gas storage and hub facility in Louisiana located approximately eight miles from the Henry Hub. The Henry Hub is the largest centralized point for natural gas spot and futures trading in the United States. The New York Mercantile Exchange, Inc. (NYMEX) uses the Henry Hub as the point of delivery for its natural gas futures contracts. Many natural gas marketers also use the Henry Hub as their physical contract delivery point or their price benchmark for spot trades of natural gas. Our natural gas storage and hub facility consists of two salt dome gas storage caverns with approximately 9.72 Bcf of total capacity and about 7.23 Bcf of working gas capacity. The facility has approximately 0.72 Bcf/day withdrawal capacity and 0.36 Bcf/day injection capacity. We completed a project during 2005 to expand compression capability, enabling us to increase the number of times a customer can inject and withdraw their total gas inventory annually from 10 to 12.

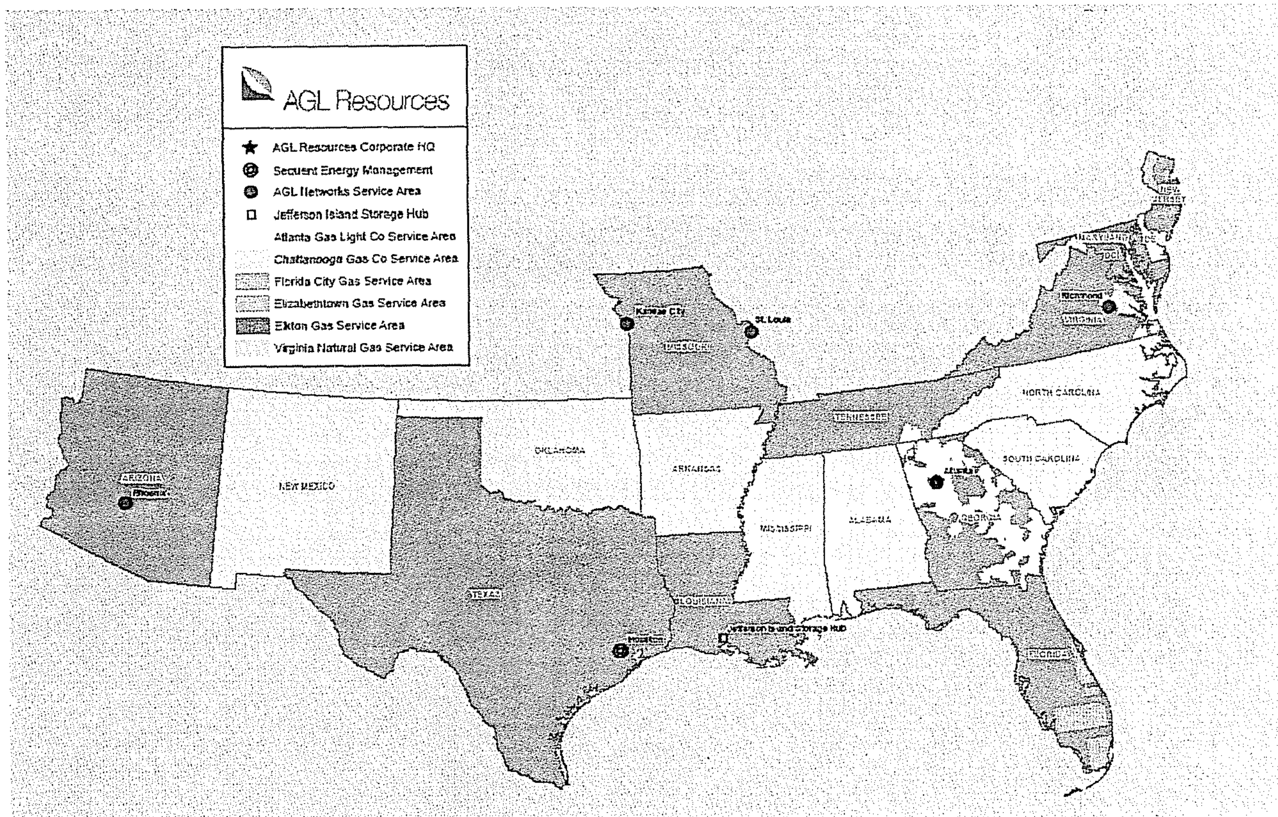
We also own a propane facility in Virginia. The propane facility provides our utility in Virginia with 0.03 Bcf of propane air per day on a 10-day per year basis. This system is important to our Virginia operations because it provides propane as a substitute for natural gas when natural gas demand is peaking.

In addition, energy investments' properties include telecommunications conduit and fiber in public rights-of-way that are leased to our customers primarily in Atlanta and Phoenix. This includes over 76,000 fiber miles, of which approximately 32% of our dark fiber in Atlanta and 24% of our dark fiber in Phoenix has been leased.

Retail Energy Operations, Wholesale Services and Corporate The properties used at our retail energy operations, wholesale services and corporate segments consist primarily of leased and owned office space in Atlanta and Houston and their contents, including furniture and fixtures. The majority of our Atlanta-based employees are located at our corporate headquarters, a leased building with approximately 227,000 square feet of office space. In addition, our retail energy operations segment leases approximately 30,200 square feet at another office building in Atlanta. We lease approximately 32,000 square feet of office space for our employees in Houston.

We own or lease additional office, warehouse and other facilities throughout our operating areas. We consider our properties and the properties of our subsidiaries to be well maintained, in good operating condition and suitable for their intended purpose. We expect additional or substitute space to be available as needed to accommodate expansion of our operations.

Below is a map illustrating our total asset base and existing service territories as of December 31, 2006:



ITEM 3. LEGAL PROCEEDINGS

The nature of our business ordinarily results in periodic regulatory proceedings before various state and federal authorities. In addition, we are party, as both plaintiff and defendant, to a number of lawsuits related to our business on an ongoing basis. Management believes that the outcome of all regulatory proceedings and litigation in which we are currently involved will not have a material adverse effect on our consolidated financial condition or results of operations. Information regarding some of these proceedings is contained in Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations" under the caption "Results of Operations" and in Note 8 to our consolidated financial statements under the caption "Litigation" set forth in Item 8. "Financial Statements and Supplementary Data."

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of our security holders during the fourth quarter ended December 31, 2006.

ITEM 4A. EXECUTIVE OFFICERS OF THE REGISTRANT

Set forth below are the names, ages and positions of our executive officers along with their business experience during the past five years. All officers serve at the discretion of our Board of Directors. All information is as of the date of the filing of this report.

Name, age and position with the company	Periods served
John W. Somerhalder II, Age 51 (1)	
President and Chief Executive Officer	March 2006 – Present
Andrew W. Evans, Age 40 (2)	
Executive Vice President and Chief Financial Officer	May 2006 – Present
Senior Vice President and Chief Financial Officer	September 2005 – May 2006
Vice President and Treasurer	April 2002 – September 2005
Kevin P. Madden, Age 54	
Executive Vice President, External Affairs	November 2005 – Present
Executive Vice President, Distribution and Pipeline Operations	April 2002 – November 2005
Executive Vice President, Legal, Regulatory and Governmental Strategy	September 2001 – April 2002
R. Eric Martinez, Jr., Age 38	
Executive Vice President, Utility Operations	November 2005 – Present
Senior Vice President, Business Process Initiatives	August 2005 – November 2005
Vice President and General Manager of Elizabethtown Gas	December 2004 – August 2005
Senior Vice President, Engineering & Construction of Pivotal Energy Development	August 2003 – December 2004
Chief Operating Officer of AGL Networks, LLC	December 2002 – August 2003
Vice President and General Manager of AGL Networks, LLC	June 2002 – December 2002
Vice President, Business Development	October 2000 – June 2002
Paul R. Shlanta, Age 49	
Executive Vice President, General Counsel and Chief Ethics and Compliance Officer	September 2005 – Present
Senior Vice President, General Counsel and Chief Corporate Compliance Officer	September 2002 – September 2005
Senior Vice President, General Counsel and Corporate Secretary	July 2002 – September 2002
Senior Vice President and General Counsel	September 1998 – July 2002
Melanie M. Platt, Age 52	
Senior Vice President, Human Resources	September 2004 – Present
Senior Vice President and Chief Administrative Officer	November 2002 – September 2004
Vice President of Investor Relations	May 1998 – November 2002
Vice President and Corporate Secretary	January 1995 – June 2002
Douglas N. Schantz, Age 51 (3)	
President, Sequent Energy Management, LP	May 2003 – Present

(1) Mr. Somerhalder was executive vice president of El Paso Corporation (NYSE: EP) from 2000 until May 2005, and he continued service under a professional services agreement from May 2005 until March 2006.

(2) Mr. Evans was vice president of corporate development of Mirant Corporation's (NYSE: MIR) (formerly Southern Energy, Inc.) Mirant Americas business unit from June 2001 until April 2002.

(3) Mr. Schantz served as vice president of the gas origination division at Cinergy Marketing & Trading, LP, an affiliate of Cinergy Corp (NYSE: CIN), from September 2000 to April 2003.

PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Holders of Common Stock, Stock Price and Dividend Information

Our common stock is listed on the New York Stock Exchange under the symbol ATG. At January 31, 2007, there were 7,512 record holders of our common stock. Quarterly information concerning our high and low stock prices and cash dividends paid in 2006 and 2005 is as follows:

Quarter ended:	Sales price of common stock High	Sales price of common stock Low	Cash dividend per common share
2006			
March 31, 2006	$36.48	$34.40	$0.37
June 30, 2006	38.13	34.43	0.37
September 30, 2006	40.00	34.76	0.37
December 31, 2006	40.09	36.04	0.37
2005			
March 31, 2005	$36.09	$32.00	$0.31
June 30, 2005	38.89	33.37	0.31
September 30, 2005	39.32	35.29	0.31
December 31, 2005	37.54	32.23	0.37

We have historically paid dividends to common shareholders four times a year: March 1, June 1, September 1 and December 1. We have paid 237 consecutive quarterly dividends beginning in 1948. Our common shareholders may receive dividends when declared at the discretion of our Board of Directors. See Item 7 "Management's Discussion and Analysis of Financial Condition and Results of Operations – Liquidity and Capital Resources – Cash Flow from Financing Activities – Dividends on Common Stock." Dividends may be paid in cash, stock or other form of payment, and payment of future dividends will depend on our future earnings, cash flow, financial requirements and other factors, some of which are noted below. In certain cases, our ability to pay dividends to our common shareholders is limited by the following:

- our ability to satisfy our obligations under certain financing agreements, including debt-to-capitalization and total shareholders' equity covenants
- our ability to satisfy our obligations to any preferred shareholders

Under Georgia law, the payment of cash dividends to the holders of our common stock is limited to our legally available assets and subject to the prior payment of dividends on any outstanding shares of preferred stock. Our assets are not legally available for paying cash dividends if, after payment of the dividend;

- we could not pay our debts as they become due in the usual course of business, or
- our total assets would be less than our total liabilities plus, subject to some exceptions, any amounts necessary to satisfy (upon dissolution) the preferential rights of shareholders whose preferential rights are superior to those of the shareholders receiving the dividends

Issuer Purchases of Equity Securities

The following table sets forth information regarding purchases of our common stock by us and any affiliated purchasers during the three months ended December 31, 2006. Stock repurchases may be made in the open market or in private transactions at times and in amounts that we deem appropriate. However, there is no guarantee as to the exact number of additional shares that may be repurchased, and we may terminate or limit the stock repurchase program at any time. We will hold the repurchased shares as treasury shares.

Period	Total number of shares purchased (1) (2) (3)	Average price paid per share	Total number of shares purchased as part of publicly announced plans or programs (3)	Maximum number of shares that may yet be purchased under the publicly announced plans or programs (3)
October 2006	111,000	$37.02	109,100	7,160,400
November 2006	108,421	$37.74	105,000	7,055,400
December 2006	98,480	$39.10	82,900	6,972,500
Total fourth quarter	**317,901**	**$37.92**	297,000	

(1) The total number of shares purchased includes an aggregate of 8,100 shares surrendered to us to satisfy tax withholding obligations in connection with the vesting of shares of restricted stock and/or the exercise of stock options.

(2) On March 20, 2001, our Board of Directors approved the purchase of up to 600,000 shares of our common stock in the open market to be used for issuances under the Officer Incentive Plan (Officer Plan). We purchased 20,000 and 12,801 shares for such purposes in the third and fourth quarters of 2006, respectively. As of December 31, 2006, we had purchased a total 286,567 of the 600,000 shares authorized for purchase, leaving 313,433 shares available for purchase under this program.

(3) On February 3, 2006, we announced that our Board of Directors had authorized a plan to repurchase up to a total of 8 million shares of our common stock, excluding the shares remaining available for purchase in connection with the Officer Plan as described in note (2) above, over a five-year period.

The information required by this item regarding securities authorized for issuance under our equity compensation plans will be set forth under the caption "Executive Compensation – Equity Compensation Plan Information" in the Proxy Statement for our 2007 Annual Meeting of Shareholders or in a subsequent amendment to this report. All such information will be incorporated by reference from the Proxy Statement in Item 12, "Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters" hereof or set forth in such amendment to this report.

ITEM 6. SELECTED FINANCIAL DATA

Selected financial data about AGL Resources is set forth in the table below. You should read the data in the table in conjunction with the consolidated financial statements and related notes set forth in Item 8, "Financial Statements and Supplementary Data."

Dollars and shares in millions, except per share amounts	2006	2005	2004	2003	2002
Income statement data					
Operating revenues	$2,621	$2,718	$1,832	$983	$877
Cost of gas	1,482	1,626	995	339	268
Operating margin (1)	1,139	1,092	837	644	609
Operating expenses					
Operation and maintenance	473	477	377	283	274
Depreciation and amortization	138	133	99	91	89
Taxes other than income taxes	40	40	29	28	29
Total operating expenses	651	650	505	402	392
Gain on sale of Caroline Street campus	-	-	-	16	-
Operating income	488	442	332	258	217
Equity in earnings of SouthStar Energy Services LLC	-	-	-	46	27
Other (expense) income	(1)	(1)	-	(6)	3
Minority interest	(23)	(22)	(18)	-	-
Earnings before interest and taxes (EBIT) (1)	464	419	314	298	247
Interest expense	123	109	71	75	86
Earnings before income taxes	341	310	243	223	161
Income taxes	129	117	90	87	58
Income before cumulative effect of change in accounting principle	212	193	153	136	103
Cumulative effect of change in accounting principle, net of $5 in income taxes	-	-	-	(8)	-
Net income	$212	$193	$153	$128	$103
Common stock data					
Weighted average shares outstanding basic	77.6	77.3	66.3	63.1	56.1
Weighted average shares outstanding diluted	78.0	77.8	67.0	63.7	56.6
Total shares outstanding (2)	77.7	77.8	76.7	64.5	56.7
Earnings per share basic	$2.73	$2.50	$2.30	$2.03	$1.84
Earnings per share diluted	$2.72	$2.48	$2.28	$2.01	$1.82
Dividends declared per share	$1.48	$1.30	$1.15	$1.11	$1.08
Dividend payout ratio	54%	52%	50%	55%	59%
Dividend yield	3.8%	3.7%	3.5%	3.8%	4.4%
Book value per share (3)	$20.72	$19.27	$18.04	$14.66	$12.52
Price-earnings ratio	14.3	13.9	14.5	14.3	13.2
Market value per share (4)	$38.91	$34.81	$33.24	$29.10	$24.30
Market value (2)	$3,023	$2,708	$2,551	$1,877	$1,378
Balance sheet data (2)					
Total assets	$6,147	$6,320	$5,637	$3,972	$3,742
Property, plant and equipment – net	3,436	3,333	3,178	2,345	2,194
Working capital	195	73	(20)	(306)	(429)
Total debt	2,161	2,137	1,957	1,340	1,413
Common shareholders' equity	1,609	1,499	1,385	945	710
Cash flow data					
Net cash provided by operating activities	$354	$80	$287	$122	$286
Property, plant and equipment expenditures	253	267	264	158	187
Net payments and borrowings of short-term debt	6	188	(480)	(82)	4
Cash paid for interest	108	89	50	60	73
Financial ratios (2)					
Total debt	57%	59%	59%	59%	67%
Common shareholders' equity	43%	41%	41%	41%	33%
Total	100%	100%	100%	100%	100%
Return on average common shareholders' equity	13.6%	13.4%	13.1%	15.5%	14.7%

(1) These are non-GAAP measurements. A reconciliation of operating margin and EBIT to our operating income and net income is contained in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations-AGL Resources-Results of Operations."
(2) As of the last day of the fiscal period.
(3) Common shareholders' equity divided by total outstanding common shares as of the last day of the fiscal period.
(4) Closing price of common stock on the New York Stock Exchange as of the last trading day of the fiscal period.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

We are an energy services holding company whose principal business is the distribution of natural gas in six states - Florida, Georgia, Maryland, New Jersey, Tennessee and Virginia. Our six utilities serve more than 2.2 million end-use customers, making us the largest distributor of natural gas in the southeastern and mid-Atlantic regions of the United States based on customer count. We are involved in various related businesses, including retail natural gas marketing to end-use customers primarily in Georgia; natural gas asset management and related logistics activities for our own utilities as well as for nonaffiliated companies; natural gas storage arbitrage and related activities; and the development and operation of high-deliverability underground natural gas storage assets. We also own and operate a small telecommunications business that constructs and operates conduit and fiber infrastructure within select metropolitan areas. We manage these businesses through four operating segments – distribution operations, retail energy operations, wholesale services and energy investments – and a nonoperating corporate segment. As of December 31, 2006, we employed a total of 2,369 employees across these five segments.

The distribution operations segment is the largest component of our business and is subject to regulation and oversight by agencies in each of the six states we serve. These agencies approve natural gas rates designed to provide us the opportunity to generate revenues to recover the cost of natural gas delivered to our customers and our fixed and variable costs such as depreciation, interest, maintenance and overhead costs, and to earn a reasonable return for our shareholders. With the exception of Atlanta Gas Light, our largest utility, the earnings of our regulated utilities can be affected by customer consumption patterns that are a function of weather conditions and price levels for natural gas. Our non-Georgia jurisdictions have various regulatory mechanisms to provide us with a reasonable opportunity to recover our costs, but these methods of recovery are not direct offsets to the potential impacts on earnings. Atlanta Gas Light charges rates to its customers primarily as monthly fixed charges. Our retail energy operations segment, which consists of SouthStar, also is weather sensitive and uses a variety of hedging strategies, such as weather derivative instruments and other risk management tools, to mitigate potential weather impacts. Our Sequent subsidiary within our wholesale services segment is weather sensitive, with increased earnings opportunities, as well as increased loss potential, during periods of extreme weather conditions, which typically produce greater price volatility. Our energy investments segment's primary business is our natural gas storage, which develops, acquires and operates high-deliverability salt-dome storage assets in the Gulf Coast region of the United States. While this business also can generate additional revenue during times of peak market demand for natural gas storage services, the majority of our storage services are covered under medium to long-term contracts at a fixed market rate.

2006 Business Highlights

We achieved several significant milestones during 2006 that position us well for future growth and for providing long-term value to our shareholders.

- We completed our rate proceeding in Virginia, which resulted in a five-year rate freeze for customers under the first performance based rate (PBR) plan approved in that state for a natural gas utility. As part of the settlement reached with the parties in the case, we have committed to spend approximately $48 million to $60 million to build a new pipeline that will improve access to natural gas in certain areas we serve in Virginia, particularly during critical peak periods. Also, the Virginia Commission approved a permanent WNA for residential customers as part of the settlement.

- We successfully resolved our rate proceeding in Tennessee, which resulted in a $3 million base rate increase effective January 1, 2007 to offset higher costs and lower natural gas consumption. Additionally, the rate proceeding improved our authorized return and improved our capital structure (55% debt and 45% equity) in a manner that is more consistent with our utilities and other non-affiliated utilities.

- We continued to grow our asset management business at Sequent which enables them to generate greater levels of economic value during periods of market volatility.

- We expanded, through SouthStar, our retail footprint into the Ohio and Florida markets.

- We announced our intention to develop a 12 Bcf natural gas salt-dome storage facility, known as Golden Triangle Storage, in Beaumont, Texas, at a capital cost of approximately $180 million. The project will provide high-deliverability Gulf Coast storage at a key market point, with the first phase scheduled to be in commercial operation in 2010.

2006 Business Results

In 2006, we earned $212 million in net income or $2.72 per diluted share, compared with net income of $193 million, or $2.48 per diluted share, in 2005. The 10% increase in net income was the result of a variety of factors:

- Our distribution operations segment's EBIT improved by $11 million or 4% in 2006 as compared to 2005. We continued to benefit from the improved operating metrics of the utilities we acquired in 2004. These results were offset, however, by customer consumption declines due to warmer-than-normal weather throughout the year and high natural gas prices, particularly during the first quarter of 2006.

- Our retail energy operations segment provided stable year-over-year earnings contributions despite the effects of declining customer consumption, warmer weather and a lower of weighted average cost or current market price (LOCOM) adjustment to inventory. This segment's marketing efforts during the year also resulted in a slight increase in customer count.

- Our wholesale services segment captured significant arbitrage opportunities due to price volatility and periods of extreme weather conditions. As a result, this segment's EBIT contribution of $90 million was $41 million higher than in 2005, primarily as a result of additional commercial activity and storage arbitrage opportunities throughout the year, as well as the recognition of hedge gains as forward NYMEX prices declined.

- Our energy investments segment made progress on the evaluation and development of several projects during 2006. While these projects are expected to provide future earnings contributions, the associated business development expenses resulted in a lower year-over-year performance in this segment as well as the disposition in the second half of 2005 of certain non-strategic assets acquired as part of the acquisition of NUI in December 2004.

- Our interest expense for 2006 increased $14 million as compared to 2005. The increase reflects higher carrying costs associated with higher inventory storage balances, as well as higher short-term interest rates, relative to the prior year.

Results of Operations

<u>**AGL Resources**</u>

Revenues We generate nearly all our operating revenues through the sale, distribution and storage of natural gas. We include in our consolidated revenues an estimate of revenues from natural gas distributed, but not yet billed, to residential and commercial customers from the latest meter reading date to the end of the reporting period.

Operating Margin and EBIT We evaluate the performance of our operating segments using the measures of operating margin and EBIT. We believe operating margin is a better indicator than revenues for the contribution resulting from customer growth in our distribution operations segment since the cost of gas can vary significantly and is generally passed directly to our customers. We also consider operating margin to be a better indicator in our retail energy operations, wholesale services and energy investments segments since it is a direct measure of gross profit before overhead costs. We believe EBIT is a useful measurement of our operating segments' performance because it provides information that can be used to evaluate the effectiveness of our businesses from an operational perspective, exclusive of the costs to finance those activities and exclusive of income taxes, neither of which is directly relevant to the efficiency of those operations.

Our operating margin and EBIT are not measures that are considered to be calculated in accordance with accounting principles generally accepted in the United States of America (GAAP). You should not consider operating margin or EBIT an alternative to, or a more meaningful indicator of, our operating performance than operating income or net income as determined in accordance with GAAP. In addition, our operating margin or EBIT measure may not be comparable to similarly titled measures of other companies. The following table sets forth a reconciliation of our operating margin and EBIT to our operating income and net income, together with other consolidated financial information for the years ended December 31, 2006, 2005 and 2004.

In millions	2006	2005	2004
Operating revenues	$2,621	$2,718	$1,832
Cost of gas	1,482	1,626	995
Operating margin	1,139	1,092	837
Operating expenses			
Operation and maintenance	473	477	377
Depreciation and amortization	138	133	99
Taxes other than income	40	40	29
Total operating expenses	651	650	505
Operating income	488	442	332
Other expenses	(1)	(1)	-
Minority interest	(23)	(22)	(18)
EBIT	464	419	314
Interest expense	123	109	71
Earnings before income taxes	341	310	243
Income taxes	129	117	90
Net income	$212	$193	$153
Earnings per common share:			
Basic	$2.73	$2.50	$2.30
Diluted	$2.72	$2.48	$2.28
Weighted average number of common shares outstanding:			
Basic	77.6	77.3	66.3
Diluted	78.0	77.8	67.0

Segment information Operating revenues, operating margin, operating expenses and EBIT information for each of our segments are presented in the following table for the years ended December 31, 2006, 2005 and 2004:

In millions	**Operating revenues**	**Operating margin** (1)	**Operating expenses**	**EBIT** (1)
2006				
Distribution operations	$1,624	$807	$499	$310
Retail energy operations	930	156	68	63
Wholesale services	182	139	49	90
Energy investments	41	36	26	10
Corporate (2)	(156)	1	9	(9)
Consolidated	$2,621	$1,139	$651	$464
2005				
Distribution operations	$1,753	$814	$518	$299
Retail energy operations	996	146	61	63
Wholesale services	95	92	42	49
Energy investments	56	40	23	19
Corporate (2)	(182)	-	6	(11)
Consolidated	$2,718	$1,092	$650	$419
2004				
Distribution operations	$1,111	$640	$394	$247
Retail energy operations	827	132	62	52
Wholesale services	54	53	29	24
Energy investments	25	13	8	7
Corporate (2)	(185)	(1)	12	(16)
Consolidated	$1,832	$837	$505	$314

(1) These are non-GAAP measurements. A reconciliation of operating margin and EBIT to our operating income and net income is contained in Results of Operations – AGL Resources.

(2) Includes the elimination of intercompany revenues and cost of gas.

Discussion of Consolidated Results

2006 compared to 2005 The increase in EBIT of $45 million or 11% in 2006 was primarily the result of increases at the distribution operations and wholesale services segments. Wholesale services' EBIT improvement of $41 million primarily reflected the recognition of hedge gains during 2006, as forward NYMEX prices declined significantly. In contrast, NYMEX price increases experienced during 2005 had the opposite effect, but to a lesser extent. In the distribution operations segment, EBIT improved by $11 million, and operating margin declined $7 million offset primarily by reduced operating expenses of $19 million. Our retail energy operations segment's EBIT was flat compared to 2005. The energy investments segment's EBIT was down $9 million primarily due to the loss of EBIT contributions as the result of the sale in 2005 of certain assets that were originally acquired with the 2004 acquisition of NUI.

Our operating margin increased $47 million or 4% from 2005. The following table indicates the significant changes in our operating margin:

In millions	
Operating margin for 2005	$1,092
Net change in the fair value of hedges at wholesale services	60
Increased operating margins at retail energy operations	16
Increased wholesale services commercial activities	5
Wholesale services inventory LOCOM adjustments (net of hedging recoveries)	(18)
Retail energy operations inventory LOCOM adjustments	(6)
Lower operating margins at distribution operations utilities	(7)
Loss of margin from energy investment assets sold in 2005	(9)
Other	6
Operating margin for 2006	$1,139

Changes in commodity prices subject a significant portion of our operations to earnings variability. Our nonutility businesses principally use physical and financial arrangements to economically hedge the risks associated with both weather-related seasonal fluctuations and changing commodity prices. In addition, because these economic hedges are generally not designated for hedge accounting treatment, our reported earnings for the wholesale services and retail energy operations segments reflect changes in the fair values of certain derivatives. These values may change significantly from period to period and are reflected as gains or losses within our operating margin or our other comprehensive income (OCI) for those derivative instruments that qualify and are designated as accounting hedges.

Forward NYMEX prices decreased during 2006, especially during the third and fourth quarters. This resulted in the wholesale services segment recognizing $41 million of storage hedge gains in 2006, compared to the recognition of $7 million of storage hedge losses in 2005. In addition, wholesale services recognized $12 million in gains associated with the financial instruments used to hedge its transportation capacity. Consequently, wholesale services experienced a net change of $60 million from its hedging activities for 2006 compared to 2005.

The results of the wholesale services segment also reflect improved commercial activities of approximately $5 million. Sequent was able to capture higher seasonal storage margins in 2006 and additional operating margin opportunities brought on by higher temperatures during the late summer months. This offset the lower operating margins that resulted from milder weather earlier in the year.

As a result of decreasing NYMEX prices, the wholesale services segment evaluated the weighted average cost of its natural gas inventory and recorded LOCOM adjustments totaling $43 million during 2006; however, as inventory was physically withdrawn from storage during the year, $22 million of the 2006 adjustments were recovered and reflected in 2006 operating revenues when the original economic results were realized as the related hedging derivatives were settled.

We experienced increased operating margins at our retail energy operations segment of $10 million driven by improved retail margins of $6 million and slightly higher storage and commercial margins of $4 million. Storage and commercial margins were driven by improved optimization of storage and transportation assets and effective commodity risk management, including net gains on weather derivatives offset by a $6 million adjustment in 2006 to reduce inventory to market for which no LOCOM adjustment was recorded in 2005. Retail operating margins increased due to improved retail price spreads and an increase in the average number of customers offset by lower customer consumption due to weather that was more than 10% warmer than the previous year and lower late payment fees of $1 million due to an increase in the number of customers utilizing payment arrangements.

Operating margin for the distribution operations segment decreased $7 million primarily from warmer

weather affecting customer usage and from our exiting the New Jersey and Florida appliance businesses. The margin at Elizabethtown Gas decreased $3 million with 18% warmer weather than in 2005. Virginia Natural Gas' margin decreased $4 million with 17% warmer weather, and the margin at Florida City Gas decreased $2 million with 16% warmer weather. Further, our exiting from the New Jersey and Florida appliance businesses reduced margin by $3 million. This margin reduction was partially offset by increased margin at Atlanta Gas Light of $6 million primarily from gas storage carrying costs from higher average inventory balances and pipeline replacement program revenues from the continuing expenditures under the program.

Our energy investments segment operating margin decreased $4 million due to the loss of contributions from certain assets we acquired with the 2004 acquisition of NUI, but later sold in 2005.

Our operating expenses increased $1 million or 0.2% from the same period in 2005. The following table sets forth the significant components of operating expenses:

In millions	
Operating expenses for 2005	$650
Increased depreciation and amortization	5
Increased payroll, incentive compensation and corporate overhead allocated costs at wholesale services	7
Increased bad debt expenses at retail energy operations and distribution operations	4
Lower expenses resulting from energy investment assets sold in 2005	(8)
Lower expenses at distribution operations related to workforce and facilities restructurings in 2005 and 2006	(15)
Other	8
Operating expenses for 2006	$651

The wholesale services segment recorded $7 million of additional costs associated with payroll due to an increased number of employees to support growth and increased incentive compensation, which is generally based on Sequent's operating performance. Bad debt expense for 2006 increased over 2005 primarily in our retail energy operations segment. The retail energy operation's bad debt for 2006 was $13 million, a $3 million increase from the same period in 2005, driven by an increase in the number of accounts receivable balances past due more than 60 days due to higher natural gas bills.

These increases were offset by $15 million in lower costs primarily related to a 2005 restructuring at the distribution operations segment, as a result of a reduction in the workforce and elimination of unnecessary facilities following the 2004 acquisition of NUI. An additional $8 million decrease in operating expenses was related to the operation of assets, primarily in the energy investments segment, that were originally acquired in the 2004 acquisition of NUI and later sold in 2005.

Interest expense for 2006 increased by $14 million or 13% as compared to 2005. As indicated in the following table, higher short-term interest rates and higher debt outstanding combined to increase our interest expense in 2006 relative to the previous year. The increase of $200 million in average debt outstanding for 2006 compared to 2005 was due to additional debt incurred as a result of higher working capital requirements.

In millions	**2006**	**2005**
Total interest expense	$123	$109
Average debt outstanding (1)	2,023	1,823
Average interest rate	6.1%	6.0%

(1) Daily average of all outstanding debt.

Based on $733 million of variable-rate debt, which includes $527 million of variable-rate short-term debt, $100 million of variable-rate senior notes and $106 million of variable-rate gas facility revenue bonds outstanding at December 31, 2006, a 100 basis point change in market interest rates from 5% to 6% would result in an increase in annual pretax interest expense of $7 million.

The increase in income tax expense of $12 million or 10% for 2006 compared to 2005 reflected additional income taxes primarily due to higher corporate earnings year over year. We expect our effective tax rate for the year ending December 31, 2007, to be similar to the effective rate for the year ended December 31, 2006.

2005 compared to 2004 Consolidated EBIT for 2005 increased by $105 million or 33% from the previous year, of which $56 million related to EBIT contributions from the 2004 acquisitions of NUI and Jefferson Island Storage & Hub, LLC (Jefferson Island) and from Pivotal Propane of Virginia, Inc. (Pivotal Propane) which became operational in 2005. The increase further reflected increased contributions of $8 million from Atlanta Gas Light in distribution operations, $11 million from retail energy operations and $3 million from AGL Networks, LLC (AGL Networks) in energy investments. Wholesale services' EBIT increased $25 million primarily due to increased operating margins partially offset by higher operating expenses. Corporate segment results improved by $5 million compared to 2004, primarily due to merger and acquisition-related costs incurred in 2004 but not in 2005.

Our operating margin in 2005 increased $255 million or 30% from 2004. The following table indicates the significant changes in our operating margin:

In millions	
Operating margin in 2004	$837
Increased operating margin at distribution operations from acquired utilities	167
Increased wholesale services commercial activities	53
Increased operating margins at retail energy operations	14
Increased operating margins at Jefferson Island	13
Operating margin from energy investment assets acquired from NUI Corp.	8
Increased operating margin at distribution operations, primarily Atlanta Gas Light	7
Increased operating margins at Pivotal Propane and AGL Networks	7
Inventory LOCOM adjustments at wholesale services	(2)
Net change in the fair value of hedges at wholesale services	(12)
Operating margin in 2005	$1,092

The increase primarily reflects the NUI and Jefferson Island acquisitions and completion of the Pivotal Propane facility in Virginia, as well as improved margins at SouthStar, Sequent and AGL Networks. Excluding the addition of the NUI utilities, distribution operations' margins improved by $7 million mainly as a result of higher pipeline replacement revenues and additional carrying costs charged to Marketers for gas storage. Retail energy operations' margins increased $14 million, due primarily to higher commodity margins. Wholesale services' operating margin increased $39 million year over year, primarily due to significant market volatility following the hurricane activity during the third quarter and the continuing volatile market conditions during the fourth quarter of 2005. Energy investments' margins were up $27 million, primarily as a result of the acquisition of Jefferson Island that contributed $13 million, contributions from NUI's nonutility businesses of $8 million, contribution from Pivotal Propane of $3 million and improved operating margin at AGL Networks of $4 million.

Our operating expenses increased $145 million or 29% from 2004. The following table sets forth the significant changes in our operating expenses:

In millions	
Operating expenses in 2004	$505
Operating expenses at distribution operations from NUI utilities acquired December 2004	125
Increased operating expenses at wholesale services, primarily payroll, incentive compensation and depreciation	13
Operating expenses at energy investments from NUI acquired assets	8
Operating expenses at Jefferson Island	3
Operating expenses at energy investments from Pivotal Propane	3
Other	(7)
Operating expenses in 2005	$650

The increase was primarily a result of $124 million in higher expenses at distribution operations due to the addition of NUI. In addition, operating expenses at energy investments increased $15 million primarily due to the addition of Jefferson Island, the NUI nonutility assets and Pivotal Propane. Operating expenses at wholesale services increased $13 million due to increased payroll and employee incentive compensation costs resulting from its operational and financial growth and depreciation on a trading and risk management system placed in service during 2004. The increased operating expenses were offset by lower corporate operating expenses primarily due to prior-year costs incurred with merger and acquisition activities.

Interest expense for 2005 increased by $38 million or 54% as compared to 2004. As indicated in the table below, higher short-term interest rates and higher average debt outstanding combined to increase our interest expense in 2005 relative to the previous year. The increase of $549 million in average debt outstanding for 2005 was due to additional debt incurred as a result of the acquisitions of NUI and Jefferson Island and higher working capital requirements as a result of higher natural gas prices.

in millions	**2005**	**2004**
Total interest expense	$109	$71
Average debt outstanding (1)	1,823	1,274
Average interest rate	6.0%	5.6%

(1) Daily average of all outstanding debt.

The increase in income tax expense of $27 million or 30% for 2005 compared to 2004 reflected additional income taxes of $25 million due to higher corporate earnings year over year and $2 million due to a slightly higher effective tax rate of 38% for 2005 as compared to 37% in 2004.

Distribution Operations

Distribution operations includes our six natural gas local distribution utility companies that construct, manage and maintain intrastate natural gas pipelines and distribution facilities and serve more than 2.2 million end-use customers.

Atlanta Gas Light This natural gas local distribution utility operates distribution systems and related facilities throughout Georgia serving approximately 1.5 million end-use customers. Atlanta Gas Light customer counts are approximately 94% residential and 6% commercial or industrial. Atlanta Gas Light is regulated by the Georgia Commission and its rates are frozen until 2010.

Atlanta Gas Light's natural gas market was deregulated in 1997 with Georgia's Natural Gas Competition and Deregulation Act (Deregulation Act). Prior to this act, Atlanta Gas Light was the supplier and seller of natural gas to its customers. Today, Marketers—that is, marketers who are certificated by the Georgia Commission to sell retail natural gas in Georgia on terms approved by the Georgia Commission — sell natural gas to end-use customers in Georgia and handle customer billing functions. The Marketers file their rates monthly with the Georgia Commission. Atlanta Gas Light's role includes

- distributing natural gas for Marketers
- constructing, operating and maintaining the gas system infrastructure, including responding to customer service calls and leaks
- reading meters and maintaining underlying customer premise information for Marketers

Elizabethtown Gas This natural gas local distribution utility operates distribution systems and related facilities serving approximately 269,000 customers in central and northwestern New Jersey. Most Elizabethtown Gas customers are located in densely populated central New Jersey, where increases in the number of customers primarily result from conversions to gas heating from alternative forms of heating. In the northwestern region of the state, customer additions are driven primarily by new construction. Elizabethtown Gas customer counts are approximately 92% residential and 8% commercial or industrial. Elizabethtown Gas is regulated by the New Jersey Commission and its rates are frozen until 2010.

Virginia Natural Gas This natural gas local distribution utility operates distribution systems and related facilities serving approximately 264,000 customers in southeastern Virginia. Virginia Natural Gas customer counts are approximately 92% residential and 8% commercial or industrial. Virginia Natural Gas is regulated by the Virginia Commission and its rates are frozen until 2011 subject to the terms of its PBR plan.

Florida City Gas This natural gas local distribution utility operates distribution systems and related facilities serving approximately 104,000 customers in central and southern Florida. Florida City Gas customers purchase gas primarily for heating water, drying clothes and cooking. Some customers, mainly in central Florida, also purchase gas to provide space heating during the winter season. Florida City Gas customer counts are approximately 94% residential and 6% commercial or industrial. Florida City Gas is regulated by the Florida Commission.

Chattanooga Gas This natural gas local distribution utility operates distribution systems and related facilities serving approximately 61,000 customers in the Chattanooga and Cleveland areas of southeastern Tennessee. Chattanooga Gas customer counts are approximately 86% residential and 14% commercial or industrial. Chattanooga Gas is regulated by the Tennessee Commission.

Elkton Gas This natural gas local distribution utility operates distribution systems and related facilities serving approximately 6,000 customers in Cecil County, Maryland. Elkton Gas customer counts are approximately 92% residential and 8% commercial or industrial. Elkton Gas is regulated by the Maryland Commission.

The following table provides operational information for our five largest utilities. The daily capacity represents total system capability, and the storage capacity includes on-system LNG and propane volumes.

	Atlanta Gas Light	Elizabethtown Gas	Virginia Natural Gas	Florida City Gas	Chattanooga Gas
Operations					
2006 avg. customers (in thousands)	1,546	269	264	104	61
2005 avg. customers (in thousands)	1,545	266	261	103	61
2004 avg. customers (in thousands) (6)	1,533	263	256	103	60
Storage capacity (1)	48.4	13.0	9.6	-	3.6
Throughput -- 2006 (1)	211	46	33	9	15
Throughput -- 2005 (1)	232	59	36	10	16
Throughput -- 2004 (1) (6)	233	65	34	9	16
Peak storage capacity (1)	7.8	0.8	1.6	-	1.2
Miles of main (7)	30,284	3,030	5,235	3,207	1,521
Heating degree days -- 2006 (2)	2,466	4,110	2,869	696	2,898
2006 % warmer than 2005	(10%)	(18%)	(17%)	(16%)	(7%)
Heating degree days -- 2005 (2)	2,726	5,017	3,465	829	3,115
2005 % colder than 2004	5%	2%	8%	3%	3%
Heating degree days -- 2004 (2) (6)	2,589	4,918	3,214	802	3,010
Rates					
Last decision on change in rates	Jun. 2005	Nov. 2002	Oct. 1996	Feb. 2004	Dec. 2006
Authorized return on rate base (5)	8.53%	7.95%	9.24%	7.36%	7.43%
Estimated 2006 return on rate base (3)	8.45%	7.83%	7.65%	7.41%	7.00%
Authorized return on equity	10.9%	10.0%	10.9%	11.25%	10.2%
Estimated 2006 return on equity (3)	10.73%	9.40%	8.49%	10.67%	9.01%
Authorized rate base % of equity (4)	47.9%	53.0%	52.4%	36.8%	35.5%
Rate base included in 2006 return on equity (in millions) (4)	$1,238	$417	$351	$120	$102

(1) In Bcf
(2) We measure effects of weather on our businesses using "degree days." The measure of degree days for a given day is the mean daily temperature (average of the daily high and low temperature) and a baseline temperature of 65 degrees Fahrenheit. Heating degree days result when the mean daily temperature is less than the 65-degree baseline. Generally, increased heating degree days result in greater demand for gas on our distribution systems.
(3) Estimate based on principles consistent with utility ratemaking in each jurisdiction. Returns are not necessarily consistent with GAAP returns.
(4) Estimated based on 13-month average.
(5) The authorized return on rate base, return on equity, and percentage of equity reflected above were those authorized as of December 31, 2006. Effective January 1, 2007, Chattanooga Gas' authorized return on rate base, return on equity and percentage of equity are 7.89%, 10.2% and 44.8%, respectively, due to the results of its base rate case settled in December 2006.
(6) Includes amounts for the full year of 2004; however, we acquired these utilities in December 2004. The December 2004 end-use customers for Elizabethtown Gas was 266 and 103 for Florida City Gas, December 2004 distribution for Elizabethtown Gas was 8.2 and 0.9 for Florida City Gas; and December 2004 heating degree days for Elizabethtown Gas was 873 and 239 for Florida City Gas.
(7) Includes distribution and transmission main only.

Regulatory Environment Each utility operates subject to regulations provided by the state regulatory agency in its service territories with respect to rates charged to our customers and various service and safety matters. Rates charged to our customers vary according to customer class (residential, commercial or industrial) and rate jurisdiction. Rates are set at levels that allow recovery of all prudently incurred costs, including a return on rate base sufficient to pay interest on debt and provide a reasonable return on common equity. Rate base generally consists of the original cost of utility plant in service, working capital, inventories and certain other assets; less accumulated depreciation on utility plant in service, net deferred income tax liabilities and certain other deductions. Our utilities are authorized to use a purchased gas adjustment (PGA) mechanism that allows them to automatically adjust their rates to reflect changes in the wholesale cost of natural gas and to ensure the utilities recover 100% of the costs incurred in purchasing gas for their customers. We continuously monitor the performance of our utilities to determine whether rates need to be further adjusted through a rate case filing.

Straight-Fixed-Variable Rates Atlanta Gas Light recognizes revenue under a straight-fixed-variable rate design whereby Atlanta Gas Light charges rates to its customers based primarily on monthly fixed charges, however the Marketers bill these charges directly to their customers. This mechanism minimizes the seasonality of revenues since the monthly fixed charge is not volumetric and the monthly charge is not set to be directly weather dependent. Weather indirectly influences the number of customers that have active accounts during the heating season, and this has a seasonal impact on Atlanta Gas Light's revenues since generally more customers are connected in periods of colder weather than in periods of warmer weather.

Weather Normalization The tariffs of Elizabethtown Gas, Virginia Natural Gas, and Chattanooga Gas contain WNA provisions that are designed to help stabilize operating margin results by increasing base rate amounts charged to customers when weather is warmer than normal and decreasing amounts charged when weather is colder than normal. The WNA is most effective in a reasonable temperature range relative to normal weather using historical averages. For Elizabethtown Gas, the weather normalization provision was renewed in October 2004 and is based on a 20-year average of weather conditions.

Virginia Natural Gas received from the Virginia Commission approval of a weather normalization program in September 2002 as a two-year experiment involving the use of special rates. In September 2004, Virginia Natural Gas received approval from the Virginia Commission to extend the WNA program for an additional two years with certain modifications to the existing program. The modifications included removal of the commercial class of customers from the WNA program and the use of a rolling 30-year average to calculate the weather factor that is updated annually. The residential WNA program was made permanent by Virginia Commission order in September 2006.

Chattanooga Gas' base rates include a weather normalization provision that allows for revenue to be recognized based on a factor derived from average temperatures over a 30-year period, which offsets the impact of unusually cold or warm weather on its operating income.

Rate Settlement Agreements On July 24, 2006, the Virginia Commission issued an order approving Virginia Natural Gas' PBR plan with modifications. Under the PBR rate plan, Virginia Natural Gas' rates were frozen as an incentive for it to promote cost containment, productivity and rate stability without traditional rate proceedings that set rates based on investment, return and cost of service. These modifications include a requirement to construct and report on the progress of a pipeline connecting Virginia Natural Gas' northern and southern systems and reporting requirements to monitor compliance with the terms of the PBR plan. Virginia Natural Gas accepted the terms of the PBR plan as modified by the Virginia Commission in August 2006. The modified PBR plan was effective August 1, 2006 with base rates frozen at current levels for five years. The estimated cost to construct the pipeline is between $48 million and $60 million, and the pipeline is expected to be completed in 2009.

On June 30, 2006, we filed a general rate case with the Tennessee Commission seeking approximately $6 million in increased annual base rates to cover the rising cost of service at Chattanooga Gas. Our rate case included a proposal for comprehensive rate design, including an energy conservation program (ECP) and a conservation and usage adjustment (CUA). The ECP would provide incentives for customers to reduce their natural gas consumption by offering rebates for more energy-efficient appliances and to help customers better manage their energy costs. The CUA is designed to mitigate the financial impact on Chattanooga Gas of expected increased energy conservation by customers through rate adjustments.

The Tennessee Commission divided the case into two phases: one phase to examine the revenue requirements and traditional rate design issues and a second phase to review the CUA and ECP. Approximately $5 million of our base rate request was related to the revenue requirement. In December 2006, the Tennessee Commission approved a settlement agreement between Chattanooga Gas, the Consumer Advocate and Protection Division of the Attorney General's Office (Consumer Advocate) and the Chattanooga Manufacturers Association settling the revenue requirements and traditional rate design issues of the case. The settlement agreement was effective January 1, 2007 and provides for a base rate increase of approximately $3 million of which $2 million will be an increase in operating margin and the remaining will be a $1 million shift from WNA to base rates and have no overall impact on operating margin.

The settlement agreement establishes and authorized return on equity of 10.2% for Chattanooga Gas, resulting in an overall authorized rate of return of 7.89%. Prior to the settlement agreement, Chattanooga Gas' authorized return on equity was 10.2% and its overall authorized rate of return was set at 7.43%. The second phase of the case is scheduled to begin in February 2007 with a final ruling expected by September 30, 2007.

Customer Demand Our distribution operations businesses face competition based on customer preferences for natural gas compared to other energy products and the comparative prices of those products. Our principal competition relates to electric utilities and oil and propane providers serving the residential and commercial markets throughout our service areas primarily through the potential displacement or replacement of natural gas appliances with electric appliances. The primary competitive factors are the prices for competing sources of energy and the desirability of natural gas heating versus alternative heating sources.

Competition for space heating and general household and small commercial energy needs generally occurs at the initial installation phase when the customer or builder makes decisions as to which types of equipment to install. Customers generally continue to use the chosen energy source for the life of the equipment. Customer demand for natural gas could be affected by numerous factors, including:

- changes in the availability or price of natural gas and other forms of energy
- general economic conditions
- energy conservation
- legislation and regulations
- the capability to convert from natural gas to alternative fuels
- weather
- new housing starts

In some of our service areas, net growth continues to be slowed due to the number of customers who leave our systems because of higher natural gas prices and competition from alternative fuel sources, including incentives offered by the local electric utilities to switch to electric heat alternatives.

We expect customer growth to improve in the future through our efforts to obtain new customers and retain existing customers. These efforts include working to add residential customers, multifamily complexes and high-value commercial customers that use natural gas for purposes other than space heating. In addition, we partner with numerous entities to market the benefits of gas appliances and to identify potential retention options early in the process for those customers who might consider converting to alternative fuels.

Collective Bargaining Agreements In 2006, a collective bargaining agreement representing approximately 300 Atlanta Gas Light employees by Teamsters Local 528 was not renewed. As a result, these employees are no longer represented by a bargaining unit and now fall under our standard human resources pay and benefit plans and policies. In January 2007, a majority of Chattanooga Gas' bargaining unit employees submitted a petition to Chattanooga Gas requesting the decertification of the Utility Workers Union of America, Local 461, as their bargaining representative. Based on that majority showing, Chattanooga Gas filed a petition with the National Labor Relations Board requesting that the Board conduct a decertification election.The decertification election is currently scheduled to take place on February 16, 2007. The following table provides information about the collective bargaining agreements to which our natural gas local distribution utilities are parties:

	Affiliated subsidiary	Approximate # of employees	Date of contract expiration
Communications Workers of America (Local No. 1023)	Elizabethtown Gas	8	April 2007
Utility Workers Union of America (Local No. 461)	Chattanooga Gas	21	April 2007
International Union of Operating Engineers (Local No. 474)	Atlanta Gas Light	26	August 2007
Teamsters (Local Nos. 769 and 385)	Florida City Gas	50	March 2008
Utility Workers Union of America (Local No. 424)	Elizabethtown Gas	160	November 2009
International Brotherhood of Electrical Workers (Local No. 50)	Virginia Natural Gas	141	May 2010
	Total	406	

Results of Operations The following table presents results of operations for distribution operations for the years ended December 31, 2006, 2005 and 2004.

In millions	2006	2005	2004
Operating revenues	$1,624	$1,753	$1,111
Cost of gas	817	939	471
Operating margin (1)	807	814	640
Operating expenses	499	518	394
Operating income	308	296	246
Other income	2	3	1
EBIT (1)	$310	$299	$247
Metrics (2)			
Average end-use customers (in thousands)	2,250	2,242	1,880
Operation and maintenance expenses per customer	$156	$166	$152
EBIT per customer	$138	$133	$131

(1) These are non-GAAP measurements. A reconciliation of operating margin and EBIT to our operating income and net income is contained in "Results of Operations – AGL Resources."
(2) 2004 metrics include only December for Florida City Gas, Elizabethtown Gas and Elkton Gas.

2006 compared to 2005 EBIT increased $11 million or 4% in 2006 reflecting a decrease in operating expenses of $19 million, partially offset by decreased operating margin of $7 million.

The operating margin decrease of $7 million or 1% in 2006 was primarily the result of lower usage resulting from customer conservation and warmer weather. Operating margins decreased $4 million at Virginia Natural Gas, $3 million at Elizabethtown Gas and $2 million at Florida City Gas. Also contributing to the decrease was a $3 million decrease due to our exit from the New Jersey and Florida appliance business operations in 2005. These decreases were offset by a net increase in Atlanta Gas Light's operating margin of $6 million consisting of $5 million in gas storage carrying costs and $2 million in pipeline replacement program (PRP) revenues, offset primarily by $2 million as a result of the effect of the Georgia Commission's June 2005 Rate Order.

Operating expenses decreased $19 million or 4% in 2006 compared to the same period in 2005, primarily due to lower compensation and facilities expense of $10 million, resulting from a workforce and facilities restructuring in 2005, $5 million of reduced outside services and $3 million in lower costs due to our exiting the appliance businesses acquired with our purchase of NUI. These decreases were offset by a $1 million increase in bad debt expense primarily at Elizabethtown Gas due to higher gas prices in 2006. Operating expenses also reflect a $2 million net gain compared to 2005 primarily due to the sale of properties in Georgia in 2006.

2005 compared to 2004 EBIT increased $52 million or 21% reflecting an increase in operating margin of $174 million, partially offset by increased operating expenses of $124 million. The businesses acquired from NUI on November 30, 2004 contributed approximately $50 million of EBIT in 2005 compared to $7 million in 2004. This was due to the inclusion of the full-year NUI results in 2005 as compared to the inclusion of one month in 2004.

The $174 million or 27% increase in operating margin was primarily due to the addition of NUI's operations, which contributed $167 million. The remainder was primarily due to $8 million of higher operating margin at Atlanta Gas Light. The increase at Atlanta Gas Light resulted primarily from higher PRP revenues of $6 million and higher revenue of $3 million from additional carrying charges to Marketers for gas stored, primarily due to higher gas prices. Atlanta Gas Light also had approximately $3 million of increased operating margin from net customer growth, which offset a $3 million decrease in operating revenues that resulted from the June 2005 Settlement Agreement with the Georgia Commission. Operating margin at Virginia Natural Gas and Chattanooga Gas remained relatively flat compared to 2004.

The $124 million or 31% increase in operating expenses primarily reflected the addition of NUI's operations which increased operating expenses by $125 million.

Retail Energy Operations

Our retail energy operations segment consists of SouthStar, a joint venture owned 70% by our subsidiary, Georgia Natural Gas Company, and 30% by Piedmont Natural Gas (Piedmont). SouthStar markets natural gas and related services to retail customers on an unregulated basis, principally in Georgia as well as to commercial and industrial customers in Tennessee, North Carolina, South Carolina and Alabama. During 2006, SouthStar entered into agreements with customers in Ohio and Florida to supply natural gas starting in the fourth quarter of 2006.

The SouthStar executive committee, which acts as the governing board, is comprised of six members, three representatives from AGL Resources and three from Piedmont. Under the joint venture agreement, all significant management decisions require the unanimous approval of the SouthStar executive committee; accordingly, our 70% financial interest is considered to be noncontrolling. Although our ownership interest in the SouthStar partnership is

70%, SouthStar's earnings are allocated 75% to us and 25% to Piedmont, under an amended and restated joint venture agreement executed in March 2004. Earnings related to customers in Ohio and Florida are allocated 70% to us and 30% to Piedmont. We record the earnings allocated to Piedmont as a minority interest in our consolidated statements of income, and we record Piedmont's portion of SouthStar's capital as a minority interest in our consolidated balance sheets.

Competition SouthStar competes with other energy marketers, including Marketers in Georgia, to provide natural gas and related services to customers in Georgia and the Southeast. Based on its market share, SouthStar is the largest Marketer of natural gas in Georgia, with average customers over the last three years in excess of 530,000.

In addition, similar to distribution operations, SouthStar faces competition based on customer preferences for natural gas compared to other energy products and the comparative prices of those products. SouthStar's principal competition for other non-natural gas energy products relates to electric utilities and the potential displacement or replacement of natural gas appliances with electric appliances. This competition with other energy products has been exacerbated by price volatility in the wholesale natural gas commodity market and related significant increases in the cost of natural gas billed to SouthStar's customers, especially during the fourth quarter of 2005 and the first and second quarters of 2006.

Operating Margin SouthStar generates operating margin primarily in three ways. The first is through the sale of natural gas to retail customers in the residential, commercial and industrial sectors, primarily in Georgia where SouthStar captures a spread between wholesale and retail natural gas prices. The second way is through the collection of monthly service fees and customer late payment fees.

The combination of these two retail price components is evaluated by SouthStar to ensure such pricing is structured to cover related retail customer costs, such as bad debt expense, customer service and billing, and lost and unaccounted-for gas, and to provide a reasonable profit, as well as being competitive to attract new customers and maintain market share. SouthStar's operating margins are impacted by seasonal weather, natural gas prices, customer growth and SouthStar's related market share in Georgia, which has historically been approximately 35%. SouthStar employs strategies to attract and retain a higher credit-quality customer base. These strategies result not only in higher operating margin, as these customers tend to utilize higher volumes of natural gas, but also help to mitigate bad debt expense due to the higher credit-quality of customers.

The third way SouthStar generates margin is through its commercial operations of optimizing storage and transportation assets and effectively managing commodity risk, which enables SouthStar to maintain competitive retail prices and operating margins. SouthStar is allocated storage and pipeline capacity that is used to supply gas to its customers in Georgia. Through hedging transactions, SouthStar manages exposures arising from changing commodity prices using natural gas storage transactions to capture margin from natural gas pricing differences that occur over time. SouthStar's risk management policies allow the use of derivative instruments for hedging and risk management purposes but prohibit the use of derivative instruments for speculative purposes.

SouthStar accounts for its natural gas inventories at the lower of weighted average cost or current market price. SouthStar evaluates the weighted average cost of its natural gas inventories against market prices and determines whether any declines in market prices below the weighted average cost are other than temporary. For declines considered to be other than temporary, SouthStar records adjustments to cost of gas in our consolidated statement of income to reduce the weighted average cost of the natural gas inventory to the current market price. As of December 31, 2006, SouthStar recorded a LOCOM adjustment of $6 million. SouthStar did not record a LOCOM adjustment in 2005 or 2004.

We have designated a portion of SouthStar's derivative transactions as cash flow hedges under Statement of Financial Accounting Standards (SFAS) No. 133, "Accounting for Derivative Instruments and Hedging Activities" (SFAS 133). We record derivative gains or losses arising from cash flow hedges in OCI and reclassify them into earnings in the same period as the underlying hedged item occurs and is recorded in earnings. We record any hedge ineffectiveness, defined as when the gains or losses on the hedging instrument do not offset and are greater than the losses or gains on the hedged item, in cost of gas in our consolidated statement of income in the period in which the ineffectiveness occurs. SouthStar currently has minimal hedge ineffectiveness. We have not designated the remainder of SouthStar's derivative instruments as hedges under SFAS 133 and, accordingly, we record changes in their fair value in earnings in the period of change.

SouthStar also enters into weather derivative instruments in order to preserve margins in the event of warmer-than-normal weather in the winter months. These contracts are accounted for using the intrinsic value method under Emerging Issues Task Force (EITF) Issue No. 99-02, "Accounting for Weather Derivatives." The weather derivative contracts contain settlement provisions based on cumulative heating degree days for the covered periods. In September 2006, SouthStar entered into weather derivatives (swaps and options) for the current winter heating season. During 2006, SouthStar recorded net gains on these weather derivatives of approximately $5 million. These gains were largely offset by a corresponding loss of operating margin due to the warm weather the hedge was designed to protect against.

Impact of Volatility in Natural Gas Prices
SouthStar's operating margin and EBIT from the sales of natural gas to retail customers were affected by lower average usage in part due to conservation and higher bad debt as a result of higher and more volatile natural gas prices during the 2005-2006 heating season. SouthStar was also affected when natural gas prices further declined at the end of 2006 resulting in a LOCOM adjustment to inventory.

SouthStar's operating margin and EBIT associated with the optimization of storage and transportation assets and commodity risk management during 2006 were affected by the decline in wholesale natural gas prices. In 2005, natural gas prices were significantly higher in part due to gas supply disruptions brought on by hurricanes Katrina and Rita. For derivatives not designated as hedges under SFAS 133, SouthStar generally records fair value losses as natural gas prices decrease and fair value gains as natural gas prices increase.

SouthStar's bad debt expense was $13 million for 2006, a $3 million increase from 2005. The increase in bad debt was impacted by an increase in the amount of accounts receivable balances past due more than 60 days and the expectation that a majority of these past due accounts will not be collected. In addition, $1 million of aged deposits were applied to SouthStar's bad debt on a one-time basis in 2005. SouthStar entered into payment arrangements with these customers in an effort to help customers pay their higher natural gas bills during the 2005-2006 heating season. We expect that SouthStar's collection efforts will continue to help mitigate the overall impact of bad debt expense as a percentage of operating revenues, which were 1.4% for the year ended December 31, 2006 compared to approximately 1.1% (excluding the one-time application of aged deposits) for the same period in 2005. We further believe that SouthStar's higher credit-quality customer base mitigates our exposure to higher bad debt expenses.

SouthStar also has experienced lower average usage per customer during 2006, compared to the same period in 2005 due to a number of factors including warmer weather and the effects of customer conservation. Though these two factors have contributed to a $16 million unfavorable impact on operating margin, net of gains on weather derivatives, relative to wholesale prices and normalized temperatures. SouthStar achieved a net increase in operating margin of $10 million for 2006 compared to 2005.

Ohio Retail Market In August 2006, SouthStar was awarded the right to supply approximately a total of 10 Bcf of natural gas to customers of Dominion East Ohio (Dominion Ohio) through August 2008 (approximately 5 Bcf/year). As part of this agreement, SouthStar will manage supply, transportation and storage of natural gas on behalf of Dominion Ohio. While we do not expect the Dominion Ohio agreement to materially impact our results of operations, SouthStar's entrance into the Ohio market is part of its continued growth strategy.

Results of Operations The following table presents results of operations for retail energy operations for the years ended December 31, 2006, 2005, and 2004.

In millions	**2006**	**2005**	**2004**
Operating revenues	$930	$996	$827
Cost of gas	774	850	695
Operating margin (1)	156	146	132
Operating expenses	68	61	62
Operating income	88	85	70
Other expense	(2)	-	-
Minority interest	(23)	(22)	(18)
EBIT (1)	$63	$63	$52
Metrics – Georgia Market			
Average customers (in thousands)	533	531	533
Market share in Georgia	35%	35%	36%
Natural gas volumes (Bcf)	38	44	45

(1) These are non-GAAP measurements. A reconciliation of operating margin and EBIT to our operating income and net income is contained in "Results of Operations – AGL Resources."

2006 compared to 2005 EBIT for 2006 was relatively flat as compared to 2005, driven by a $10 million increase in operating margin which was offset by a $7 million increase in operating expenses, a $2 million increase in other expense and a $1 million increase in minority interest due to the slightly higher operating income.

Operating margin increased by $10 million or 7% driven by improved retail operating margins of $6 million and higher storage margin gains of $4 million. Retail operating margins increased due to improved retail spreads and an increase of approximately 2,000 average customers in 2006 compared to 2005, offset by lower customer consumption due to weather that was approximately 10% warmer than 2005 and conservation. Late payment fees were $1 million lower in 2006 as compared to 2005 due to more customers being on payment arrangements in 2006. Additionally, retail operating margins decreased compared to 2005 due to higher interruptible margins in 2005 driven by peaking sales during curtailments. Storage margins were driven by improved optimization of storage and transportation assets and effective commodity risk management including net gains on weather derivatives. Storage operating margins were impacted by an adjustment in 2006 of $6 million to reduce inventory to market for which no LOCOM adjustment was recorded in 2005.

Operating expenses increased $7 million or 11% primarily due to higher bad debt expense of $3 million, increased depreciation of $1 million due to the implementation of system enhancements, higher outside service costs of $1 million principally driven by the current-year implementation of a new energy trading and risk management (ETRM) system and $1 million from increases in other general corporate overhead costs.

The retail energy operations segment made a $2 million charitable contribution in 2006. Minority interest increased $1 million as a result of increased operating income in 2006 compared to 2005.

2005 compared to 2004 The $11 million or 21% increase in EBIT for 2005 was driven by a $14 million increase in operating margin and a $1 million decrease in total operating expenses, offset by a $4 million increase in minority interest due to higher earnings.

The $14 million or 11% increase in operating margin was primarily the result of higher commodity margins and positive margin captured with SouthStar's storage assets, offset by lower customer usage and lower late payment fees relative to 2004.

There was a slight decrease in operating expenses in 2005 compared to 2004. The decrease was primarily due to $1 million in lower bad debt expense resulting from ongoing collection process improvements. Minority interest increased $4 million or 22% as a direct result of increased operating income in 2005 compared to 2004.

Wholesale Services

Wholesale services consists of Sequent, our subsidiary involved in asset management, transportation, storage, producer and peaking services and wholesale marketing. Our asset management business focuses on capturing economic value from idle or underutilized natural gas assets, which are typically amassed by companies via investments in or contractual rights to natural gas transportation and storage assets. Margin is typically created in this business by participating in transactions that balance the needs of varying markets and time horizons.

Sequent provides customers with natural gas from the major producing regions and market hubs primarily in the eastern and mid-continental United States. Sequent purchases transportation and storage capacity to meet its delivery requirements and customer obligations in the marketplace. Sequent's customers benefit from its logistics expertise and ability to deliver natural gas at prices that are advantageous relative to other alternatives available to its customers. In 2006, Sequent entered into an agreement which should facilitate the expansion of its operations into the western United States and Canada and plans to pursue additional opportunities in these regions during 2007. Sequent continues to work on projects and transactions to extend its operating territory and is entering into agreements of longer duration, as well as evaluating opportunities to expand its business focus and models.

Seasonality Fixed cost commitments are generally incurred evenly over the year, while margins generated through the use of the assets are generally greatest in the winter heating season and occasionally in the summer due to peak usage by power generators in meeting air-conditioning load. This increases the seasonality of Sequent's business, generally resulting in higher margins in the first and fourth quarters.

Competition Sequent competes for asset management business with other energy wholesalers, often through a competitive bidding process. There has been significant consolidation of energy wholesale operations, particularly among major gas producers. Financial institutions have also entered the marketplace. As a result, energy wholesalers have become increasingly willing to place bids for asset management transactions that are priced to capture market share. We expect this trend to continue in the near term, which could result in downward pressure on the volume of transactions and the related margins available in this portion of Sequent's business.

Asset Management Transactions Our asset management customers include our own utilities, nonaffiliated utilities, municipal utilities and large industrial customers. These customers must independently contract for transportation and storage capacity to meet their demands, and they typically contract for this capacity on a 365-day basis even though they may only need a portion of the capacity to meet their peak demands. Sequent enters into agreements with these customers, either through contract assignment or agency arrangement, whereby Sequent uses the customers' rights to transportation and storage capacity during periods when customers do not need it. Sequent captures margin by optimizing the purchase, transportation, storage and sale of natural gas, and Sequent typically either shares profits with customers or pays them a fee for using their assets.

The following table provides additional information on Sequent's asset management agreements with its affiliated utilities.

					Profit sharing / fees payments		
In millions	**Expiration date**	**Timing of payment**	**Type of fee structure**	**% Shared or annual fee**	**2006**	**2005**	**2004**
Elkton Gas	Mar 2008	Monthly	Fixed-fee	(A)	$-	$-	$-
Chattanooga Gas	Mar 2008	Annually	Profit -sharing	50%	4	2	1
Atlanta Gas Light	Mar 2008	Semi-Annually	Profit -sharing	60%	6	4	4
Elizabethtown Gas	Mar 2008	Monthly	Fixed -fee	$4	4	-	-
Florida City Gas	Mar 2008	Annually	Profit -sharing	50%	-	-	-
Virginia Natural Gas	Mar 2009	Annually	Profit -sharing	(B)	2	5	3
Total					$16	$11	$8

(A) Annual fixed fee is less than $1 million.
(B) Profit sharing is based on a tiered sharing structure.

In January 2006, the Georgia Commission extended the asset management agreement between Sequent and Atlanta Gas Light for two additional years. In addition, Sequent's asset management agreements with Chattanooga Gas and Elkton Gas were extended for an additional year through March 2008.

Transportation Transactions Sequent contracts for natural gas transportation capacity and participates in transactions that manage the natural gas commodity and transportation costs to result in the lowest cost to serve its various markets. Sequent seeks to optimize this process on a daily basis as market conditions change by evaluating all the natural gas supplies, transportation alternatives and markets to which it has access and identifying the least-cost alternatives to serve the various markets. This enables Sequent to capture geographic pricing differences across these various markets as delivered gas prices change.

As Sequent executes transactions to secure transportation capacity, it often enters into forward financial contracts to hedge its positions. The hedging instruments are derivatives, and Sequent reflects changes in the derivatives' fair value in its reported operating results. During 2006, Sequent reported gains of $12 million associated with transportation capacity hedges. The majority of this amount will be reversed during 2007 as the positions are settled. Sequent did not report any significant gains or losses on these types of hedges during 2005 or 2004.

Producer Services Sequent's producer services business primarily focuses on aggregating natural gas supply from various small and medium-sized producers located throughout the natural gas production areas of the United States, principally in the Gulf Coast region. Sequent provides producers with certain logistical and risk management services that offer producers attractive options to move their supply into the pipeline grid. Aggregating volumes of natural gas from these producers allows Sequent to provide markets to producers who seek a reliable outlet for their natural gas production.

Peaking Services Sequent generates operating margin through, among other things, the sale of peaking services, which includes receiving a fee from affiliated and nonaffiliated customers that guarantees those customers will receive gas under peak conditions. Sequent incurs costs to support its obligations under these agreements, which are reduced in whole or in part as the matching obligations expire. Sequent will continue to seek new peaking transactions as well as work toward extending those that are set to expire.

Credit Rating Sequent has certain trade and credit contracts that have explicit minimum credit rating requirements. These credit rating requirements typically give counterparties the right to suspend or terminate credit if our credit ratings are downgraded to non-investment grade status. Under such circumstances, Sequent would need to post collateral to continue transacting with some of its counterparties. Posting collateral would have a negative effect on our liquidity. If such collateral were

not posted, Sequent's ability to continue transacting with these counterparties would be impaired. If at December 31, 2006 our credit ratings had been downgraded to non-investment grade, the required amounts to satisfy potential collateral demands under such agreements between Sequent and its counterparties would have totaled $10 million.

Energy Marketing and Risk Management Activities We account for derivative transactions in connection with Sequent's energy marketing activities on a fair value basis in accordance with SFAS 133. We record derivative energy commodity contracts (including both physical transactions and financial instruments) at fair value, with unrealized gains or losses from changes in fair value reflected in our earnings in the period of change.

Sequent's energy-trading contracts are recorded on an accrual basis as required under the EITF Issue No. 02-03, "Issues Involved in Accounting for Contracts under EITF Issue No. 98-10, 'Accounting for Contracts Involved in Energy Trading and Risk Management Activities'" (EITF 02-03) rescission of EITF 98-10, unless they are derivatives that must be recorded at fair value under SFAS 133.

As shown in the table below, Sequent recorded a net unrealized gain related to changes in the fair value of derivative instruments utilized in its energy marketing and risk management activities of $132 million during 2006, $30 million of unrealized losses during 2005 and unrealized gains of $22 million during 2004. The tables below illustrate the change in the net fair value of the derivative instruments and energy-trading contracts during 2006, 2005 and 2004 and provide details of the net fair value of contracts outstanding as of December 31, 2006.

In millions	2006	2005	2004
Net fair value of contracts outstanding at beginning of period	$(13)	$17	($5)
Contracts realized or otherwise settled during period	17	(47)	11
Change in net fair value of contract gains	115	17	11
Net fair value of new contracts entered into during period	-	-	-
Net fair value of contracts outstanding at end of period	119	(13)	17
Less net fair value of contracts outstanding at beginning of period	(13)	17	(5)
Unrealized gain (loss) related to changes in the fair value of derivative instruments	$132	$(30)	$22

The sources of Sequent's net fair value at December 31, 2006, are as follows. The "prices actively quoted" category represents Sequent's positions in natural gas, which are valued exclusively using NYMEX futures prices. "Prices provided by other external sources" are basis transactions that represent the cost to transport the commodity from a NYMEX delivery point to the contract delivery point. Sequent's basis spreads are primarily based on quotes obtained either through electronic trading platforms or directly from brokers.

In millions	Prices actively quoted	Prices provided by other external sources
Mature through 2007	$21	$80
Mature 2008 – 2009	6	8
Mature 2010 – 2012	-	2
Mature after 2012	-	2
Total net fair value	$27	$92

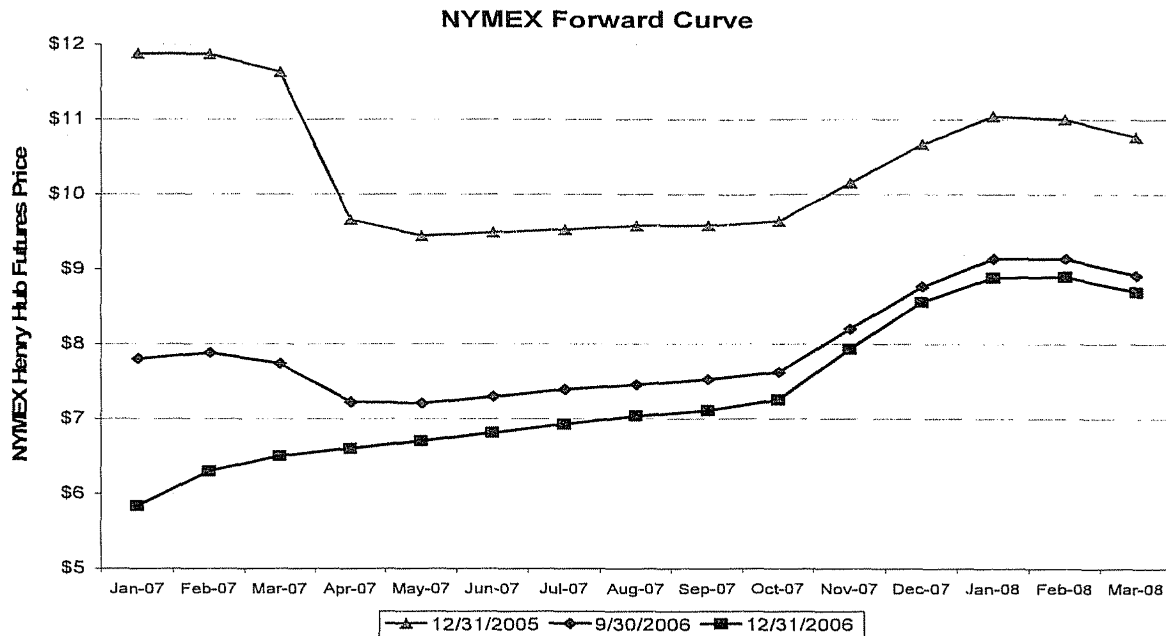
Mark-to-Market Versus Lower of Average Cost or Market Sequent purchases natural gas for storage when the current market price it pays plus the cost for transportation and storage is less than the market price it could receive in the future. Sequent attempts to mitigate substantially all of the commodity price risk associated with its storage portfolio. Sequent uses derivative instruments to reduce the risk associated with future changes in the price of natural gas. Sequent sells NYMEX futures contracts or other over-the-counter derivatives in forward months to substantially lock in the profit margin it will ultimately realize when the stored gas is actually sold.

We view Sequent's trading margins from two perspectives. First, our commercial decisions are based on economic value, which is defined as the locked-in gain to be realized in the statement of income at the time the physical gas is withdrawn from storage and ultimately sold and the derivative instrument used to hedge natural gas price risk on that physical storage is settled. Second is the GAAP reported value both prior to and at the point of physical withdrawal. The GAAP amount is impacted by the process of accounting for the financial hedging instruments in interim periods at fair value between the time the gas is injected into storage and when it is ultimately withdrawn and the financial instruments are settled. The change in the fair value of the hedging instruments is recognized in earnings in the period of change and is characterized as unrealized gains or losses.

Natural gas stored in inventory is accounted for differently than the derivatives Sequent uses to mitigate the commodity price risk associated with its storage portfolio. The natural gas that Sequent

purchases and injects into storage is accounted for at the lower of average cost or current market value. The derivatives that Sequent uses to mitigate commodity price risk are accounted for at fair value and marked to market each period. This difference in accounting treatment can result in volatility in Sequent's reported results, even though the expected profit margin is essentially unchanged from the date the transactions were consummated. These accounting differences also affect the comparability of Sequent's period-over-period results, since changes in forward NYMEX prices do not increase and decrease on a consistent basis from year to year. During most of 2006, Sequent's reported results were positively impacted by decreases in forward NYMEX prices which resulted in the recognition of unrealized gains. In contrast, during most of 2005, Sequent's reported results were negatively impacted by increases in forward NYMEX prices which resulted in the recognition of unrealized losses, although to a lesser extent. During 2004, the reported results were not as significantly affected by changes in forward NYMEX prices. As a result, unrealized gains during 2006 had a positive impact on the favorable variance between 2006 and 2005 and unrealized losses during 2005 had a negative impact on the favorable variance between 2005 and 2004.

Storage Inventory Outlook The following graph presents the NYMEX forward natural gas prices as of December 31, 2005, September 30, 2006, and December 31, 2006 for the period of January 2007 through March 2008, and reflects the prices at which Sequent could buy natural gas at the Henry Hub for delivery in the same time period.



Sequent's expected withdrawals from physical salt dome and reservoir storage are presented in the table below along with the expected gross margin. Sequent's expected gross margin is net of the impact of regulatory sharing and reflects the amounts that it would expect to realize in future periods based on the inventory withdrawal schedule and forward natural gas prices at December 31, 2006. Sequent's storage inventory is hedged with futures, and as shown below, the NYMEX short positions are equal to the physical long positions, which results in an overall locked-in margin, timing notwithstanding. Sequent's physical salt dome and reservoir volumes are presented in NYMEX equivalent contract units of 10,000 million British thermal units (MMBtu).

	Q1 2007	Q2 2007	Q3 2007	Q4 2007	Q1 2008	Total
Salt dome	412	-	-	-	7	419
Reservoir	850	1	-	96	116	1,063
Total volumes	1,262	1	-	96	123	1,482
Expected gross margin *(in millions)*	$9	$-	$-	$4	$5	$18

As of December 31, 2006, the weighted average cost of natural gas in inventory was $5.52 for physical salt dome storage and $5.18 for physical reservoir storage. These costs reflect adjustments that were recorded at the end of each quarter in 2006 in order to reduce the value of Sequent's natural gas inventory to market value at certain locations. Sequent reduced the inventory value by $9 million after regulatory sharing for the quarter ended December 31 and by $43 million for the year ended December 31, 2006. These adjustments negatively impacted Sequent's reported earnings. However, as the carrying value of the inventory was reduced, the expected gross margin in the table above increased by an equal and offsetting amount. Sequent recovered $22 million of the aggregate $43 million of gross margin reductions during 2006 and expects to recover the majority of the remainder during the first quarter of 2007, as both the inventory is withdrawn from storage and sold and the hedging instruments in place to lock in the original margins on the storage transactions are settled and recorded in our earnings.

Park and Loan Transactions Sequent routinely enters into park and loan transactions with various pipelines which allow it to park gas on or borrow gas from the pipeline in one period and reclaim gas from or repay gas to the pipeline in a subsequent period. The economics of these transactions are evaluated and price risks are managed in much the same way traditional reservoir and salt dome storage transactions are evaluated and managed.

During the spring and summer months of 2006, natural gas prices were significantly lower than the futures prices for the upcoming winter months. As a result, Sequent has entered into transactions to park natural gas with the pipelines during the summer and receive the natural gas back during the winter.

Sequent enters into forward NYMEX contracts to hedge its park and loan transactions. While the hedging instruments mitigate the price risk associated with the delivery and receipt of natural gas, they can also result in volatility in Sequent's reported results during the period before the initial delivery or receipt of natural gas. During this period, if the forward NYMEX prices in the months of delivery and receipt do not change in equal amounts, Sequent will report a net unrealized gain or loss on the hedges.

Although Sequent's quarterly results were modestly impacted by unrealized hedge losses during 2006, on an annual basis Sequent did not report any significant gains or losses on park and loan hedges during 2006, 2005, or 2004.

Results of Operations The following table presents results of operations for wholesale services for the years ended December 31, 2006, 2005, and 2004.

In millions	**2006**	**2005**	**2004**
Operating revenues	$182	$95	$54
Cost of sales	43	3	1
Operating margin (1)	139	92	53
Operating expenses	49	42	29
Operating income	90	50	24
Other expenses	-	(1)	-
EBIT (1)	$90	$49	$24
Metrics			
Physical sales volumes (Bcf / day)	2.20	2.17	2.10

(1) These are non-GAAP measurements. A reconciliation of operating margin and EBIT to our operating income and net income is contained in "Results of Operations – AGL Resources."

The following table indicates the significant changes in operating margin for the years ended December 31, 2006, 2005 and 2004:

In millions	2006	2005	2004
Gain (loss) on storage hedges	$41	$(7)	$5
Gain on transportation hedges	12	-	-
Commercial activity	107	102	49
Inventory LOCOM, net of hedging recoveries	(21)	(3)	(1)
Operating margin	$139	$92	$53

2006 compared to 2005 The increase in EBIT of $41 million or 84% in 2006 compared to 2005 was primarily due to an increase in operating margin of $47 million partially offset by an increase in operating expenses of $7 million.

Sequent's operating margin increased by $47 million or 51% primarily due to improved commercial opportunities associated with larger seasonal storage spreads during the first half of 2006 and above average temperatures during the late summer months. These conditions offset the impacts of mild weather during the winter and early summer and the lower level of market volatility that we experienced compared to the hurricane activity in the Gulf of Mexico in 2005.

Additionally, the 2006 reported results were positively impacted by forward NYMEX prices moving downward and the narrowing of future seasonal spreads which resulted in the recognition of $41 million of gains on Sequent's economic storage hedges in contrast to the prior period when forward prices increased and resulted in the recognition of $7 million of hedge losses. During 2006, Sequent also recognized $12 million in gains associated with financial instruments used to hedge its transportation capacity. There were no significant gains or losses associated with transportation hedges recognized in the prior period.

The positive impact from the price movements in 2006 was partially offset by LOCOM adjustments that Sequent recorded at certain storage locations during the year in order to reduce the carrying value of its natural gas inventory to current market prices. In 2006, Sequent recorded a total of $43 million in LOCOM adjustments; however $22 million of the adjustments were recovered during the period as the affected inventory was withdrawn from storage and sold and the hedging instruments in place to lock in the original margins on the storage transactions were settled. In 2005, Sequent recorded LOCOM adjustments of $3 million.

Operating expenses increased by $7 million or 17% primarily due to higher costs associated with an increase in the number of employees to support Sequent's growth and additional incentive compensation costs directly related to stronger financial performance in 2006, as well as a higher percentage of corporate overhead costs than in 2005, primarily due to Sequent's growth. The increased expenses were partially offset by lower costs associated with outside services and other expenses.

2005 compared to 2004 The increase in EBIT of $25 million or 104% in 2005 compared to 2004 was primarily due to an increase in operating margin of $39 million partially offset by an increase in operating expenses of $13 million.

Sequent's operating margin increased by $39 million or 74% primarily due to the significant effects of the Gulf Coast hurricanes during the third quarter of 2005 and lingering market disruptions and price volatility throughout the fourth quarter. For the first nine months of the year, reported operating margins were similar to that of the prior year, with quarterly decreases being offset by quarterly increases. However, during the third quarter of 2005, while Sequent created substantial economic value by serving its customers during the storms, the reported operating margin was negatively impacted by accounting losses associated with storage hedges as a result of increases in forward NYMEX prices of approximately $6 per MMBtu. During the fourth quarter, natural gas prices continued to be volatile in the aftermath of the hurricanes and Sequent was able to further optimize its storage and transportation positions at levels in excess of the prior year. In addition, previously reported hedge losses were partially recovered during the fourth quarter as NYMEX prices decreased approximately $3 per MMBtu.

Operating expenses increased by $13 million or 45% due to additional payroll associated with increased headcount and increased employee incentive compensation costs driven by Sequent's operational and financial growth and depreciation expense in connection with a new ETRM system, which was implemented during the fourth quarter of the prior year.

Energy Investments

Jefferson Island This wholly owned subsidiary operates a salt dome storage and hub facility in Louisiana, approximately eight miles from the Henry Hub. The storage facility is regulated by the Louisiana Department of Natural Resources (Louisiana DNR) and by the FERC which has limited regulatory authority over the storage and transportation services. The facility consists of two salt dome gas storage caverns with approximately 9.72 Bcf of total capacity and about 7.23 Bcf of working gas capacity. The facility has approximately 0.72 Bcf/day withdrawal capacity and 0.36 Bcf/day injection capacity. Jefferson Island provides storage and hub services through its direct connection to the Henry Hub via the Sabine Pipeline and its interconnection with seven other pipelines in the area. Jefferson Island's entire portfolio is under firm subscription for the 2006-2007 winter period.

In August 2006, the Office of Mineral Resources of the Louisiana DNR informed Jefferson Island that its mineral lease – which authorizes salt extraction to create two new storage caverns – at Lake Peigneur had been terminated. The Louisiana DNR identified two bases for the termination: (1) failure to make certain mining leasehold payments in a timely manner, and (2) the absence of salt mining operations for six months.

In September 2006, Jefferson Island filed suit against the State of Louisiana to maintain its lease to complete an ongoing natural gas storage expansion project in Louisiana. The project would add two salt dome storage caverns under Lake Peigneur to the two caverns currently owned and operated by Jefferson Island. In its suit, Jefferson Island alleges that the Louisiana DNR accepted all leasehold payments without reservation and never provided Jefferson Island with notice and opportunity to cure, as required by state law. In its answer to the suit, the State denied that anyone with proper authority approved late payments. As to the second basis for termination, the suit contends that Jefferson Island's lease with the State of Louisiana was amended in 2004 so that mining operations are no longer required to maintain the lease. The State's answer denies that the 2004 amendment was properly authorized. We continue to seek resolution of this dispute and we are optimistic that a settlement can be reached with the State of Louisiana that would allow us to proceed with the expansion. If we are unable to reach a settlement, we are not able to predict the outcome of the litigation. As of January 2007, our current estimate of costs incurred that would be considered unusable if the Louisiana DNR was successful in terminating our lease and causing us to cease the expansion project is approximately $8 million.

Golden Triangle Storage In December 2006, we announced plans to build an approximate $180 million natural gas storage facility in the Beaumont, Texas area in the Spindletop salt dome. The project will consist of two underground salt dome storage caverns approximately a half-mile to a mile below ground that will hold about 12 Bcf of working natural gas, or 17 Bcf total storage capacity. Golden Triangle Storage expects to finalize engineering plans and obtain regulatory permits to begin construction in 2008. The first salt dome cavern is expected to begin operations in 2010, and the second cavern is expected to begin operations in 2012.

Pivotal Propane In 2005, this wholly owned subsidiary completed the construction of a propane air facility in the Virginia Natural Gas service area that provides up to 0.03 Bcf/day of propane air on a 10-day-per-year basis to serve Virginia Natural Gas' peaking needs.

AGL Networks This wholly owned subsidiary provides telecommunications conduit and dark fiber. AGL Networks leases and sells its fiber to a variety of customers in the Atlanta, Georgia and Phoenix, Arizona metropolitan areas, with a small presence in other cities in the United States. Its customers include local, regional and national telecommunications companies, internet service providers, educational institutions and other commercial entities. AGL Networks typically provides underground conduit and dark fiber to its customers under leasing arrangements with terms that vary from one to twenty years. In addition, AGL Networks offers telecommunications construction services to companies. AGL Networks' competitors are any entities that have laid or will lay conduit and fiber on the same route as AGL Networks in the respective metropolitan areas.

Results of Operations The following table presents results of operations for energy investments for the years ended December 31, 2006, 2005 and 2004.

In millions	**2006**	**2005**	**2004**
Operating revenues	$41	$56	$25
Cost of sales	5	16	12
Operating margin (1)	36	40	13
Operating expenses	26	23	8
Operating income	10	17	5
Other income	-	2	2
EBIT (1)	$10	$19	$7

(1) These are non-GAAP measurements. A reconciliation of operating margin and EBIT to our operating income and net income is contained in "Results of Operations – AGL Resources."

2006 compared to 2005 The $9 million or 47% decrease in EBIT is due primarily to the loss of operating margin and other income contributions from the 2005 sale of certain assets that we originally acquired with the 2004 acquisition of NUI and an increase in operating expenses due to higher business development expenses and increased costs at Jefferson Island offset by lower expenses related to the sale of the former NUI assets in 2005.

Operating margin decreased $4 million or 10% largely due to the loss of $9 million of operating margin contributions from certain assets we acquired with the 2004 acquisition of NUI but sold in 2005. Jefferson Island's operating margin increased by $1 million compared to the prior year, in part due to increases in both firm and interruptible margin opportunities. AGL Networks' operating margin increased by $1 million due to a larger customer base. Pivotal Propane contributed a $2 million increase primarily in the first quarter of 2006 as it did not become operational until April 2005.

Operating expenses increased $3 million or 13% compared to 2005. Operating expenses at Pivotal Propane increased as it did not become operational until April 2005. Jefferson Island's operating expenses increased by $2 million due to the installation of new compression equipment and higher legal costs and property taxes. Additionally, project and corporate development costs increased $9 million. These costs were offset by decreased operating expenses of $8 million resulting from the 2005 sale of certain assets that we originally acquired with the 2004 acquisition of NUI. Other income decreased by $2 million due to the loss of earnings contributions from certain assets we acquired with the 2004 acquisition of NUI but sold in 2005.

2005 compared to 2004 The $12 million or 171% increase in EBIT in 2005 was primarily the result of increased operating margin of $27 million, offset by $15 million in higher operating expenses.

Of the $27 million or 208% increase in operating margin, $13 million resulted from Jefferson Island, $8 million resulted from NUI's nonutility businesses and $3 million resulted from Pivotal Propane. AGL Networks contributed $4 million primarily as a result of recurring revenues from fiber leasing activities of $1 million and construction and new business activities of $3 million.

Of the $15 million or 188% increase in operating expenses, $8 million resulted from NUI's nonutility businesses, $3 million resulted from Jefferson Island and $3 million resulted from Pivotal Propane. AGL Networks' operating expenses were relatively flat in 2005 as compared to 2004.

Corporate

Our corporate segment includes our nonoperating business units, including AGL Services Company (AGSC) and AGL Capital Corporation (AGL Capital). AGL Capital provides for our ongoing financing needs through a commercial paper program, the issuance of various debt and hybrid securities, and other financing arrangements.

Pivotal Energy Development coordinates among our related operating segments, the development, construction or acquisition of assets in the southeastern, mid-Atlantic and northeastern regions in order to extend our natural gas capabilities and improve system reliability while enhancing service to our customers in those areas. The focus of Pivotal Energy Development's commercial activities is to improve the economics of system reliability and natural gas deliverability in these targeted regions.

We allocate substantially all of AGSC's operating expenses and interest costs to our operating segments in accordance with various regulations. Our corporate segment also includes intercompany eliminations for transactions between our operating business segments. Our EBIT results include the impact of these allocations to the various operating segments. The acquisition of additional assets, such as NUI and Jefferson Island, typically enables us to allocate corporate costs across a larger number of businesses and, as a result, lower the relative allocations charged to those business units we owned prior to the acquisition of the new businesses.

Results of Operations The following table presents results of operations for our corporate segment for the years ended December 31, 2006, 2005 and 2004.

In millions	2006	2005	2004
Operating revenues	$(156)	$(182)	$(185)
Cost of sales	(157)	(182)	(184)
Operating margin (1) (2)	1	-	(1)
Operating expenses (3)	9	6	12
Operating loss	(8)	(6)	(13)
Other expenses	(1)	(5)	(3)
EBIT (2)	$(9)	$(11)	$(16)

(1) Includes intercompany eliminations
(2) These are non-GAAP measurements. A reconciliation of operating margin and EBIT to our operating income and net income is contained in "Results of Operations – AGL Resources."
(3) The following table summarizes the major components of operating expenses.

In millions	2006	2005	2004
Payroll	$55	$57	$48
Benefits and incentives	36	34	32
Outside services	41	43	29
All other expenses	50	57	50
Allocations	(173)	(185)	(147)
Total operating expenses	$9	$6	$12

The corporate segment is a nonoperating segment. As such, changes in EBIT amounts for the indicated periods reflect the relative changes in various general and administrative expenses, such as payroll, benefits and incentives, and outside services.

Liquidity and Capital Resources

To meet our capital and liquidity requirements we rely on operating cash flow; short-term borrowings under our commercial paper program, which is backed by our Credit Facility; borrowings under Sequent's and SouthStar's lines of credit; and borrowings or stock issuances in the long-term capital markets. Our issuance of various securities, including long-term and short-term debt, is subject to customary approval or authorization by state and federal regulatory bodies including state public service commissions and the SEC. Furthermore, a substantial portion of our consolidated assets, earnings and cash flow is derived from the operation of our regulated utility subsidiaries, whose legal authority to pay dividends or make other distributions to us is subject to regulation. The availability of borrowings under our Credit Facility is limited and subject to a total debt-to-capital ratio financial covenant specified within the Credit Facility, which we currently meet.

We will continue to evaluate our need to increase available liquidity based on our view of working capital requirements, including the impact of changes in natural gas prices, liquidity requirements established by rating agencies and other factors. Additionally, our liquidity and capital resource requirements may change in the future due to a number of other factors, some of which we cannot control. These factors include:

- the seasonal nature of the natural gas business and our resulting short-term borrowing requirements, which typically peak during colder months
- increased gas supplies required to meet our customers' needs during cold weather
- changes in wholesale prices and customer demand for our products and services
- regulatory changes and changes in ratemaking policies of regulatory commissions
- contractual cash obligations and other commercial commitments
- interest rate changes
- pension and postretirement funding requirements
- changes in income tax laws
- margin requirements resulting from significant increases or decreases in our commodity prices
- operational risks
- the impact of natural disasters, including weather

Contractual Obligations and Commitments We have incurred various contractual obligations and financial commitments in the normal course of our operating and financing activities. Contractual obligations include future cash payments required under existing contractual arrangements, such as debt and lease agreements. These obligations may result from both general financing activities and from commercial arrangements that are directly supported by related revenue-producing activities. The following table illustrates our expected future contractual obligations as of December 31, 2006.

		Payments due before December 31,			
In millions	**Total**	**2007**	**2008 & 2009**	**2010 & 2011**	**2012 & thereafter**
Interest charges (1)	$1,398	$99	$198	$177	$924
Pipeline charges, storage capacity and gas supply (2) (3) (4)	1,916	441	625	389	461
Long-term debt (5)	1,622	-	-	300	1,322
Short-term debt	539	539	-	-	-
PRP costs (6)	237	35	82	85	35
Operating leases (7)	170	32	47	34	57
ERC (6)	96	13	18	54	11
Total	$5,978	$1,159	$970	$1,039	$2,810

(1) Floating rate debt is based on the interest rate as of December 31, 2006 and the maturity of the underlying debt instrument.
(2) Charges recoverable through a PGA mechanism or alternatively billed to Marketers. Also includes demand charges associated with Sequent.
(3) A subsidiary of NUI entered into two 20-year agreements for the firm transportation and storage of natural gas during 2003 with annual aggregate demand charges of approximately $5 million. As a result of our acquisition of NUI and in accordance with SFAS No. 141, "Business Combinations," we valued the contracts at fair value and established a long-term liability that will be amortized over the remaining lives of the contracts.
(4) Amount includes SouthStar gas commodity purchase commitments of 1.4 Bcf at floating gas prices calculated using forward natural gas prices as of December 31, 2006, and is valued at $89 million.
(5) Includes $77 million of notes payable to Trusts redeemable in 2007.
(6) Includes charges recoverable through rate rider mechanisms.
(7) We have certain operating leases with provisions for step rent or escalation payments and certain lease concessions. We account for these leases by recognizing the future minimum lease payments on a straight-line basis over the respective minimum lease terms, in accordance with SFAS No. 13, "Accounting for Leases." However, this accounting treatment does not affect the future annual operating lease cash obligations as shown herein.

We calculate any required pension contributions using the projected unit credit cost method. Under this method, we were not required to make any pension contribution in 2006, but we voluntarily made a $5 million contribution in October 2006. See Note 4 "Employee Benefit Plans," for additional pension information.

We also have incurred various financial commitments in the normal course of business. Contingent financial commitments represent obligations that become payable only if certain predefined events occur, such as financial guarantees, and include the nature of the guarantee and the maximum potential amount of future payments that could be required of us as the guarantor. The following table illustrates our expected contingent financial commitments as of December 31, 2006.

		Commitments due before Dec. 31,	
In millions	**Total**	**2007**	**2008 & thereafter**
Standby letters of credit, performance/ surety bonds	$14	$12	$2

Cash Flow from Operating Activities We prepare our statement of cash flows using the indirect method. Under this method, we reconcile net income to cash flows from operating activities by adjusting net income for those items that impact net income but do not result in actual cash receipts or payments during the period. These reconciling items include depreciation, changes in risk management assets and liabilities, undistributed earnings from equity investments, changes in deferred income taxes, gains or losses on the sale of assets and changes in the consolidated balance sheet for working capital from the beginning to the end of the period.

Year-over-year changes in our operating cash flows are attributable primarily to working capital changes within our distribution operations, wholesale services and retail energy operations segments resulting from the impact of weather, the price of natural gas, the timing of customer collections, payments for natural gas purchases and deferred gas cost recoveries.

We generate a large portion of our annual net income and subsequent increases in our accounts receivable in the first and fourth quarters of each year due to significant volumes of natural gas delivered by distribution operations and SouthStar to our customers during the peak heating season. In addition, our natural gas inventories, which usually peak on November 1, are largely drawn down in the heating season and provide a source of cash as this asset is used to satisfy winter sales demand.

During this period, our accounts payable increases to reflect payments due to providers of the natural gas commodity and pipeline capacity. The value of the natural gas commodity can vary significantly from one period to the next as a result of volatility in the price of natural gas. Our natural gas costs and deferred purchased natural gas costs due from or to our customers represent the difference between natural gas costs that we have paid to suppliers in the past and amounts that we have collected from customers. These natural gas costs can cause significant variations in cash flows from period to period.

In 2006, our net cash flow provided from operating activities was $354 million, an increase of $274 million or 343% from the same period of 2005. The increase was primarily a result of higher earnings in 2006 of $19 million, the recovery of working capital during 2006 that was deployed in 2005 due to the significantly higher commodity prices and the amount of working capital required during the last quarter of 2004 when prices were significantly lower. Contributing to this increase was a decrease in the amount of natural gas purchased for inventory at Sequent and our utilities of $157 million as a result of mild weather in the prior heating season and therefore higher inventory balances for the current heating season.

In 2005, our net cash flow provided from operating activities was $80 million, a decrease of $207 million or 72% from the same period of 2004. The decrease was primarily a result of increased working capital requirements including increased spending of $183 million for seasonal inventory injections in advance of the winter sales demand. We spent more on these injections in 2005 primarily because of higher natural gas prices due to the effects of the hurricanes in the Gulf Coast region and the full-year impact associated with the purchase of natural gas for the utilities acquired in November 2004 from NUI, principally Elizabethtown Gas. These higher natural gas prices resulted in a 45% increase in the average cost of our natural gas inventories.

Cash Flow from Investing Activities Our investing activities consisted primarily of property, plant and equipment (PP&E) expenditures and our acquisitions of NUI for $116 million and Jefferson Island for $90 million in 2004. Additionally in 2006, we received approximately $5 million for the sale of land associated with former operating sites. In 2005, we sold our 50% interest in Saltville Gas Storage Company (Saltville) and associated subsidiaries for $66 million to a subsidiary of Duke Energy Corporation. We acquired Saltville through our acquisition of NUI. In 2004, we sold our general and limited partnership interests in US Propane LP which was a joint venture formed in 2000, for $31 million.. The following table provides additional information on our actual and estimated PP&E expenditures.

In millions	**2007** (1)	**2006**	**2005**	**2004**
Construction or preservation of distribution facilities	$159	$144	$135	$64
Southern Natural Gas pipeline	-	-	32	-
PRP	35	31	48	95
Pivotal Propane plant	-	-	-	29
Jefferson Island	53	20	8	2
Telecommunications	3	3	1	5
Other (2)	28	55	43	69
Total	$278	$253	$267	$264

(1) Estimated
(2) Includes corporate information technology systems and infrastructure expenditures.

The decrease of $14 million or 5% in PP&E expenditures for 2006 compared to 2005 was primarily due to the $32 million acquisition of a 250-mile pipeline in Georgia from Southern Natural Gas (SNG) in 2005 and $7 million for construction of distribution facilities in Georgia. This was offset by higher expenditures of $8 million at the corporate segment primarily on information technology projects, $12 million at Jefferson Island on its expansion project and $5 million at retail energy operations primarily due to the implementation of a new energy trading and risk management (ETRM) system and enhancements to the retail billing system.

The increase of $3 million or 1% in PP&E expenditures for 2005 compared to 2004 was primarily due to the $32 million acquisition of the SNG pipeline in 2005 and increased expenditures of $71 million for the construction of distribution facilities, including $27 million at Elizabethtown Gas and Florida City Gas, both of which were acquired in

November 2004. Also contributing to the increase was $6 million of additional expenditures at Jefferson Island which completed a capital project to improve its compression capabilities. These increases were offset by reduced PRP expenditures of $47 million due to the rate case settlement agreement between Atlanta Gas Light and the Georgia Commission that extended the program to 2013, reduced expenditures of $29 million at the Pivotal Propane plant in Virginia as most of its construction expenditures were incurred in 2004 and reduced expenditures at Sequent as its ETRM system was implemented in 2004.

We expect our future PRP expenditures will primarily include larger-diameter pipe than in prior years, the majority of which is located in more densely populated areas. The following table provides more information on our expected PRP expenditures.

Year	Miles of pipe to be replaced	Expenditures (in millions)
2007	107	$35
2008	144	38
2009	147	44
2010-2013	337	120
Totals	735	$237

Cash Flow from Financing Activities Our financing activities are primarily composed of borrowings and payments of short-term debt, payments of medium-term notes, borrowings of senior notes, distributions to minority interests, cash dividends on our common stock issuances, and purchases and issuances of treasury shares. Our capitalization and financing strategy is intended to ensure that we are properly capitalized with the appropriate mix of equity and debt securities. This strategy includes active management of the percentage of total debt relative to total capitalization, appropriate mix of debt with fixed to floating interest rates (our variable debt target is 25% to 45% of total debt), as well as the term and interest rate profile of our debt securities. As of December 31, 2006, our variable rate debt was $733 million or 34% of our total debt. This included $527 million of variable-rate short-term debt, $100 million of variable-rate senior notes and $106 million of variable-rate gas facility revenue bonds. In 2005, our variable rate debt was also 34% of our total debt.

We also work to maintain or improve our credit ratings on our debt to effectively manage our existing financing costs and enhance our ability to raise additional capital on favorable terms. Factors we consider important in assessing our credit ratings include our balance sheet leverage, capital spending, earnings, cash flow generation, available liquidity and overall business risks. We do not have any trigger events in our debt instruments that are tied to changes in our specified credit ratings or our stock price and have not entered into any agreements that would require us to issue equity based on credit ratings or other trigger events. The table below summarizes our credit ratings as of December 31, 2006, which reflects no change from last year.

	S&P	Moody's	Fitch
Corporate rating	A-		
Commercial paper	A-2	P-2	F-2
Senior unsecured	BBB+	Baa1	A-
Ratings outlook	Negative	Stable	Stable

Our credit ratings may be subject to revision or withdrawal at any time by the assigning rating organization, and each rating should be evaluated independently of any other rating. We cannot ensure that a rating will remain in effect for any given period of time or that a rating will not be lowered or withdrawn entirely by a rating agency if, in its judgment, circumstances so warrant. If the rating agencies downgrade our ratings, particularly below investment grade, it may significantly limit our access to the commercial paper market and our borrowing costs would increase. In addition, we would likely be required to pay a higher interest rate in future financings, and our potential pool of investors and funding sources would decrease.

Our debt instruments and other financial obligations include provisions that, if not complied with, could require early payment, additional collateral support or similar actions. Our most important default events include maintaining covenants with respect to a maximum leverage ratio, insolvency events, nonpayment of scheduled principal or interest payments, and acceleration of other financial obligations and change of control provisions. Our Credit Facility's financial covenant requires us to maintain a ratio of total debt to total capitalization of no greater than 70%; however, our goal is to maintain this ratio at levels between 50% and 60%. We are currently in compliance with all existing debt provisions and covenants. For more information on our debt, see Note 7 "Debt."

We believe that accomplishing these capitalization objectives and maintaining sufficient cash flow are necessary to maintain our investment-grade credit ratings and to allow us access to capital at reasonable costs. The components of our capital structure, as of the dates indicated, are summarized in the following tables.

In millions	Dec. 31, 2006	
Short-term debt	$539	14%
Long-term debt (1)	1,622	43
Total debt	2,161	57
Common shareholders' equity	1,609	43
Total capitalization	$3,770	100%

In millions	Dec. 31, 2005	
Short-term debt	$522	14%
Long-term debt (1)	1,615	45
Total debt	2,137	59
Common shareholders' equity	1,499	41
Total capitalization	$3,636	100%

(1) Net of interest rate swaps.

Short-term Debt Our short-term debt is composed of borrowings under our commercial paper program, lines of credit at Sequent, SouthStar and Pivotal Utility, the current portion of our medium-term notes and the current portion of our capital leases. Our short-term debt financing generally increases between June and December because our payments for natural gas and pipeline capacity are generally made to suppliers prior to the collection of accounts receivable from our customers. We typically reduce short-term debt balances in the spring because a significant portion of our current assets are converted into cash at the end of the winter heating season.

In August 2006, we replaced our previous Credit Facility with a new Credit Facility that supports our commercial paper program. Under the terms of the new Credit Facility, the aggregate principal amount available has been increased from $850 million to $1 billion and we can request an option to increase the aggregate principal amount available for borrowing to $1.25 billion on not more than three occasions during each calendar year. This Credit Facility expires August 31, 2011. The increased capacity under our Credit Facility increases our ability to borrow under our commercial paper program. Our total cash and available liquidity under our Credit Facility as of the dates indicated are shown in the table below.

In millions	Dec. 31, 2006	Dec. 31, 2005
Unused availability under the Credit Facility	$1,000	$850
Cash and cash equivalents	20	32
Total cash and available liquidity under the Credit Facility	$1,020	$882

As of December 31, 2006 and 2005, we had no outstanding borrowings under the Credit Facility. However, the availability of borrowings and unused availability under our Credit Facility is limited and subject to conditions specified within the Credit Facility, which we currently meet. These conditions include:

- the maintenance of a ratio of total debt to total capitalization of no greater than 70%
- the continued accuracy of representations and warranties contained in the agreement

In 2006, we extended Sequent's two lines of credit through June 2007 and August 2007. In addition, we extended Pivotal Utility's line of credit through August 2007. These unsecured lines of credit are unconditionally guaranteed by us.

In November of 2006, SouthStar closed a five-year $75 million credit facility. This facility will be used for working capital needs and general corporate needs. At December 31, 2006, there were no outstanding borrowings on this line of credit.

Long-term Debt In May 2006, we used the proceeds from the sale of commercial paper to redeem $150 million of junior subordinated debentures and to pay a $5 million note representing our investment in our Capital Trust, previously included in notes payable to trusts. In June 2006, we issued $175 million of 10-year senior notes at an interest rate of 6.375% and used the net proceeds of $173 million to repay the commercial paper. In January 2007, we used proceeds from the sale of commercial paper to redeem $11 million of 7% medium-term notes previously scheduled to mature in January 2015.

Interest Rate Swaps To maintain an effective capital structure, it is our policy to borrow funds using a mix of fixed-rate debt and variable-rate debt. We have entered into interest rate swap agreements for the purpose of hedging the interest rate risk associated with our fixed-rate and variable-rate debt obligation.

Minority Interest As a result of our consolidation of SouthStar's accounts effective January 1, 2004, we recorded Piedmont's portion of SouthStar's contributed capital as a minority interest in our consolidated balance sheets and included it as a component of our total capitalization. A cash distribution of $22 million in 2006, $19 million in 2005 and $14 million in 2004 for SouthStar's dividend distributions to Piedmont were recorded in our consolidated statement of cash flows as a financing activity.

Dividends on Common Stock In 2006, we made $111 million in common stock dividend payments. This was an increase of $11 million or 11% from 2005, which resulted from increases in the amount of our quarterly common stock dividends per share. In

2005, we made $100 million in common stock dividend payments. This was an increase of $25 million or 33% from 2004. The increase was due to our 11 million share common stock offering in November 2004, which increased the number of shares outstanding, and the increases in the amount of our quarterly common stock dividends per share.

In the last three fiscal years, we have made the following increases in dividends on our common stock. For information about restrictions on our ability to pay dividends on our common stock, see Note 6.

Date of change	% increase	Quarterly dividend	Indicated annual dividend
Nov 2005	19%	$0.37	$1.48
Feb 2005	7	0.31	1.24
Apr 2004	4	0.29	1.16

Share Repurchases In March 2001 our Board of Directors approved the purchase of up to 600,000 shares of our common stock to be used for issuances under the Officer Incentive Plan. During 2006, we purchased 32,801 shares. As of December 31, 2006, we had purchased a total 286,567 shares, leaving 313,433 shares available for purchase.

In February 2006, our Board of Directors authorized a plan to purchase up to eight million shares of our outstanding common stock over a five-year period. These purchases are intended principally to offset share issuances under our employee and non-employee director incentive compensation plans and our dividend reinvestment and stock purchase plans. Stock purchases under this program may be made in the open market or in private transactions at times and in amounts that we deem appropriate. There is no guarantee as to the exact number of shares that we will purchase, and we can terminate or limit the program at any time. We will hold the purchased shares as treasury shares. During 2006, we repurchased 1,027,500 shares at a weighted average price of $36.67. For more information on our share repurchases see Item 5 "Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities."

Shelf Registration We currently have remaining capacity under an October 2004 shelf registration statement of approximately $782 million. We may seek additional financing through debt or equity offerings in the private or public markets at any time.

Critical Accounting Policies

The preparation of our financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and the related disclosures of contingent assets and liabilities. We based our estimates on historical experience and various other assumptions that we believe to be reasonable under the circumstances, and we evaluate our estimates on an ongoing basis. Our actual results may differ from our estimates. Each of the following critical accounting policies involves complex situations requiring a high degree of judgment either in the application and interpretation of existing literature or in the development of estimates that impact our financial statements.

Pipeline Replacement Program Atlanta Gas Light was ordered by the Georgia Commission (through a joint stipulation between Atlanta Gas Light and the Commission staff) to undertake a PRP that would replace all bare steel and cast iron pipe in its system in the state of Georgia within a 10-year period beginning October 1, 1998. Atlanta Gas Light identified and in accordance with this stipulation, provided notice to the Georgia Commission of 2,632 miles of bare steel and cast iron pipe to be replaced.

On June 10, 2005, the Georgia Commission approved a Settlement Agreement with Atlanta Gas Light that, among other things, extends Atlanta Gas Light's PRP by five years to require that all replacements be completed by December 2013. The timing of replacements was subsequently specified in an amendment to the PRP stipulation. This amendment, which was approved by the Georgia Commission on December 20, 2005, requires Atlanta Gas Light to replace all cast iron pipe and 70% of all bare steel pipe by December 2010. The remaining 30% of bare steel pipe is required to be replaced by December 2013. Approximately 131 miles of cast iron and 604 miles of bare steel pipe still require replacement. If Atlanta Gas Light does not perform in accordance with the initial and amended PRP stipulation, it can be assessed certain nonperformance penalties. However, to date, Atlanta Gas Light is in full compliance.

The stipulation also provides for recovery of all prudent costs incurred under the program, which Atlanta Gas Light has recorded as a regulatory asset. The regulatory asset has two components:

- the costs incurred to date that have not yet been recovered through rate riders
- the future expected costs to be recovered through rate riders

The determination of future expected costs involves judgment. Factors that must be considered in estimating the future expected costs are projected capital expenditure spending, including labor and material costs, and the remaining infrastructure footage to be replaced for the remaining years of the program. Atlanta Gas Light recorded a long-term liability of $202 million as of December 31, 2006 and

$235 million as of December 31, 2005, which represented engineering estimates for remaining capital expenditure costs in the PRP. As of December 31, 2006, Atlanta Gas Light had recorded a current liability of $35 million, representing expected PRP expenditures for the next 12 months. We report these estimates on an undiscounted basis. If the recorded liability for PRP had been higher or lower by $10 million, Atlanta Gas Light's expected recovery would have changed by approximately $1 million.

Environmental Remediation Liabilities Atlanta Gas Light historically reported estimates of future remediation costs based on probabilistic models of potential costs. We report these estimates on an undiscounted basis. As we continue to conduct the actual remediation and enter cleanup contracts, Atlanta Gas Light is increasingly able to provide conventional engineering estimates of the likely costs of many elements of its remediation program. These estimates contain various engineering uncertainties, and Atlanta Gas Light continuously attempts to refine and update these engineering estimates.

Our latest available estimate as of December 31, 2006 for those elements of the remediation program with in-place contracts or engineering cost estimates is $13 million for Atlanta Gas Light's Georgia and Florida sites. This is an increase of $1 million from the December 31, 2005 estimate of projected engineering and in-place contracts, resulting from increased cost estimates during 2006. For elements of the remediation program where Atlanta Gas Light still cannot perform engineering cost estimates, considerable variability remains in available estimates. The estimated remaining cost of future actions at these sites is $14 million. Atlanta Gas Light estimates certain other costs it pays related to administering the remediation program and remediation of sites currently in the investigation phase. Beyond 2008, these costs cannot be estimated.

Atlanta Gas Light's environmental remediation liability is included in its corresponding regulatory asset. As of December 31, 2006, the regulatory asset was $104 million, which is a combination of the accrued remediation liability and unrecovered cash expenditures. Atlanta Gas Light's estimate does not include other potential expenses, such as unasserted property damage, personal injury or natural resource damage claims, unbudgeted legal expenses, or other costs for which it may be held liable but with respect to which the amount cannot be reasonably forecast. Atlanta Gas Light's recovery of environmental remediation costs is subject to review by the Georgia Commission which may seek to disallow the recovery of some expenses.

In New Jersey, Elizabethtown Gas is currently conducting remediation activities with oversight from the New Jersey Department of Environmental Protection. Although the actual total cost of future environmental investigation and remediation efforts cannot be estimated with precision, the range of reasonably probable costs is $60 million to $118 million. As of December 31, 2006, we have recorded a liability of $60 million.

The New Jersey Commission has authorized Elizabethtown Gas to recover prudently incurred remediation costs for the New Jersey properties through its remediation adjustment clause. As a result, Elizabethtown Gas has recorded a regulatory asset of approximately $66 million, inclusive of interest, as of December 31, 2006, reflecting the future recovery of both incurred costs and future remediation liabilities in the state of New Jersey. Elizabethtown Gas has also been successful in recovering a portion of remediation costs incurred in New Jersey from its insurance carriers and continues to pursue additional recovery. As of December 31, 2006, the variation between the amounts of the environmental remediation cost liability recorded in the consolidated balance sheet and the associated regulatory asset is due to expenditures for environmental investigation and remediation exceeding recoveries from ratepayers and insurance carriers.

We also own several former NUI remediation sites located outside of New Jersey. One site, in Elizabeth City, North Carolina, is subject to an order by the North Carolina Department of Environment and Natural Resources. Preliminary estimates for investigation and remediation costs range from $10 million to $17 million. As of December 31, 2006, we had recorded a liability of $10 million related to this site. There is another site in North Carolina where investigation and remediation is probable, although no regulatory order exists and we do not believe costs associated with this site can be reasonably estimated. In addition, there are as many as six other sites with which NUI had some association, although no basis for liability has been asserted. We do not believe that costs to investigate and remediate these sites, if any, can be reasonably estimated at this time.

With respect to these costs, we currently pursue or intend to pursue recovery from ratepayers, former owners and operators and insurance carriers. Although we have been successful in recovering a portion of these remediation costs from our insurance carriers, we are not able to express a belief as to the success of additional recovery efforts. We are working with the regulatory agencies to prudently manage our remediation costs so as to mitigate the

impact of such costs on both ratepayers and shareholders.

Derivatives and Hedging Activities SFAS 133, as updated by SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities" (SFAS 149), established accounting and reporting standards which require that every derivative financial instrument (including certain derivative instruments embedded in other contracts) be recorded in the balance sheet as either an asset or liability measured at its fair value. However, if the derivative transaction qualifies for and is designated as a normal purchase and sale, it is exempted from the fair value accounting treatment of SFAS 133, as updated by SFAS 149, and is accounted for using traditional accrual accounting.

SFAS 133 requires that changes in the derivative's fair value be recognized currently in earnings unless specific hedge accounting criteria are met. If the derivatives meet those criteria, SFAS 133 allows a derivative's gains and losses to offset related results on the hedged item in the income statement in the case of a fair value hedge, or to record the gains and losses in OCI until maturity in the case of a cash flow hedge. Additionally, SFAS 133 requires that a company formally designate a derivative as a hedge as well as document and assess the effectiveness of derivatives associated with transactions that receive hedge accounting treatment. SFAS 133 applies to Treasury Locks and interest rate swaps executed by AGL Capital and gas commodity contracts executed by both Sequent and SouthStar. Our derivative and hedging activities are described in further detail in Note 1, "Accounting Policies and Methods of Application," Note 2 "Risk Management" and Item 7 "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Commodity-related Derivative Instruments We are exposed to risks associated with changes in the market price of natural gas. Through Sequent and SouthStar, we use derivative instruments to reduce our exposure to the risk of changes in the price of natural gas.

Sequent recognizes the change in value of derivative instruments as an unrealized gain or loss in revenues in the period when the market value of the instrument changes. Sequent recognizes cash inflows and outflows associated with the settlement of its risk management activities in operating cash flows, and reports these settlements as receivables and payables in the balance sheet separately from the risk management activities reported as energy marketing receivables and trade payables.

We attempt to mitigate substantially all our commodity price risk associated with Sequent's natural gas storage portfolio and lock in the economic margin at the time we enter into purchase transactions for our stored natural gas. We purchase natural gas for storage when the current market price we pay plus storage costs is less than the market price we could receive in the future. We lock in the economic margin by selling NYMEX futures contracts or other over-the-counter derivatives in the forward months corresponding with our withdrawal periods. We use contracts to sell natural gas at that future price to substantially lock in the profit margin we will ultimately realize when the stored natural gas is actually sold. These contracts meet the definition of a derivative under SFAS 133.

The purchase, storage and sale of natural gas are accounted for differently from the derivatives we use to mitigate the commodity price risk associated with our storage portfolio. The difference in accounting can result in volatility in our reported net income, even though the economic margin is essentially unchanged from the date the transactions were consummated. We do not currently use hedge accounting under SFAS 133 to account for this activity.

Natural gas that we purchase and inject into storage is accounted for at the lower of average cost or market. Under current accounting guidance, we would recognize a loss in any period when the market price for natural gas is lower than the carrying amount of our purchased natural gas inventory. Costs to store the natural gas are recognized in the period the costs are incurred. We recognize revenues and cost of natural gas sold in our statement of consolidated income in the period we sell gas and it is delivered out of the storage facility.

The derivatives we use to mitigate commodity price risk and substantially lock in the margin upon the sale of stored natural gas are accounted for at fair value and marked to market each period, with changes in fair value recognized as unrealized gains or losses in the period of change. This difference in accounting, the lower of average cost or market basis for our storage inventory versus the fair value accounting for the derivatives used to mitigate commodity price risk, can and does result in volatility in our reported earnings.
Over time, gains or losses on the sale of storage inventory will be substantially offset by losses or gains on the derivatives, resulting in realization of the economic profit margin we expected when we entered into the transactions. This accounting difference causes Sequent's earnings on its storage positions to be affected by natural gas price

changes, even though the economic profits remain essentially unchanged.

See "Results of Operations - Wholesale Services" for a discussion of the potential volatility in earnings due to changes in natural gas prices.

SouthStar also uses derivative instruments to manage exposures arising from changing commodity prices. SouthStar's objective for holding these derivatives is to minimize volatility in wholesale commodity natural gas prices. A portion of SouthStar's derivative transactions are designated as cash flow hedges under SFAS 133. Derivative gains or losses arising from cash flow hedges are recorded in OCI and are reclassified into earnings in the same period the underlying hedged item is reflected in the income statement. As of December 31, 2006, the ending balance in OCI for derivative transactions designated as cash flow hedges under SFAS 133 was a gain of $6 million, net of minority interest and taxes. Any hedge ineffectiveness, defined as when the gains or losses on the hedging instrument do not offset the losses or gains on the hedged item, is recorded into earnings in the period in which it occurs. SouthStar currently has minimal hedge ineffectiveness. SouthStar's remaining derivative instruments are not designated as hedges under SFAS 133. Therefore, changes in their fair value are recorded in earnings in the period of change.

SouthStar also enters into weather derivative instruments in order to preserve margins in the event of warmer-than-normal weather in the winter months. These contracts are accounted for using the intrinsic value method under the guidance of EITF Issue No. 99-02, "Accounting for Weather Derivatives." Changes in the fair value of these derivatives are recorded in earnings in the period of change. The weather derivative contracts contain strike amount provisions based on cumulative heating degree days for the covered periods. In September 2006, SouthStar entered into weather derivatives (swaps and options) for the 2006-2007 winter heating season, primarily from November through March. As of December 31, 2006, SouthStar recorded a receivable of $7 million for this hedging activity.

Contingencies Our accounting policies for contingencies cover a variety of business activities, including contingencies for potentially uncollectible receivables, rate matters, and legal and environmental exposures. We accrue for these contingencies when our assessments indicate that it is probable that a liability has been incurred or an asset will not be recovered, and an amount can be reasonably estimated in accordance with SFAS No. 5, "Accounting for Contingencies." We base our estimates for these liabilities on currently available facts and our estimates of the ultimate outcome or resolution of the liability in the future. Actual results may differ from estimates, and estimates can be, and often are, revised either negatively or positively, depending on actual outcomes or changes in the facts or expectations surrounding each potential exposure.

Pension and Other Postretirement Plans Our pension and other postretirement plan costs and liabilities are determined on an actuarial basis and are affected by numerous assumptions and estimates including the market value of plan assets, estimates of the expected return on plan assets, assumed discount rates and current demographic and actuarial mortality data. We annually review the estimates and assumptions underlying our pension and other postretirement plan costs and liabilities. The assumed discount rate and the expected return on plan assets are the assumptions that generally have the most significant impact on our pension costs and liabilities. The assumed discount rate, the assumed health care cost trend rate and the assumed rates of retirement generally have the most significant impact on our postretirement plan costs and liabilities.

The discount rate is used principally to calculate the actuarial present value of our pension and postretirement obligations and net pension and postretirement cost. When establishing our discount rate, we consider high quality corporate bond rates based on Moody's Corporate AA long-term bond rate of 5.8% and the Citigroup Pension Liability rate of 5.9% at December 31, 2006. We further use these market indices as a comparison to a single equivalent discount rate derived with the assistance of our actuarial advisors. This analysis as of December 31, 2006 produced a single equivalent discount rate of 5.8%.

The actuarial assumptions used may differ materially from actual results due to changing market and economic conditions, higher or lower withdrawal rates, or longer or shorter life spans of participants. These differences may result in a significant impact on the amount of pension expense recorded in future periods.

The expected long-term rate of return on assets is used to calculate the expected return on plan assets component of our annual pension and postretirement plan cost. We estimate the expected return on plan assets by evaluating expected bond returns, equity risk premiums, asset allocations, the effects of active plan management, the impact of periodic plan asset rebalancing and historical performance. We also consider guidance from our investment advisors in making a final determination of our expected rate of

return on assets. To the extent the actual rate of return on assets realized over the course of a year is greater than or less than the assumed rate, that year's annual pension or postretirement plan cost is not affected. Rather, this gain or loss reduces or increases future pension or postretirement plan costs.

Prior to 2006, we estimated the assumed health care cost trend rate used in determining our postretirement net expense based on our actual health care cost experience, the effects of recently enacted legislation and general economic conditions. However, starting in 2006, our postretirement plans have been capped at 2.5% for increases in health care costs. Consequently, a one-percentage-point increase or decrease in the assumed health care trend rate does not materially affect the periodic benefit cost for our postretirement plans. A one-percentage-point increase in the assumed health care cost trend rate would increase our accumulated projected benefit obligation by $4 million. A one percentage-point decrease in the assumed health care cost trend rate would decrease our accumulated projected benefit obligation by $4 million. Our assumed rate of retirement is estimated based upon an annual review of participant census information as of the measurement date.

At December 31, 2006, our pension and postretirement liability decreased by approximately $18 million, resulting in an after-tax gain to OCI of $11 million. This adjustment reflected our funding contributions to the plan and updated valuations for the projected benefit obligation (PBO) and plan assets.

Equity market performance and corporate bond rates have a significant effect on our reported unfunded accumulated benefit obligation (ABO), as the primary factors that drive the value of our unfunded ABO are the assumed discount rate and the actual return on plan assets. Additionally, equity market performance has a significant effect on our market-related value of plan assets (MRVPA), which is a calculated value and differs from the actual market value of plan assets. The MRVPA recognizes differences between the actual market value and expected market value of our plan assets and is determined by our actuaries using a five-year moving weighted average methodology. Gains and losses on plan assets are spread through the MRVPA based on the five-year moving weighted average methodology, which affects the expected return on plan assets component of pension expense.

The actual return on our pension plan assets compared to the expected return on plan assets will have an impact on our ABO as of December 31, 2006 and our pension expense for 2007. We are unable to determine how this actual return on plan assets will affect future ABO and pension expense, as actuarial assumptions and differences between actual and expected returns on plan assets are determined at the time we complete our actuarial evaluation as of December 31, 2006. Our actual returns may also be positively or negatively impacted as a result of future performance in the equity and bond markets. The following tables illustrate the effect of changing the critical actuarial assumptions, as discussed above, while holding all other assumptions constant:

AGL Resources Inc. Retirement and Postretirement Plans

In millions		Pension Benefits		Health and Life Benefits	
Actuarial assumptions	Percentage-point change in assumption	Increase (decrease) in ABO	Increase (decrease) in cost	Increase (decrease) in obligation	Increase (decrease) in cost
Expected long-term return on plan assets	+/- 1%	$- / -	$(3) / 3		
Discount rate	+/- 1%	(40) / 45	(4) / 4		
Healthcare cost trend rate	+/- 1%			$4 / (4)	$- / -

NUI Corporation Retirement Plan

In millions			Pension Benefits
Actuarial assumptions	Percentage-point change in assumption	Increase (decrease) in ABO	Increase (decrease) in cost
Expected long-term return on plan assets	+/- 1%	$- / -	$(1) / 1
Discount rate	+/- 1%	(8) / 8	- / -

At December 31, 2006 NUI's PBO was $86 million, reflecting $12 million in adjustments for terminations and settlement of liabilities affected by the NUI purchase transaction, offset by net periodic benefit cost of $3 million in 2006. Differences between actuarial assumptions and actual plan results are deferred and amortized into cost when the accumulated differences exceed 10% of the greater of the PBO or the MRVPA. If necessary, the excess is amortized over the average remaining service period of active employees.

In addition to the assumptions listed above, the measurement of the plans' obligations and costs depend on other factors such as employee demographics, the level of contributions made to the

plans, earnings on the plans' assets and mortality rates.

Income Taxes Our net long-term deferred tax liability totaled $544 million at December 31, 2006 (see Note 10 "Income Taxes"). This liability is estimated based on the expected future tax consequences of items recognized in the financial statements. After application of the federal statutory tax rate to book income, judgment is required with respect to the timing and deductibility of expense in our income tax returns. For state income tax and other taxes, judgment is also required with respect to the apportionment among the various jurisdictions. A valuation allowance is recorded if we expect that it is more likely than not that our deferred tax assets will not be realized. We had a $3 million valuation allowance on $47 million of deferred tax assets as of December 31, 2006, reflecting the expectation that most of these assets will be realized. In addition, we maintain a liability for the estimate of potential income tax exposure. We believe this liability for potential exposure to be adequate

Accounting Developments

For information regarding accounting developments, see Note 1, "Accounting Policies and Methods of Application.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to risks associated with commodity prices, interest rates and credit. Commodity price risk is defined as the potential loss that we may incur as a result of changes in the fair value of a particular instrument or commodity. Interest rate risk results from our portfolio of debt and equity instruments that we issue to provide financing and liquidity for our business. Credit risk results from the extension of credit throughout all aspects of our business but is particularly concentrated at Atlanta Gas Light in distribution operations and in wholesale services.

Our Risk Management Committee (RMC) is responsible for establishing the overall risk management policies and monitoring compliance with, and adherence to, the terms within these policies, including approval and authorization levels and delegation of these levels. Our RMC consists of members of senior management who monitor open commodity price risk positions and other types of risk, corporate exposures, credit exposures and overall results of our risk management activities. It is chaired by our chief risk officer, who is responsible for ensuring that appropriate reporting mechanisms exist for the RMC to perform its monitoring functions. Our risk management activities and related accounting treatments are described in further detail in Note 2, "Risk Management."

Commodity Price Risk

Retail Energy Operations SouthStar's use of derivatives is governed by a risk management policy, approved and monitored by its Risk and Asset Management Committee, which prohibits the use of derivatives for speculative purposes. A 95% confidence interval is used to evaluate VaR exposure. A 95% confidence interval means there is a 5% probability that the actual change in portfolio value will be greater than the calculated VaR value over the holding period. We calculate VaR based on the variance-covariance technique. This technique requires several assumptions for the basis of the calculation, such as price volatility, confidence interval and holding period. Our VaR may not be comparable to a similarly titled measure of another company because, although VaR is a common metric in the energy industry, there is no established industry standard for calculating VaR or for the assumptions underlying such calculations. The following table provides more information on SouthStar's 1-day holding period VaR.

In millions	**1-day**
2006 period end	$0.1
2005 period end	0.3

SouthStar generates operating margin from the active management of storage positions through a variety of hedging transactions and derivative instruments aimed at managing exposures arising from changing commodity prices. SouthStar uses these hedging instruments to lock in economic margins as wholesale prices fluctuate and thereby minimize its exposure to declining operating margins.

Wholesale Services Sequent routinely utilizes various types of financial and other instruments to mitigate certain commodity price risks inherent in the natural gas industry. These instruments include a variety of exchange-traded and over-the-counter energy contracts, such as forward contracts, futures contracts, options contracts and financial swap agreements. The following table includes the fair values and average values of Sequent's energy marketing and risk management assets and liabilities as of December 31, 2006 and 2005. Sequent bases the average values on monthly averages for the 12 months ended December 31, 2006 and 2005.

	Average values at December 31,	
In millions	**2006**	**2005**
Asset	$95	$83
Liability	43	102

In millions	Fair value at December 31, 2006	2005
Asset	$133	$97
Liability	14	110

Sequent employs a systematic approach to evaluating and managing the risks associated with contracts related to wholesale marketing and risk management, including VaR. Similar to SouthStar, Sequent uses a 1-day holding period and a 95% confidence interval to evaluate its VaR exposure.

Sequent's open exposure is managed in accordance with established policies that limit market risk and require daily reporting of potential financial exposure to senior management, including the chief risk officer. Because Sequent generally manages physical gas assets and economically protects its positions by hedging in the futures and over-the-counter markets, its open exposure is generally minimal, permitting Sequent to operate within relatively low VaR limits. Sequent employs daily risk testing, using both VaR and stress testing, to evaluate the risks of its open positions.
Sequent's management actively monitors open commodity positions and the resulting VaR. Sequent continues to maintain a relatively matched book, where its total buy volume is close to its sell volume, with minimal open commodity risk. Based on a 95% confidence interval and employing a 1-day holding period for all positions, Sequent's portfolio of positions for the 12 months ended December 31, 2006, 2005 and 2004 had the following 1-day holding period VaRs.

In millions	2006	2005	2004
Period end	$1.3	$0.6	$0.1
12-month average	1.2	0.4	0.1
High	2.5	1.1	0.4
Low (1)	0.7	0.0	0.0

(1) $0.0 values represent amounts less than $0.1 million.

During most of 2005 and 2006, Sequent experienced increases in its high, average and period end 1-day VaR amounts compared to prior periods. These increases were directly associated with higher prices and related price volatility created by the Gulf Coast hurricanes during the third quarter of 2005 and the hurricanes lingering effects through the fourth quarters of 2005 and into 2006. In addition, Sequent has entered into additional storage and transportation positions, some of which are longer dated and are not fully hedged due to a lack of liquidity in certain markets for the future periods. As a result, these positions have increased Sequent's reported VaR amounts.

Sequent has refined the methodology associated with its VaR calculation to incorporate dynamic volatility factors and to exclude interruptible transportation positions. These changes had somewhat offsetting effects as the dynamic volatility factors increased the VaR and the exclusion of interruptible transportation positions reduced the VaR. This new methodology was applied on a prospective basis beginning in the second quarter of 2006. While not considered material, Sequent's VaR amounts increased compared to prior periods as its calculation is now more sensitive to market volatility and the relative level of risk associated with increased storage and transportation positions. Due to the dynamic nature of measuring VaR, Sequent will continually evaluate the components of its VaR calculation and will make refinements as deemed necessary.

Interest Rate Risk

Interest rate fluctuations expose our variable-rate debt to changes in interest expense and cash flows. Our policy is to manage interest expense using a combination of fixed-rate and variable-rate debt. To facilitate the achievement of desired fixed-rate to variable-rate debt ratios, AGL Capital entered into interest rate swaps whereby it agreed to exchange, at specified intervals, the difference between fixed and variable amounts calculated by reference to agreed-on notional principal amounts. These swaps are designated to hedge the fair values of $100 million of the $300 million Senior Notes due in 2011.

Credit Risk

Distribution Operations Atlanta Gas Light has a concentration of credit risk as it bills only 11 Marketers in Georgia for its services. The credit risk exposure to Marketers varies with the time of the year, with exposure at its lowest in the nonpeak summer months and highest in the peak winter months. Marketers are responsible for the retail sale of natural gas to end-use customers in Georgia. These retail functions include customer service, billing, collections, and the purchase and sale of the natural gas commodity. The provisions of Atlanta Gas Light's tariff allow Atlanta Gas Light to obtain security support in an amount equal to a minimum of two times a Marketer's highest month's estimated bill from Atlanta Gas Light. For 2006, the four largest Marketers based on customer count, one of which was SouthStar, accounted for approximately 36% of our consolidated operating margin and 47% of distribution operations' operating margin.

Several factors are designed to mitigate our risks from the increased concentration of credit that has resulted from deregulation. In addition to the security support described above, Atlanta Gas Light bills intrastate delivery service to Marketers in advance

rather than in arrears. We accept credit support in the form of cash deposits, letters of credit/surety bonds from acceptable issuers and corporate guarantees from investment-grade entities. The RMC reviews on a monthly basis the adequacy of credit support coverage, credit rating profiles of credit support providers and payment status of each Marketer. We believe that adequate policies and procedures have been put in place to properly quantify, manage and report on Atlanta Gas Light's credit risk exposure to Marketers.

Atlanta Gas Light also faces potential credit risk in connection with assignments to Marketers of interstate pipeline transportation and storage capacity. Although Atlanta Gas Light assigns this capacity to Marketers, in the event that a Marketer fails to pay the interstate pipelines for the capacity, the interstate pipelines would in all likelihood seek repayment from Atlanta Gas Light. The fact that some of the interstate pipelines require Marketers to maintain security for their obligations to the interstate pipelines arising out of the assigned capacity somewhat mitigates this risk.

Retail Energy Operations SouthStar obtains credit scores for its firm residential and small commercial customers using a national credit reporting agency, enrolling only those customers that meet or exceed SouthStar's credit threshold. The average credit score of SouthStar's Georgia customers has increased 3% since 2004.

SouthStar considers potential interruptible and large commercial customers based on a review of publicly available financial statements and review of commercially available credit reports. Prior to entering into a physical transaction, SouthStar also assigns physical wholesale counterparties an internal credit rating and credit limit based on the counterparties' Moody's, S&P and Fitch ratings, commercially available credit reports and audited financial statements.

Wholesale Services Sequent has established credit policies to determine and monitor the creditworthiness of counterparties, as well as the quality of pledged collateral. Sequent also utilizes master netting agreements whenever possible to mitigate exposure to counterparty credit risk. When Sequent is engaged in more than one outstanding derivative transaction with the same counterparty and it also has a legally enforceable netting agreement with that counterparty, the "net" mark-to-market exposure represents the netting of the positive and negative exposures with that counterparty and a reasonable measure of Sequent's credit risk. Sequent also uses other netting agreements with certain counterparties with whom it conducts significant transactions.

Master netting agreements enable Sequent to net certain assets and liabilities by counterparty. Sequent also nets across product lines and against cash collateral provided the master netting and cash collateral agreements include such provisions. Additionally, Sequent may require counterparties to pledge additional collateral when deemed necessary. Sequent conducts credit evaluations and obtains appropriate internal approvals for its counterparty's line of credit before any transaction with the counterparty is executed. In most cases, the counterparty must have a minimum long-term debt rating of Baa3 from Moody's and BBB- from S&P. Generally, Sequent requires credit enhancements by way of guaranty, cash deposit or letter of credit for transaction counterparties that do not meet the minimum ratings threshold.

Sequent, which provides services to Marketers and utility and industrial customers, also has a concentration of credit risk as measured by its 30-day receivable exposure plus forward exposure. As of December 31, 2006, Sequent's top 20 counterparties represented approximately 57% of the total counterparty exposure of $394 million, derived by adding together the top 20 counterparties' exposures and dividing by the total of Sequent's counterparties' exposures.

As of December 31, 2006, Sequent's counterparties, or the counterparties' guarantors, had a weighted average S&P equivalent credit rating of A-, which is consistent with the prior year. The S&P equivalent credit rating is determined by a process of converting the lower of the S&P or Moody's ratings to an internal rating ranging from 9 to 1, with 9 being equivalent to AAA/Aaa by S&P and Moody's and 1 being D or Default by S&P and Moody's. A counterparty that does not have an external rating is assigned an internal rating based on the strength of the financial ratios of that counterparty. To arrive at the weighted average credit rating, each counterparty's assigned internal rating is multiplied by the counterparty's credit exposure and summed for all counterparties. That sum is divided by the aggregate total counterparties' exposures, and this numeric value is then converted to an S&P equivalent. The following tables show Sequent's commodity receivable and payable positions as of December 31, 2006 and 2005.

	As of December 31,	
In millions	**2006**	**2005**
Gross receivables		
Receivables with netting agreements in place:		
Counterparty is investment grade	$359	$462
Counterparty is non-investment grade	62	66
Counterparty has no external rating	75	113
Receivables without netting agreements in place:		
Counterparty is investment grade	9	34
Amount recorded on balance sheet	$505	$675
Gross payables		
Payables with netting agreements in place:		
Counterparty is investment grade	$297	$456
Counterparty is non-investment grade	52	56
Counterparty has no external rating	156	255
Payables without netting agreements in place:		
Counterparty is investment grade	5	4
Counterparty has no external rating	-	4
Amount recorded on balance sheet	$510	$775

Sequent has certain trade and credit contracts that have explicit minimum credit rating requirements. These credit rating requirements typically give counterparties the right to suspend or terminate credit if our credit ratings are downgraded to non-investment grade status. Under such circumstances, Sequent would need to post collateral to continue transacting business with some of its counterparties. Posting collateral would have a negative effect on our liquidity. If such collateral were not posted, Sequent's ability to continue transacting business with these counterparties would be impaired. If at December 31, 2006 Sequent's credit ratings had been downgraded to non-investment grade status, the required amounts to satisfy potential collateral demands under such agreements between Sequent and its counterparties would have totaled $10 million.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

AGL Resources Inc.
Consolidated Balance Sheets - Assets

In millions	As of December 31, 2006	December 31, 2005
Current assets		
Cash and cash equivalents	$20	$32
Receivables		
Energy marketing	505	675
Gas	197	303
Unbilled revenues	172	246
Other	21	11
Less allowance for uncollectible accounts	(15)	(15)
Total receivables	880	1,220
Inventories		
Natural gas stored underground	568	509
Other	29	34
Total inventories	597	543
Energy marketing and risk management assets	159	103
Unrecovered environmental remediation costs – current portion	27	31
Unrecovered PRP costs – current portion	27	27
Other current assets	112	85
Total current assets	1,822	2,041
Property, plant and equipment		
Property, plant and equipment	4,976	4,791
Less accumulated depreciation	1,540	1,458
Property, plant and equipment — net	3,436	3,333
Deferred debits and other assets		
Goodwill	420	420
Unrecovered PRP costs	247	276
Unrecovered environmental remediation costs	143	165
Other	79	85
Total deferred debits and other assets	889	946
Total assets	$6,147	$6,320

See Notes to Consolidated Financial Statements.

AGL Resources Inc.
Consolidated Balance Sheets - Liabilities and Capitalization

In millions, except share amounts	As of December 31, 2006	As of December 31, 2005
Current liabilities		
Short-term debt	$539	$522
Energy marketing trade payable	510	775
Accounts payable – trade	213	266
Accrued wages and salaries	50	43
Customer deposits	42	42
Energy marketing and risk management liabilities – current portion	41	117
Accrued interest	37	32
Accrued PRP costs – current portion	35	30
Deferred purchased gas adjustment	24	40
Accrued environmental remediation costs – current portion	13	13
Other current liabilities	123	88
Total current liabilities	1,627	1,968
Accumulated deferred income taxes	544	423
Long-term liabilities		
Accrued PRP costs	202	235
Accumulated removal costs	162	156
Accrued environmental remediation costs	83	84
Accrued pension obligations	78	88
Accrued postretirement benefit costs	32	50
Other long-term liabilities	146	164
Total long-term liabilities	703	777
Commitments and contingencies (see Note 8)		
Minority interest	42	38
Capitalization		
Long-term debt	1,622	1,615
Common shareholders' equity, $5 par value; 750 million shares authorized; 77.7 million and 77.8 million shares outstanding at December 31, 2006 and 2005	1,609	1,499
Total capitalization	3,231	3,114
Total liabilities and capitalization	$6,147	$6,320

See Notes to Consolidated Financial Statements.

AGL Resources Inc.
Statements of Consolidated Income

In millions, except per share amounts	Years ended December 31, 2006	2005	2004
Operating revenues	$2,621	$2,718	$1,832
Operating expenses			
Cost of gas	1,482	1,626	995
Operation and maintenance	473	477	377
Depreciation and amortization	138	133	99
Taxes other than income taxes	40	40	29
Total operating expenses	2,133	2,276	1,500
Operating income	488	442	332
Other expenses	(1)	(1)	-
Minority interest	(23)	(22)	(18)
Interest expense	(123)	(109)	(71)
Earnings before income taxes	341	310	243
Income taxes	129	117	90
Net income	$212	$193	$153
Per common share data			
Basic earnings per common share	$2.73	$2.50	$2.30
Diluted earnings per common share	$2.72	$2.48	$2.28
Cash dividends declared per common share	$1.48	$1.30	$1.15
Weighted average number of common shares outstanding			
Basic	77.6	77.3	66.3
Diluted	78.0	77.8	67.0

See Notes to Consolidated Financial Statements.

AGL Resources Inc.
Statements of Consolidated Common Shareholders' Equity

In millions, except per share amounts	Common stock Shares	Common stock Amount	Premium on common stock	Earnings reinvested	Other comprehensive loss	Shares held in treasury and trust	Total
Balance as of December 31, 2003	64.5	$322	$326	$337	$(40)	-	$945
Comprehensive income:							
Net income	-	-	-	153	-	-	153
Other comprehensive income (OCI) - loss resulting from unfunded pension obligation (net of tax of $7)	-	-	-	-	(11)	-	(11)
Unrealized gain from equity investment hedging activities (net of tax of $2)	-	-	-	-	4	-	4
Other					1		1
Total comprehensive income							147
Dividends on common stock ($1.15 per share)	-	-	-	(75)	-	-	(75)
Issuance of common shares:							
Equity offering on November 24, 2004	11.0	55	277	-	-	-	332
Benefit, stock compensation, dividend reinvestment and stock purchase plans (net of tax of $5)	1.2	7	29	-	-		36
Balance as of December 31, 2004	76.7	384	632	415	(46)	-	1,385
Comprehensive income:							
Net income	-	-	-	193	-	-	193
OCI - loss resulting from unfunded pension obligation (net of tax of $3)	-	-	-	-	(5)	-	(5)
Unrealized loss from hedging activities (net of tax of $1)	-	-	-	-	(2)	-	(2)
Other	-	-	-	-	-	-	-
Total comprehensive income							186
Dividends on common stock ($1.30 per share)	-	-	-	(100)	-	-	(100)
Issuance of common shares:							
Benefit, stock compensation, dividend reinvestment and stock purchase plans (net of tax of $9)	1.1	5	23	-	-	-	28
Balance as of December 31, 2005	77.8	389	655	508	(53)	-	1,499
Comprehensive income:							
Net income	-	-	-	212	-	-	212
OCI - gain resulting from unfunded pension and postretirement obligation (net of tax of $7)	-	-	-	-	11	-	11
Unrealized gain from hedging activities (net of tax of $7)	-	-	-	-	10	-	10
Total comprehensive income							233
Dividends on common stock ($1.48 per share)	-	-	1	(115)	-	3	(111)
Benefit, stock compensation, dividend reinvestment and stock purchase plans	0.3	1	2	-	-	-	3
Issuance of treasury shares	0.6	-	(3)	(4)	-	21	14
Purchase of treasury shares	(1.0)	-	-	-	-	(38)	(38)
Stock-based compensation expense (net of tax of $5)	-	-	9	-	-	-	9
Balance as of December 31, 2006	77.7	$390	$664	$601	$(32)	$(14)	$1,609

See Notes to Consolidated Financial Statements.

AGL Resources Inc.
Statements of Consolidated Cash Flows

In millions	Years ended December 31, 2006	2005	2004
Cash flows from operating activities			
Net income	$212	$193	$153
Adjustments to reconcile net income to net cash flow provided by operating activities			
Depreciation and amortization	138	133	99
Minority interest	23	22	18
Change in risk management assets and liabilities	(130)	27	(32)
Deferred income taxes	133	17	65
Changes in certain assets and liabilities			
Receivables	340	(338)	(264)
Inventories	(54)	(211)	(28)
Payables	(318)	311	247
Other – net	12	(74)	29
Net cash flow provided by operating activities	354	80	287
Cash flows from investing activities			
Expenditures for property, plant and equipment	(253)	(267)	(264)
Sale of Saltville Gas Storage Company, LLC	-	66	-
Acquisition of NUI Corporation, net of cash acquired	-	-	(116)
Acquisition of Jefferson Island Storage & Hub, LLC	-	-	(90)
Sale of US Propane LP	-	-	31
Other	5	7	17
Net cash flow used in investing activities	(248)	(194)	(422)
Cash flows from financing activities			
Payments of trust preferred securities	(150)	-	-
Dividends paid on common shares	(111)	(100)	(75)
Purchase of treasury shares	(38)	-	-
Distribution to minority interest	(22)	(19)	(14)
Issuances of senior notes	175	-	450
Issuance of treasury shares	14	-	-
Net payments and borrowings of short-term debt	6	188	(480)
Sale of common stock	3	28	36
Equity offering	-	-	332
Payments of medium-term notes	-	-	(82)
Other	5	-	-
Net cash flow (used in) provided by financing activities	(118)	97	167
Net (decrease) increase in cash and cash equivalents	(12)	(17)	32
Cash and cash equivalents at beginning of period	32	49	17
Cash and cash equivalents at end of period	$20	$32	$49
Cash paid during the period for			
Interest (net of allowance for funds used during construction of $3 for the year ended December 31, 2006 and $2 for the years ended December 31, 2005 and 2004, respectively)	$108	$89	$50
Income taxes	37	89	27

See Notes to Consolidated Financial Statements.

AGL Resources Inc. Notes to Consolidated Financial Statements

Note 1 - Accounting Policies and Methods of Application

General

AGL Resources Inc. is an energy services holding company that conducts substantially all its operations through its subsidiaries. Unless the context requires otherwise, references to "we," "us," "our," the "company", or "AGL Resources" mean consolidated AGL Resources Inc. and its subsidiaries. We have prepared the accompanying consolidated financial statements under the rules of the Securities and Exchange Commission (SEC). For a glossary of key terms and referenced accounting standards, see page 4.

Basis of Presentation

Our consolidated financial statements as of and for the periods ended December 31, 2006, include our accounts, the accounts of our majority-owned and controlled subsidiaries and the accounts of variable interest entities for which we are the primary beneficiary. This means that our accounts are combined with the subsidiaries' accounts. We have eliminated any intercompany profits and transactions in consolidation; however, we have not eliminated intercompany profits when such amounts are probable of recovery under the affiliates' rate regulation process. Certain amounts from prior periods have been reclassified and revised to conform to the current period presentation.

We currently own a noncontrolling 70% financial interest in SouthStar Energy Services, LLC (SouthStar), and Piedmont Natural Gas Company (Piedmont) owns the remaining 30%. Our 70% interest is noncontrolling because all significant management decisions require approval by both owners. Earnings related to customers in Ohio and Florida are allocated 70% to us and 30% to Piedmont. We record the earnings allocated to Piedmont as a minority interest in our consolidated statements of income and we record Piedmont's portion of SouthStar's capital as a minority interest in our consolidated balance sheets.

We are the primary beneficiary of SouthStar's activities and have determined that SouthStar is a variable interest entity as defined by Financial Accounting Standards Board (FASB) Interpretation No. 46, "Consolidation of Variable Interest Entities," as revised in December 2003 (FIN 46R). We determined that SouthStar was a variable interest entity because our equal voting rights with Piedmont are not proportional to our economic obligation to absorb 75% of any losses or residual returns from SouthStar, except those losses and returns related to customers in Ohio and Florida. In addition, SouthStar obtains substantially all its transportation capacity for delivery of natural gas through our wholly owned subsidiary, Atlanta Gas Light Company (Atlanta Gas Light).

Prior to our sale of Saltville Gas Storage Company, LLC (Saltville) in August 2005, we used the equity method to account for and report our 50% interest in Saltville. Saltville was a joint venture with a subsidiary of Duke Energy Corporate to develop a high-deliverability natural gas storage facility in Saltville, Virginia. We used the equity method because we exercised significant influence over but did not control the entity and because we were not the primary beneficiary as defined by FIN 46R.

Cash and Cash Equivalents

Our cash and cash equivalents consist primarily of cash on deposit, money market accounts and certificates of deposit with original maturities of three months or less.

Receivables and Allowance for Uncollectible Accounts

Our receivables consist of natural gas sales and transportation services billed to residential, commercial, industrial and other customers. We bill customers monthly, and accounts receivable are due within 30 days. For the majority of our receivables, we establish an allowance for doubtful accounts based on our collection experience. On certain other receivables where we are aware of a specific customer's inability or reluctance to pay, we record an allowance for doubtful accounts against amounts due to reduce the net receivable balance to the amount we reasonably expect to collect. However, if circumstances change, our estimate of the recoverability of accounts receivable could be different. Circumstances that could affect our estimates include, but are not limited to, customer credit issues, the level of natural gas prices, customer deposits and general economic conditions. We write off accounts once we deem them to be uncollectible.

Inventories

For our distribution operations subsidiaries, we record natural gas stored underground at weighted average costs. For Sequent Energy Management, L.P. (Sequent), SouthStar and Jefferson Island Storage & Hub, LLC (Jefferson Island), we account for natural gas inventory at the lower of weighted average cost or market.

Sequent and SouthStar evaluate the average cost of their natural gas inventories against market prices to determine whether any declines in market prices below the average cost are other than temporary. For any declines considered to be other than temporary, adjustments are recorded to reduce the weighted average cost of the natural gas inventory to market. Consequently, as a result of declining natural gas prices, Sequent recorded adjustments of $43 million and SouthStar recorded adjustments of $6 million in 2006 against cost of sales to reduce the value of their inventories to market value. Sequent recorded a $3 million adjustment in 2005 and a $1 million adjustment in 2004. SouthStar was not required to make similar adjustments in 2005 or in 2004.

For volumes of gas stored by Sequent under park and loan arrangements that are payable or to be repaid at predetermined dates to third parties, Sequent records the inventory at fair value. Materials and supplies inventories are stated at the lower of average cost or market.

In Georgia's competitive environment, Marketers—that is, marketers who are certificated by the Georgia Public Service Commission (Georgia Commission) to sell retail natural gas in Georgia, including SouthStar, our marketing subsidiary - began selling natural gas in 1998 to firm end-use customers at market-based prices. Part of the unbundling process, which resulted from deregulation that provides for this competitive environment, is the assignment to Marketers of certain pipeline services that Atlanta Gas Light has under contract. Atlanta Gas Light assigns, on a monthly basis, the majority of the pipeline storage services that it has under contract to Marketers, along with a corresponding amount of inventory.

Property, Plant and Equipment

A summary of our property, plant and equipment (PP&E) by classification as of December 31, 2006 and 2005 is provided in the following table.

In millions	2006	2005
Transmission and distribution	$4,047	$3,867
Storage	267	209
Other	454	476
Construction work in progress	208	239
Total gross PP&E	4,976	4,791
Accumulated depreciation	(1,540)	(1,458)
Total net PP&E	$3,436	$3,333

Distribution Operations PP&E expenditures consist of property and equipment that is in use, being held for future use and under construction. We report PP&E at its original cost, which includes:

- material and labor
- contractor costs
- construction overhead costs
- an allowance for funds used during construction (AFUDC) which represents the estimated cost of funds used to finance the construction of major projects and is capitalized in the rate base for ratemaking purposes when the completed projects are placed in service

We charge property retired or otherwise disposed of to accumulated depreciation since such costs are recovered in rates.

Retail Energy Operations, Wholesale Services, Energy Investments and Corporate PP&E expenditures include property that is in use and under construction, and we report it at cost. We record a gain or loss for retired or otherwise disposed-of property. These include such things as telecommunications conduit, fiber optic cable and other telecommunications equipment and tools.

Depreciation Expense

We compute depreciation expense for distribution operations by applying composite, straight-line rates (approved by the state regulatory agencies) to the investment in depreciable property. The composite straight-line depreciation rate for depreciable property -- excluding transportation equipment for Atlanta Gas Light, Virginia Natural Gas, Inc. (Virginia Natural Gas) and Chattanooga Gas Company (Chattanooga Gas) -- was approximately 2.5% during 2006, 2.6% during 2005 and 2.6% during 2004. The composite, straight-line rate for Elizabethtown Gas, Florida City Gas and Elkton Gas was approximately 3.0 % for 2006, 3.1% during 2005 and 3.25% for December 2004. We depreciate transportation equipment on a straight-line basis over a period of 5 to 10 years. We compute depreciation expense for other segments on a straight-line basis over a period of 1 to 35 years.

AFUDC

The applicable state regulatory agencies authorize Atlanta Gas Light, Elizabethtown Gas and Chattanooga Gas to record the cost of debt and equity funds as part of the cost of construction projects in our consolidated balance sheets and as AFUDC in the statements of consolidated income. The Georgia Commission has authorized a rate of 8.53%, and the Tennessee Regulatory Authority (Tennessee Commission) has authorized a rate of 7.43%. Effective January 1, 2007, the Tennessee Commission authorized a rate of 7.89%. The New Jersey Board of Public Utilities (New Jersey Commission) has authorized a variable rate based on the Federal Energy Regulatory Commission (FERC) method of accounting for AFUDC. At December 31, 2006 the rate was 5.37%. The total AFUDC for the years ended December 31, 2006, 2005 and 2004 was $5 million, $4 million and $5 million, respectively. The capital expenditures of our other regulated utilities do not qualify for AFUDC treatment.

Goodwill

Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets" (SFAS 142), requires us to perform an annual goodwill impairment test. We have included $420 million of goodwill in our consolidated balance sheets as of December 31, 2006, of which $229 million is related to our acquisition of NUI Corporation (NUI) in November 2004; $170 million is related to our acquisition of Virginia Natural Gas in 2000; $14 million is related to our acquisition of Jefferson Island in October 2004; and $7 million is related to our acquisition of Chattanooga Gas in 1988.

We annually assess goodwill for impairment at a reporting unit level which generally equates to our operating segments as discussed in Note 11 "Segment Information," and have not recognized any impairment charges for the years ended December 31, 2006, 2005 and 2004. We also assess goodwill for impairment if events or changes in circumstances may indicate an impairment of goodwill exists. When such events or circumstances are present, we assess the recoverability of long-lived assets by determining whether the carrying value will be recovered through the expected future cash flows. In the event the sum of the expected future cash flows resulting from the use of the asset is less than the carrying value of the asset, we record an impairment loss equal to the excess of the asset's carrying value over its fair value. We conduct this assessment principally through a review of financial results, changes in state and federal legislation and regulation, regulatory and legal proceedings and the periodic regulatory filings for our regulated utilities.

Taxes

Income taxes The reporting of our assets and liabilities for financial accounting purposes differs from the reporting for income tax purposes. The principal differences between net income and taxable income relate to the timing of deductions, primarily due to the benefits of tax depreciation since we generally depreciate assets for tax purposes over a shorter period of time than for book purposes. The determination of our provision for income taxes requires significant judgment, the use of estimates, and the interpretation and application of complex tax laws. Significant judgment is required in assessing the timing and amounts of deductible and taxable items. We report the tax effects of depreciation and other differences in those items as deferred income tax assets or liabilities in our consolidated balance sheets in accordance with SFAS No. 109, "Accounting for Income Taxes" (SFAS 109). Investment tax credits of approximately $18 million previously deducted for income tax purposes for Atlanta Gas Light, Elizabethtown Gas, Florida City Gas and Elkton Gas have been deferred for financial accounting purposes and are being amortized as credits to income over the estimated lives of the related properties in accordance with regulatory requirements.

State and local taxes We collect and remit various taxes on behalf of various governmental authorities. We record these amounts in our consolidated balance sheets except taxes in the state of Florida which we are required to include in revenues and operating expenses. These Florida related taxes are not material for any periods presented.

Revenues

Distribution operations We record revenues when services are provided to customers. Those revenues are based on rates approved by the state regulatory commissions of our utilities.

As required by the Georgia Commission, in July 1998, Atlanta Gas Light began billing Marketers in equal monthly installments for each residential, commercial and industrial customer's distribution costs. As required by the Georgia Commission, effective February 1, 2001, Atlanta Gas Light implemented a seasonal rate design for the calculation of each residential customer's annual straight-fixed-variable (SFV) capacity charge, which is billed to Marketers and reflects the historic volumetric usage pattern for the entire residential class. Generally, this change results in residential customers being billed by Marketers for a higher capacity charge in the winter months and a lower charge in the summer months. This requirement has an operating cash flow impact but does not change revenue recognition. As a result, Atlanta Gas Light continues to recognize its residential SFV capacity revenues for financial reporting purposes in equal monthly installments.

Any difference between the billings under the seasonal rate design and the SFV revenue recognized is deferred and reconciled to actual billings on an annual basis. Atlanta Gas Light had unrecovered seasonal rates of approximately $11 million as of December 31, 2006 and $11 million as of December 31, 2005 (included as current assets in the consolidated balance sheets) related to the difference between the billings under the seasonal rate design and the SFV revenue recognized.

The Elizabethtown Gas, Virginia Natural Gas, Florida City Gas, Chattanooga Gas and Elkton Gas rate structures include volumetric rate designs that allow recovery of costs through gas usage. Revenues from sales and transportation services are recognized in the same period in which the related volumes are delivered to customers. Revenues from residential and certain commercial and industrial customers are recognized on the basis of scheduled meter readings. In addition, revenues are recorded for estimated deliveries of gas, not yet billed to these customers, from the meter reading date to the end of the accounting period. These are included in the consolidated balance sheets as unbilled revenue. For other commercial and industrial customers and all wholesale customers, revenues are based on actual deliveries to the end of the period.

The tariffs for Elizabethtown Gas, Virginia Natural Gas and Chattanooga Gas contain weather normalization adjustments (WNA) that largely mitigate the impact of unusually cold or warm weather on customer billings and operating margin. The WNA's purpose is to reduce the effect of weather on customer bills by reducing bills when winter weather is colder than normal and increasing bills when weather is warmer than normal.

Retail energy operations We record retail energy operations' revenues when services are provided to customers. Revenues from sales and transportation services are recognized in the same period in which the related volumes are delivered to customers. Sales revenues from residential and certain commercial and industrial customers are recognized on the basis of scheduled meter readings. In addition, revenues are recorded for estimated deliveries of gas, not yet billed to these customers, from the most recent meter reading date to the end of the accounting period. These are included in the consolidated balance sheets as unbilled revenue. For other commercial and industrial customers and all wholesale customers, revenues are based on actual deliveries to the end of the period.

Wholesale services We record wholesale services' revenues when services are provided to customers. Profits from sales between segments are eliminated in the corporate segment and are recognized as goods or services sold to end-use customers. Transactions that qualify as derivatives under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" (SFAS 133), are recorded at fair value with changes in fair value recognized in earnings in the period of change and characterized as unrealized gains or losses.

Cost of Gas

Excluding Atlanta Gas Light, we charge our utility customers for natural gas consumed using purchased gas adjustment (PGA) mechanisms set by the state regulatory agencies. Under the PGA, we defer (that is, include as a current asset or liability in the consolidated balance sheets and exclude from the statements of consolidated income) the difference between the actual cost of gas and what is collected from or billed to customers in a given period. The deferred amount is either billed or refunded to our customers prospectively through adjustments to the commodity rate.

Our retail energy operations customers are charged for natural gas consumed. We also include within our cost of gas amounts for fuel and lost and unaccounted for gas, adjustments to reduce the value of our inventories to market value and for gains and losses associated with derivatives.

Comprehensive Income

Our comprehensive income includes net income plus other comprehensive income (OCI), which includes other gains and losses affecting shareholders' equity that accounting principles generally accepted in the United States of America (GAAP) excludes from net income. Such items consist primarily of unrealized gains and losses on certain derivatives designated as cash flow hedges and minimum pension liability adjustments. The following table illustrates our OCI activity for the years ended December 31, 2006, 2005 and 2004.

In millions	2006	2005	2004
Cash flow hedges:			
Net derivative unrealized gains arising during the period (net of $7, $3 and $3 in taxes)	$11	$5	$6
Less reclassification of realized gains included in income (net of $1, $4 and $1 in taxes)	(1)	(7)	(2)
Over funded (unfunded) pension obligation (net of $7, $3 and $7 in taxes)	11	(5)	(11)
Other (net of tax)	-	-	1
Total	$21	$(7)	$(6)

Earnings Per Common Share

We compute basic earnings per common share by dividing our income available to common shareholders by the daily weighted average number of common shares outstanding. Diluted earnings per common share reflect the potential reduction in earnings per common share that could occur when potentially dilutive common shares are added to common shares outstanding.

We derive our potentially dilutive common shares by calculating the number of shares issuable under performance units and stock options. The future issuance of shares underlying the performance units depends on the satisfaction of certain performance criteria. The future issuance of shares underlying the outstanding stock options depends on whether the exercise prices of the stock options are less than the average market price of the common shares for the respective periods. No items are antidilutive. The following table shows the calculation of our diluted earnings per share for the periods presented if performance units currently earned under the plan ultimately vest and if stock options currently exercisable at prices below the average market prices are exercised.

In millions	2006	2005	2004
Denominator for basic earnings per share (1)	77.6	77.3	66.3
Assumed exercise of potential common shares	0.4	0.5	0.7
Denominator for diluted earnings per share	78.0	77.8	67.0

(1) Daily weighted average shares outstanding.

Use of Accounting Estimates

The preparation of our financial statements in conformity with GAAP requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and the related disclosures of contingent assets and liabilities. We based our estimates on historical experience and various other assumptions that we believe to be reasonable under the circumstances, and we evaluate our estimates on an ongoing basis. Each of our estimates involve complex situations requiring a high degree of judgment either in the application and interpretation of existing literature or in the development of estimates that impact our financial statements. The most significant estimates include our regulatory accounting, pipeline replacement program (PRP) accruals, environmental liability accruals, derivative and hedging activities, allowance for contingencies, pension and postretirement obligations, derivative and hedging activities and provision for income taxes. Our actual results could differ from our estimates.

Accounting Developments

FIN 48 In July 2006, the FASB issued SFAS Interpretation No. 48, "Accounting for Uncertainty in Income Taxes – an interpretation of SFAS Statement No. 109" (FIN 48). FIN 48 applies to all "tax positions" accounted for under SFAS 109. FIN 48 refers to "tax positions" as positions taken in a previously filed tax return or positions expected to be taken in a future tax return that are reflected in measuring current or deferred income tax assets and liabilities reported in the financial statements. FIN 48 further clarifies a tax position to include the following:

- a decision not to file a tax return in a particular jurisdiction for which a return might be required,
- an allocation or a shift of income between taxing jurisdictions,
- the characterization of income or a decision to exclude reporting taxable income in a tax return, or
- a decision to classify a transaction, entity, or other position in a tax return as tax exempt.

FIN 48 clarifies that a tax benefit may be reflected in the financial statements only if it is "more likely than not" that a company will be able to sustain the tax return position, based on its technical merits. If a tax benefit meets this criterion, it should be measured and recognized based on the largest amount of benefit that is cumulatively greater than 50% likely to be realized. This is a change from current practice, whereby companies may recognize a tax benefit only if it is probable a tax position will be sustained.

FIN 48 also requires that we make qualitative and quantitative disclosures, including a discussion of reasonably possible changes that might occur in unrecognized tax benefits over the next 12 months; a description of open tax years by major jurisdictions; and a roll-forward of all unrecognized tax benefits, presented as a reconciliation of the beginning and ending balances of the unrecognized tax benefits on an aggregated basis.

This statement became effective for us on January 1, 2007 and, based on our analysis, FIN 48 does not have a material effect on our consolidated results of operations, cash flows or financial position.

SFAS 157 In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" (SFAS 157). SFAS 157 establishes a framework for measuring fair value and requires expanded disclosures regarding fair value measurements. SFAS 157 does not require any new fair value measurements. However, it eliminates inconsistencies in the guidance provided in previous accounting pronouncements.

SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year. All valuation adjustments will be recognized as cumulative-effect adjustments to the opening balance of retained earnings for the fiscal year in which SFAS 157 is initially applied. We are currently evaluating the impact that SFAS 157 will have on our consolidated results of operations, cash flows and financial position.

Note 2 - Risk Management

Our risk management activities are monitored by our Risk Management Committee (RMC). The RMC consists of members of senior management and is charged with reviewing and enforcing our risk management activities. Our risk management policies limit the use of derivative financial instruments and physical transactions within predefined risk tolerances associated with pre-existing or anticipated physical natural gas sales and purchases and system use and storage. We use the following derivative financial instruments and physical transactions to manage commodity price, interest rate and weather risks:

- forward contracts
- futures contracts
- options contracts
- financial swaps
- treasury locks
- weather derivative contracts
- storage and transportation capacity transactions

Interest Rate Swaps

To maintain an effective capital structure, our policy is to borrow funds using a mix of fixed-rate and variable-rate debt. We entered into interest rate swap agreements for the purpose of managing the interest rate risk associated with our fixed-rate and variable-rate debt obligations. We designated these interest rate swaps as fair value hedges in accordance with SFAS 133. We record the gain or loss on fair value hedges in earnings in the period of change, together with the offsetting loss or gain on the hedged item attributable to the risk being hedged.

As of December 31, 2006, a notional principal amount of $100 million of these interest rate swap agreements effectively converted the interest expense associated with a portion of our senior notes from fixed rates to variable rates based on an interest rate equal to the London Interbank Offered Rate (LIBOR), plus a spread determined at the swap date. The floating rate swap range for our interest rate swaps for the year ended December 31, 2006, was 9.0%.

Commodity-related Derivative Instruments

Elizabethtown Gas In accordance with a directive from the New Jersey Commission, Elizabethtown Gas enters into derivative transactions to hedge the impact of market fluctuations in natural gas prices. Pursuant to SFAS 133, such derivative transactions are marked to market each reporting period. In accordance with regulatory requirements, realized gains and losses related to these derivatives are reflected in purchased gas costs and ultimately included in billings to customers. As of December 31, 2006, Elizabethtown Gas had entered into New York Mercantile Exchange (NYMEX) futures contracts to purchase approximately 8.55 Bcf of natural gas. Approximately 81% of these contracts have a duration of one year or less, and none of these contracts extends beyond October 2008.

Sequent We are exposed to risks associated with changes in the market price of natural gas. Sequent uses derivative financial instruments to reduce our exposure to the risk of changes in the prices of natural gas. The fair value of these derivative financial instruments reflects the estimated amounts that we would receive or pay to terminate or close the contracts at the reporting date, taking into account the current unrealized gains or losses on open contracts. We use external market quotes and indices to value substantially all the financial instruments we use.

We mitigate substantially all the commodity price risk associated with Sequent's natural gas portfolio by locking in the economic margin at the time we enter into natural gas purchase transactions for our stored natural gas. We purchase natural gas for storage when the difference in the current market price we pay to buy and transport natural gas plus the cost to store the natural gas is less than the market price we can receive in the future, resulting in a positive net profit margin. We use NYMEX futures contracts and other over-the-counter derivatives to sell natural gas at that future price to substantially lock in the profit margin we will ultimately realize when the stored gas is actually sold. These futures contracts meet the definition of derivatives under SFAS 133 and are recorded at fair value and marked to market in our consolidated balance sheets, with changes in fair value recorded in earnings in the period of change. The purchase, transportation, storage and sale of natural gas are accounted for on a weighted average cost or accrual basis, as appropriate rather than on the mark-to-market basis we utilize for the derivatives used to mitigate the commodity price risk associated with our storage portfolio. This difference in accounting can result in volatility in our reported earnings, even though the economic margin is essentially unchanged from the date the transactions were consummated.

At December 31, 2006, Sequent's commodity-related derivative financial instruments represented purchases (long) of 607 Bcf and sales (short) of 614 Bcf with approximately 94% of these instruments are scheduled to mature in less than two years and the remaining 6% in three to nine years. At December 31, 2006, the fair values of these derivatives were reflected in our consolidated financial statements as an asset of $133 million and a liability of $14 million. Sequent recorded a net unrealized gain related to changes in the fair value of derivative instruments utilized in its energy marketing and risk management activities of $132 million during 2006, $30 million of unrealized losses during 2005 and unrealized gains of $22 million during 2004.

SouthStar Commodity-related derivative financial instruments (futures, options and swaps) are used by SouthStar to manage exposures arising from changing commodity prices. SouthStar's objective for holding these derivatives is to utilize the most effective method to reduce or eliminate the impact of this exposure. We have designated a portion of SouthStar's derivative transactions as cash flow hedges under SFAS 133. We record derivative gains or losses arising from cash flow hedges in OCI and reclassify them into earnings in the same period as the settlement of the underlying hedged item. We record any hedge ineffectiveness, defined as when the gains or losses on the hedging instrument do not offset and are greater than the losses or gains on the hedged item, in cost of gas in our statement of consolidated income in the period in which it occurs. SouthStar currently has minimal hedge ineffectiveness. We have not designated the remainder of SouthStar's derivative instruments as hedges under SFAS 133 and, accordingly, we record changes in their fair value in earnings in the period of change.

At December 31, 2006, the fair values of these derivatives were reflected in our consolidated financial statements as a current asset of $28 million and a current liability of $12 million. For those open derivatives with maturity dates beyond December 31, 2007, the fair value of these derivatives are reflected as a long-term asset of $2 million in our consolidated financial statements. The maximum maturity of open positions is less than two years, with those positions greater than one year but less than two years representing a net position of 0.2 Bcf.

SouthStar also enters into both exchange and over-the-counter derivative transactions to hedge commodity price risk. Credit risk is mitigated for exchange transactions through the backing of the NYMEX member firms. For over-the-counter transactions, SouthStar utilizes master netting arrangements to reduce overall credit risk. As of December 31, 2006, SouthStar's maximum exposure to any single over-the-counter counterparty was $7 million.

Weather Derivatives

In September 2006, SouthStar entered into weather derivative contracts as an economic hedge of operating margins in the event of warmer-than-normal weather in the current heating season, primarily from November 2006 through March 2007. SouthStar accounts for these contracts using the intrinsic value method under the guidelines of Emerging Issues Task Force Issue No. 99-02, "Accounting for Weather Derivatives." SouthStar had no weather derivatives outstanding as of December

31, 2005 or 2004. As of December 31, 2006, SouthStar recorded a receivable of $7 million for this hedging activity.

Concentration of Credit Risk

Atlanta Gas Light Concentration of credit risk occurs at Atlanta Gas Light for amounts billed for services and other costs to its customers, which consist of 11 Marketers in Georgia. The credit risk exposure to Marketers varies seasonally, with the lowest exposure in the nonpeak summer months and the highest exposure in the peak winter months. Marketers are responsible for the retail sale of natural gas to end-use customers in Georgia. These retail functions include customer service, billing, collections, and the purchase and sale of natural gas. Atlanta Gas Light's tariff allows it to obtain security support in an amount equal to a minimum of two times a Marketer's highest month's estimated bill from Atlanta Gas Light.

Wholesale Services Sequent has a concentration of credit risk for services it provides to marketers and to utility and industrial customers. This credit risk is measured by 30-day receivable exposure plus forward exposure, which is generally concentrated in 20 of its customers. Sequent evaluates the credit risk of its customers using a Standard & Poor's Ratings Services (S&P) equivalent credit rating, which is determined by a process of converting the lower of the S&P or Moody's Investors Service (Moody's) rating to an internal rating ranging from 9.00 to 1.00, with 9.00 being equivalent to AAA/Aaa by S&P and Moody's and 1.00 being equivalent to D or Default by S&P and Moody's. For a customer without an external rating, Sequent assigns an internal rating based on Sequent's analysis of the strength of its financial ratios. At December 31, 2006, Sequent's top 20 customers represented approximately 57% of the total credit exposure of $394 million, derived by adding together the top 20 customers' exposures and dividing by the total of Sequent's counterparties' exposures. Sequent's customers or the customers' guarantors had a weighted average S&P equivalent rating of A- at December 31, 2006.

The weighted average credit rating is obtained by multiplying each customer's assigned internal rating by its credit exposure and then adding the individual results for all counterparties. That total is divided by the aggregate total exposure. This numeric value is converted to an S&P equivalent.

Sequent has established credit policies to determine and monitor the creditworthiness of counterparties, including requirements for posting of collateral or other credit security, as well as the quality of pledged collateral. Collateral or credit security is most often in the form of cash or letters of credit from an investment-grade financial institution, but may also include cash or U.S. Government Securities held by a trustee. When Sequent is engaged in more than one outstanding derivative transaction with the same counterparty and it also has a legally enforceable netting agreement with that counterparty, the "net" mark-to-market exposure represents the netting of the positive and negative exposures with that counterparty and a reasonable measure of Sequent's credit risk. Sequent also uses other netting agreements with certain counterparties with which it conducts significant transactions.

All activities associated with price risk management activities and derivative instruments are included as a component of cash flows from operating activities in our consolidated statements of cash flows. Our derivatives not designated as hedges under SFAS 133, included in operating cash flows for the years ended December 31, 2006, 2005, and 2004 were $(128) million, $36 million, and $(22) million, respectively.

Note 3 - Regulatory Assets and Liabilities

We have recorded regulatory assets and liabilities in our consolidated balance sheets in accordance with SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation" (SFAS 71). Our regulatory assets and liabilities, and associated liabilities for our unrecovered PRP costs, unrecovered environmental remediation costs (ERC) and the associated assets and liabilities for our Elizabethtown Gas hedging program, are summarized in the table below.

In millions	December 31, 2006	2005
Regulatory assets		
Unrecovered PRP costs	$274	$303
Unrecovered ERC	170	196
Elizabethtown Gas hedging program	16	-
Unrecovered postretirement benefit costs	13	14
Unrecovered seasonal rates	11	11
Unrecovered PGA	14	8
Other	13	10
Total regulatory assets	511	542
Associated assets		
Elizabethtown Gas hedging program	-	17
Total regulatory and associated assets	$511	$559
Regulatory liabilities		
Accumulated removal costs	$162	$156
Elizabethtown Gas hedging program	-	17
Unamortized investment tax credit	18	19
Deferred PGA	24	40
Regulatory tax liability	22	17
Other	10	6
Total regulatory liabilities	236	255
Associated liabilities		
PRP costs	237	265
ERC	87	88
Elizabethtown Gas Hedging Program	16	-
Total associated liabilities	340	353
Total regulatory and associated liabilities	$576	$608

Our regulatory assets are recoverable through either rate riders or base rates specifically authorized by a state regulatory commission. Base rates are designed to provide both a recovery of cost and a return on investment during the period rates are in effect. As such, all our regulatory assets are subject to review by the respective state regulatory commission during any future rate proceedings. In the event that the provisions of SFAS 71 were no longer applicable, we would recognize a write-off of net regulatory assets (regulatory assets less regulatory liabilities) that would result in a charge to net income, and classified as an extraordinary item. Although the natural gas distribution industry is becoming increasingly competitive, our utility operations continue to recover their costs through cost-based rates established by the state regulatory commissions. As a result, we believe that the accounting prescribed under SFAS 71 remains appropriate. It is also our opinion that all regulatory assets are recoverable in future rate proceedings, and therefore we have not recorded any regulatory assets that are recoverable but are not yet included in base rates or contemplated in a rate rider.

All the regulatory assets included in the table above are included in base rates except for the unrecovered PRP costs, unrecovered ERC and the deferred PGA, which are recovered through specific rate riders on a dollar for dollar basis. The rate riders that authorize recovery of unrecovered PRP costs and the deferred PGA include both a recovery of costs and a return on investment during the recovery period. We have two rate riders that authorize the recovery of unrecovered ERC. The ERC rate rider for Atlanta Gas Light only allows for recovery of the costs incurred and the recovery period occurs over the five years after the expense is incurred. ERC associated with the investigation and remediation of Elizabethtown Gas remediation sites located in the state of New Jersey are recovered under a remediation adjustment clause and include the carrying cost on unrecovered amounts not currently in rates. Elizabethtown Gas's hedging program asset reflects unrealized losses that will be recovered through the PGA on a dollar for dollar basis, once the losses are realized. Unrecovered postretirement benefit costs are recoverable through base rates over the next 7 to 26 years based on the remaining recovery period as designated by the applicable state regulatory commissions. Unrecovered seasonal rates reflect the difference between the recognition of a portion of Atlanta Gas Light's residential base rates revenues on a straight-line basis as compared to the collection of the revenues over a seasonal pattern. The unrecovered amounts are fully recoverable through base rates within one year.

The regulatory liabilities are refunded to ratepayers through a rate rider or base rates. If the regulatory liability is included in base rates, the amount is reflected as a reduction to the rate base in setting rates.

Pipeline Replacement Program

Atlanta Gas Light The PRP, ordered by the Georgia Commission to be administered by Atlanta Gas Light, requires, among other things, that Atlanta Gas Light replace all bare steel and cast iron pipe in its system in the state of Georgia within a 10-year period beginning October 1, 1998. Atlanta Gas Light identified, and provided notice to the Georgia Commission of 2,312 miles of pipe to be replaced. Atlanta Gas Light has subsequently identified an additional 320 miles of pipe subject to replacement

under this program. If Atlanta Gas Light does not perform in accordance with this order, it will be assessed certain nonperformance penalties. October 1, 2006 marked the beginning of the ninth year of the 10-year PRP.

The order also provides for recovery of all prudent costs incurred in the performance of the program, which Atlanta Gas Light has recorded as a regulatory asset. Atlanta Gas Light will recover from end-use customers, through billings to Marketers, the costs related to the program net of any cost savings from the program. All such amounts will be recovered through a combination of straight fixed variable rates and a pipeline replacement revenue rider. The regulatory asset has two components:

- the costs incurred to date that have not yet been recovered through the rate rider
- the future expected costs to be recovered through the rate rider

On June 10, 2005, Atlanta Gas Light and the Georgia Commission entered into a Settlement Agreement that, among other things, extends Atlanta Gas Light's PRP by five years to require that all replacements be completed by December 2013. The timing of replacements was subsequently specified in an amendment to the PRP stipulation. This amendment, which was approved by the Georgia Commission on December 20, 2005, requires Atlanta Gas Light to replace all cast iron pipe and 70% of all bare steel pipe by December 2010. The remaining 30% of bare steel pipe is required to be replaced by December 2013.

Under the Settlement Agreement, base rates charged to customers will remain unchanged through April 30, 2010, but Atlanta Gas Light will recognize reduced base rate revenues of $5 million on an annual basis through April 30, 2010. The five-year total reduction in recognized base rate revenues of $25 million will be applied to the allowed amount of costs incurred to replace pipe, which will reduce the amounts recovered from customers under the PRP rider. The Settlement Agreement also set the per customer fixed PRP rate that Atlanta Gas Light will charge at $1.29 per customer per month from May 2005 through September 2008 and at $1.95 from October 2008 through December 2013 and includes a provision that allows for a true-up of any over- or under-recovery of PRP revenues that may result from a difference between PRP charges collected through fixed rates and actual PRP revenues recognized through the remainder of the program.

The Settlement Agreement also allows Atlanta Gas Light to recover through the PRP $4 million of the $32 million capital costs associated with its purchase of 250 miles of pipeline in central Georgia from Southern Natural Gas Company, a subsidiary of El Paso Corporation. The remaining capital costs are included in Atlanta Gas Light's rate base and collected through base rates.

Atlanta Gas Light has recorded a long-term regulatory asset of $247 million, which represents the expected future collection of both expenditures already incurred and expected future capital expenditures to be incurred through the remainder of the program. Atlanta Gas Light has also recorded a current asset of $27 million, which represents the expected amount to be collected from customers over the next 12 months. The amounts recovered from the pipeline replacement revenue rider during the last three years were:

- $27 million in 2006
- $26 million in 2005
- $28 million in 2004

As of December 31, 2006, Atlanta Gas Light had recorded a current liability of $35 million, representing expected program expenditures for the next 12 months and a long-term liability of $202 million, representing expected program expenditures starting in 2008 through the end of the program in 2013.

Atlanta Gas Light capitalizes and depreciates the capital expenditure costs incurred from the PRP over the life of the assets. Operation and maintenance costs are expensed as incurred. Recoveries, which are recorded as revenue, are based on a formula that allows Atlanta Gas Light to recover operation and maintenance costs in excess of those included in its current base rates, depreciation expense and an allowed rate of return on capital expenditures. In the near term, the primary financial impact to Atlanta Gas Light from the PRP is reduced cash flow from operating and investing activities, as the timing related to cost recovery does not match the timing of when costs are incurred. However, Atlanta Gas Light is allowed the recovery of carrying costs on the under-recovered balance resulting from the timing difference.

Elizabethtown Gas In August 2006, the New Jersey Commission issued an order adopting a pipeline replacement cost recovery rider program for the replacement of certain 8" cast iron main pipes and any unanticipated 10"-12" cast iron main pipes integral to the replacement of the 8" main pipes. The order allows Elizabethtown Gas to recognize revenues under a deferred recovery mechanism for costs to replace the pipe that exceeds a baseline amount of $3 million. The term of the stipulation is from the date of the order through December 31, 2008. Total replacement costs through December 31,

2008 are expected to be $10 million, of which $7 million will be eligible for the deferred recovery mechanism. Revenues recognized and deferred for recovery under the stipulation are estimated to be approximately $1 million. All costs incurred under the program will be included in Elizabethtown Gas' next rate case to be filed in 2009.

Environmental Remediation Costs

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.

Atlanta Gas Light The presence of coal tar and certain other byproducts of a natural gas manufacturing process used to produce natural gas prior to the 1950s has been identified at or near 10 former Atlanta Gas Light operating sites in Georgia and at 3 sites of predecessor companies in Florida. Atlanta Gas Light has active environmental remediation or monitoring programs in effect at 10 of these sites. Two sites in Florida are currently in the investigation or preliminary engineering design phase, and one Georgia site has been deemed compliant with state standards.

Atlanta Gas Light has customarily reported estimates of future remediation costs for these former sites based on probabilistic models of potential costs. These estimates are reported on an undiscounted basis. As cleanup options and plans mature and cleanup contracts are entered into, Atlanta Gas Light is better able to provide conventional engineering estimates of the likely costs of remediation at its former sites. These estimates contain various engineering uncertainties, but Atlanta Gas Light continuously attempts to refine and update these engineering estimates.

Atlanta Gas Light's current estimate for the remaining cost of future actions at its former operating sites is $27 million, a reduction of $4 million over 2005, which may change depending on whether future measures for groundwater will be required.

These liabilities do not include other potential expenses, such as unasserted property damage claims, personal injury or natural resource damage claims, unbudgeted legal expenses or other costs for which Atlanta Gas Light may be held liable but for which it cannot reasonably estimate an amount. As of December 31, 2006, the remediation expenditures expected to be incurred over the next 12 months are reflected as a current liability of $13 million.

The ERC liability is included as a corresponding regulatory asset, which is a combination of accrued ERC and unrecovered cash expenditures for investigation and cleanup costs. Atlanta Gas Light has three ways of recovering investigation and cleanup costs. First, the Georgia Commission has approved an ERC recovery rider. The ERC recovery mechanism allows for recovery of expenditures over a five-year period subsequent to the period in which the expenditures are incurred. Atlanta Gas Light expects to collect $26 million in revenues over the next 12 months under the ERC recovery rider, which is reflected as a current asset. The amounts recovered from the ERC recovery rider during the last three years were

- $29 million in 2006
- $28 million in 2005
- $25 million in 2004

The second way to recover costs is by exercising the legal rights Atlanta Gas Light believes it has to recover a share of its costs from other potentially responsible parties, typically former owners or operators of these sites. There were no material recoveries from potentially responsible parties during 2006, 2005 or 2004.

The third way to recover costs is from the receipt of net profits from the sale of remediated property. There was one sale of property during 2006.

Elizabethtown Gas In New Jersey, Elizabethtown Gas is currently conducting remediation activities with oversight from the New Jersey Department of Environmental Protection. Although we cannot estimate the actual total cost of future environmental investigation and remediation efforts with precision, based on probabilistic models similar to those used at Atlanta Gas Light's former operating sites, the range of reasonably probable costs is $60 million to $118 million. As of December 31, 2006, we have recorded a liability equal to the low end of that range, or $60 million, of which $6 million in expenditures are expected to be incurred over the next 12 months.

Prudently incurred remediation costs for the New Jersey properties have been authorized by the New Jersey Commission to be recoverable in rates through a remediation adjustment clause. As a result, Elizabethtown Gas has recorded a regulatory asset of approximately $65 million, inclusive of interest, as of December 31, 2006, reflecting the future recovery of both incurred costs and accrued carrying charges. Elizabethtown Gas expects to collect $1 million in revenues over the next 12 months. Elizabethtown Gas has also been successful in recovering a portion of remediation costs incurred in New Jersey from its insurance carriers and continues to pursue additional recovery.

Note 4 - Employee Benefit Plans

Pension Benefits

We sponsor two tax-qualified defined benefit retirement plans for our eligible employees, the AGL Resources Inc. Retirement Plan (AGL Retirement Plan) and the Employees' Retirement Plan of NUI Corporation (NUI Retirement Plan). A defined benefit plan specifies the amount of benefits an eligible participant eventually will receive using information about the participant.

We generally calculate the benefits under the AGL Retirement Plan based on age, years of service and pay. The benefit formula for the AGL Retirement Plan is a career average earnings formula, except for participants who were employees as of July 1, 2000, and who were at least 50 years of age as of that date. For those participants, we use a final average earnings benefit formula, and will continue to use this benefit formula for such participants until June 2010, at which time any of those participants who are still active will accrue future benefits under the career average earnings formula.

The NUI Retirement Plan covers substantially all of NUI's employees who were employed on or before December 31, 2005, except Florida City Gas union employees, who participate in a union-sponsored multiemployer plan. Pension benefits are based on years of credited service and final average compensation.

Effective with our acquisition of NUI in November 2004, we became sponsor of the NUI Retirement Plan. Throughout 2005, we maintained existing benefits for NUI employees, including participation in the NUI Retirement Plan. Beginning in 2006, eligible participants in the NUI Retirement Plan became eligible to participate in the AGL Retirement Plan and the benefits of those participants under the NUI Retirement Plan were frozen as of December 31, 2005, resulting in a $15 million reduction to the NUI Retirement Plan's projected benefit obligation as of December 31, 2005. Participants in the NUI Retirement Plan have the option of receiving a lump sum distribution upon retirement for all benefits earned through December 31, 2005. This resulted in settlement payments of $12 million and an immaterial settlement loss. This option is not permitted under the AGL Retirement Plan, except for accrued benefits valued at less than $10,000.

SFAS 158 In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans" (SFAS 158). We adopted SFAS 158 prospectively on December 31, 2006. SFAS 158 requires that we recognize all obligations related to defined benefit pensions and other postretirement benefits. This statement requires that we quantify the plans' funding status as an asset or a liability on our consolidated balance sheets.

SFAS 158 requires that we measure the plans' assets and obligations that determine our funded status as of the end of the fiscal year. We are also required to recognize as a component of OCI the changes in funded status that occurred during the year that are not recognized as part of net periodic benefit cost as explained in SFAS No. 87, "Employers' Accounting for Pensions," or SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions."

Based on the funded status of our defined benefit pension and postretirement benefit plans as of December 31, 2006, we reported a gain to our OCI of $11 million, a decrease of $18 million to accrued pension obligations and an increase of $7 million to accumulated deferred income taxes. Our adoption of SFAS 158 on December 31, 2006, had no impact on our earnings. The following tables present details about our pension plans.

In millions	AGL Retirement Plan Dec, 31, 2006	AGL Retirement Plan Dec. 31, 2005	NUI Retirement Plan Dec. 31, 2006	NUI Retirement Plan Dec. 31, 2005
Change in benefit obligation				
Benefit obligation at beginning of year	$359	$340	$105	$144
Service cost	7	6	-	4
Interest cost	20	19	5	8
Plan amendments	-	-	-	(15)
Settlement loss	-	-	1	-
Settlement payments	-	-	(12)	-
Actuarial loss (gain)	2	14	(7)	(4)
Benefits paid	(20)	(20)	(6)	(32)
Benefit obligation at end of year	$368	$359	$86	$105
Change in plan assets				
Fair value of plan assets at beginning of year	$286	$279	$85	$111
Actual return on plan assets	31	21	4	6
Employer contribution	6	6	1	-
Settlement payments	-	-	(12)	-
Benefits paid	(20)	(20)	(6)	(32)
Fair value of plan assets at end of year	$303	$286	$72	$85
Reconciliation of funded status (1)				
Plan assets less than benefit obligation at end of year	$(65)	$(73)	$(14)	$(20)
Unrecognized net loss	-	119	-	4
Unrecognized prior service benefit	-	(10)	-	(15)
(Prepaid) accrued pension cost (2)	$(65)	$36	$(14)	$(31)
Amounts recognized in the statement of financial position consist of				
Prepaid benefit cost	$-	$42	$-	$-
Accrued benefit liability	(65)	(7)	(14)	(31)
Accumulated OCI	-	(92)	-	-
Net amount recognized at year end (3)	$(65)	$(57)	$(14)	$(31)

(1) After adoption of SFAS 158 on December 31, 2006, these amounts are recorded and this reconciliation is no longer required.

(2) The prepaid pension cost for the NUI Retirement Plan at December 31, 2005 was adjusted for terminations and settlement of liabilities for participants affected by our acquisition of NUI in November 2004. In 2005, we recorded the associated $9 million reduction in our benefit obligation as a reduction to goodwill.

(3) As of December 31, 2006, the AGL Retirement Plan had current liabilities of $1 million, noncurrent liabilities of $64 million and no noncurrent assets. The NUI Retirement Plan had $14 million of noncurrent liabilities and no noncurrent assets or current liabilities.

The accumulated benefit obligation (ABO) and other information for the AGL Retirement Plan and the NUI Retirement Plan are set forth in the following table.

In millions	AGL Retirement Plan Dec. 31, 2006	AGL Retirement Plan Dec. 31, 2005	NUI Retirement Plan Dec. 31, 2006	NUI Retirement Plan Dec. 31, 2005
Projected benefit obligation	$368	$359	$86	$105
ABO	352	343	86	105
Fair value of plan assets	303	286	72	85
Increase in minimum liability included in OCI	13	8	-	-
Components of net periodic benefit cost				
Service cost	$7	$6	$-	$4
Interest cost	20	19	5	8
Expected return on plan assets	(24)	(24)	(7)	(9)
Net amortization	(1)	(1)	(1)	-
Recognized actuarial loss	9	7	-	-
Net annual pension cost	$11	$7	$(3)	$3

There were no other changes in plan assets and benefit obligations recognized for the AGL and NUI Retirement Plans for the year ended December 31, 2006.

The 2007 estimated OCI amortization and expected refunds for the AGL and NUI Retirement Plans are set forth in the following table.

In millions	Retirement Plan AGL	NUI
Amortization of transition obligation	$-	$-
Amortization of prior service cost	(1)	(1)
Amortization of net loss	6	-
Refunds expected	-	-

The effects of SFAS 158, including the additional minimum liability (AML) adjustments, for the AGL Retirement Plan and the NUI Retirement Plan are set forth in the following table.

AGL Retirement Plan

In millions	Pre-SFAS 158 without AML adjustment	AML adjustment	Pre-SFAS 158 with AML adjustment	SFAS 158 adoption adjustments	Post SFAS 158
Prepaid pension asset/ (accrued pension liability)	$30	($79)	($49)	$(16)	($65)
Intangible Asset	-	-	-	-	-
Deferred tax asset	-	30	30	6	36
OCI - pension, net of tax	-	49	49	10	59
OCI - pension, pre-tax	-	79	79	16	95

NUI Retirement Plan

In millions	Pre-SFAS 158 without AML adjustment (1)	AML adjustment (1)	Pre-SFAS 158 with AML adjustment (1)	SFAS 158 adoption adjustments	Post SFAS 158
Prepaid pension asset/ (accrued pension liability)	($27)	$-	($27)	$13	($14)
Intangible Asset	-	-	-	-	-
Deferred tax asset	-	-	-	(5)	(5)
OCI -- pension, net of tax	-	-	-	(8)	(8)
OCI -- pension, pre-tax	-	-	-	(13)	(13)

(1) Values represent amounts less than $1 million.

The following table sets forth the assumed weighted average discount rates and rates of compensation increase used to determine benefit obligations at December 31.

	AGL and NUI Retirement Plans 2006	2005
Discount rate	5.8%	5.5%
Rate of compensation increase	4.0%	4.0%

We consider a number of factors in determining and selecting assumptions for the overall expected long-term rate of return on plan assets. We consider the historical long-term return experience of our assets, the current and expected allocation of our plan assets, and expected long-term rates of return. We derive these expected long-term rates of return with the assistance of our investment advisors and generally base these rates on a 10-year horizon for various asset classes, our expected investments of plan assets and active asset management as opposed to investment in a passive index fund. We base our expected allocation of plan assets on a diversified portfolio consisting of domestic and international equity securities, fixed income, real estate, private equity securities and alternative asset classes.

The following tables present the assumed weighted average discount rate, expected return on plan assets and rate of compensation increase used to determine net periodic benefit cost at the beginning of the period, which was January 1.

	AGL Retirement Plan 2006	2005	2004
Discount rate	5.5%	5.8%	6.3%
Expected return on plan assets	8.8%	8.8%	8.8%
Rate of compensation increase	4.0%	4.0%	4.0%

	NUI Retirement Plan		
	2006	2005	2004
Discount rate	5.5%	5.8%	5.8%
Expected return on plan assets	8.8%	8.5%	8.5%
Rate of compensation increase	-%	4.0%	4.0%

We consider a variety of factors in determining and selecting our assumptions for the discount rate at December 31. We consider certain market indices, including Moody's Corporate AA long-term bond rate, the Citigroup Pension Liability rate our actuaries model and our own payment stream based on these indices to develop our rate. Consequently, we selected a discount rate of 5.8% as of December 31, 2006, following our review of these various factors.

Our actual retirement plans' weighted average asset allocations at December 31, 2006 and 2005 and our target asset allocation ranges are as follows.

	Target Range Asset Allocation	AGL Retirement Plan	
		2006	2005
Equity	30%-80%	67%	66%
Fixed income	10%-40%	25%	25%
Real estate and other	10%-35%	8%	8%
Cash	0%-10%	0%	1%

	Target Range Asset Allocation	NUI Retirement Plan	
		2006	2005
Equity	30%-80%	68%	88%
Fixed income	10%-40%	26%	12%
Real estate and other	10%-35%	3%	-
Cash	0%-10%	3%	-

The Retirement Plan Investment Committee (the Committee) appointed by our Board of Directors is responsible for overseeing the investments of the retirement plans. Further, we have an Investment Policy (the Policy) for the retirement plans that aims to preserve the retirement plans' capital and maximize investment earnings in excess of inflation within acceptable levels of capital market volatility. To accomplish this goal, the retirement plans' assets are actively managed to optimize long-term return while maintaining a high standard of portfolio quality and proper diversification.

The Policy's risk management strategy establishes a maximum tolerance for risk in terms of volatility to be measured at 75% of the volatility experienced by the S&P 500. We will continue to diversify retirement plan investments to minimize the risk of large losses in a single asset class. The Policy's permissible investments include domestic and international equities (including convertible securities and mutual funds), domestic and international fixed income (corporate and U.S. government obligations), cash and cash equivalents and other suitable investments. The asset mix of these permissible investments is maintained within the Policy's target allocations as included in the preceding tables, but the Committee can vary allocations between various classes or investment managers in order to improve investment results.

Equity market performance and corporate bond rates have a significant effect on our reported unfunded ABO, as the primary factors that drive the value of our unfunded ABO are the assumed discount rate and the actual return on plan assets. Additionally, equity market performance has a significant effect on our market-related value of plan assets (MRVPA), which is a calculated value and differs from the actual market value of plan assets. The MRVPA recognizes the difference between the actual market value and expected market value of our plan assets and is determined by our actuaries using a five-year moving weighted average methodology. Gains and losses on plan assets are spread through the MRVPA based on the five-year moving weighted average methodology, which affects the expected return on plan assets component of pension expense.

Our employees do not contribute to the retirement plans. We fund the plans by contributing at least the minimum amount required by applicable regulations and as recommended by our actuary. However, we may also contribute in excess of the minimum required amount. We calculate the minimum amount of funding using the projected unit credit cost method. The Pension Protection Act (the Act) of 2006 contains new funding requirements for single employer defined benefit pension plans. The Act establishes a 100% funding target for plan years beginning after December 31, 2007. However, a delayed effective date of 2011 may apply if the pension plan meets the following targets: 92% funded in 2008; 94% funded in 2009; and 96% funded in 2010. In October 2006 we made a voluntary contribution of $5 million to the AGL Resources Inc. Retirement Plan. No contribution is required for the qualified plans in 2007.

Postretirement Benefits

Until January 1, 2006, we sponsored two defined benefit postretirement health care plans for our eligible employees, the AGL Resources Inc. Postretirement Health Care Plan (AGL Postretirement Plan) and the NUI Corporation Postretirement Health Care Plan (NUI Postretirement Plan), which we acquired upon our acquisition of NUI. Eligibility for these benefits is based on age and years of service.

The NUI Postretirement Plan provided certain medical and dental health care benefits to retirees, other than retirees of Florida City Gas, depending on their age, years of service and start date. The NUI Postretirement Plan was contributory, and NUI funded a portion of these future benefits through a Voluntary Employees' Beneficiary Association. Effective July 2000, NUI no longer offered postretirement benefits other than pension for any new hires. In addition, NUI capped its share of costs at $500 per participant per month for retirees under age 65, and at $150 per participant per month for retirees over age 65. At the beginning of 2006, eligible participants in the NUI Postretirement Plan became eligible to participate in the AGL Postretirement Plan and all participation in this plan ceased, effective January 1, 2006.

The AGL Postretirement Plan covers all eligible AGL Resources employees who were employed as of June 30, 2002, if they reach retirement age while working for us. The state regulatory commissions have approved phase-ins that defer a portion of other postretirement benefits expense for future recovery. We recorded a regulatory asset for these future recoveries of $13 million as of December 31, 2006 and $14 million as of December 31, 2005. In addition, we recorded a regulatory liability of $4 million as of December 31, 2006 and $3 million as of December 31, 2005 for our expected expenses under the AGL Postretirement Plan. We expect to pay $7 million of insurance claims for the postretirement plan in 2007, but we do not anticipate making any additional contributions.

Effective December 8, 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 was signed into law. This act provides for a prescription drug benefit under Medicare (Part D) as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D.

On July 1, 2004, the AGL Postretirement Plan was amended to remove prescription drug coverage for Medicare-eligible retirees effective January 1, 2006. Certain grandfathered NUI retirees participating in the NUI Postretirement Plan will continue receiving a prescription drug benefit through some period of time.

The following tables present details about our postretirement benefits.

In millions	AGL Postretirement Plan Dec. 31, 2006	AGL Postretirement Plan Dec. 31, 2005	NUI Postretirement Plan Dec. 31, 2005
Change in benefit obligation			
Benefit obligation at beginning of year (1)	$107	$98	$23
Service cost	1	1	-
Interest cost	5	5	1
Plan amendments	-	-	(7)
Actuarial (gain) loss	(9)	(6)	1
Benefits paid	(9)	(9)	(2)
Benefit obligation at end of year	$95	$89	$16
Change in plan assets			
Fair value of plan assets at beginning of year	$59	$49	$9
Actual return on plan assets	5	4	-
Employer contribution	8	6	2
Benefits paid	(9)	(9)	(2)
Fair value of plan assets at end of year	$63	$50	$9
Reconciliation of funded status			
Plan assets less benefit obligation at end of year	$(32)	$(39)	$(7)
Unrecognized loss	-	22	2
Unrecognized transition amount	-	1	-
Unrecognized prior service benefit	-	(23)	(6)
Accrued benefit cost (2)	$(32)	$(39)	$(11)
Amounts recognized in the statement of financial position consist of			
Prepaid benefit cost	$-	$-	$-
Accrued benefit liability	(32)	(39)	(11)
Accumulated OCI	-	-	-
Net amount recognized at year end (3)	$(32)	$(39)	$(11)

(1) The NUI Postretirement Plan was terminated and eligible former participants became eligible to participate in the AGL Postretirement Plan on January 1, 2006.

(2) After adoption of SFAS 158 on December 31, 2006 these amounts are recorded and this reconciliation is no longer required.

(3) As of December 31, 2006, the AGL Postretirement Plan had $32 million of noncurrent liabilities and no noncurrent assets or current liabilities.

The following tables present details on the components of our net periodic benefit cost for the AGL Postretirement Plan and the NUI Postretirement Plan at the balance sheet dates.

	AGL Postretirement Plan	
In millions	2006	2005
Service cost	$1	$1
Interest cost	5	5
Expected return on plan assets	(4)	(4)
Amortization of prior service cost	(4)	(3)
Recognized actuarial loss	1	1
Net periodic postretirement benefit cost	$(1)	$-

	NUI Postretirement Plan (1)
In millions	2005
Service cost	$-
Interest cost	1
Expected return on plan assets	-
Amortization of prior service cost	(1)
Recognized actuarial loss	-
Net periodic postretirement benefit cost	$-

(1) The NUI postretirement plan was terminated and eligible former participants became eligible to participate in the AGL Postretirement Plan on January 1, 2006.

There were no other changes in plan assets and benefit obligations recognized for the AGL and NUI Postretirement Plans for the year ended December 31, 2006. The 2007 estimated OCI amortization and refunds expected for the AGL Postretirement Plan are set forth in the following table.

In millions	2007
Amortization of transition obligation	$-
Amortization of prior service cost	(4)
Amortization of net loss	1
Refunds expected	-

The effects of SFAS 158 and AML adjustments for the AGL Postretirement Plan are set forth in the following table.

	AGL Postretirement Plan				
In millions	Pre-SFAS 158 without AML adjustment	AML adjustment	Pre-SFAS 158 with AML adjustment	SFAS 158 adoption adjustments	Post -SFAS 158
Prepaid pension asset / (accrued pension liability)	($40)	$-	($40)	$8	$(32)
Intangible Asset	-	-	-	-	-
Deferred tax asset	-	-	-	(3)	(3)
OCI - pension, net of tax	-	-	-	(5)	(5)
OCI - pension, pre-tax	-	-	-	(8)	(8)

The following table sets forth the assumed weighted average discount rates and rates of compensation increase used to determine benefit obligations for the AGL and NUI postretirement plans at December 31.

	AGL 2006	AGL 2005	NUI 2005 (1)
Discount rate (1)	5.8%	5.5%	5.5%
Rate of compensation increase (1)	4.0%	4.0%	-%

(1) The NUI postretirement plan was terminated and eligible former participants became eligible to participate in the AGL postretirement plan on January 1, 2006.

The following tables present our weighted average assumed rates used to determine benefit obligations at the beginning of the period, January 1 for the AGL Postretirement Plan and December 1 for the NUI Postretirement Plan, and our weighted average assumed rates used to determine net periodic benefit cost at the beginning of these same periods.

	AGL Postretirement Plan		
	2006 (1)	2005	2004
Discount rate – benefit obligation	5.8%	5.5%	5.8%
Discount rate – net periodic benefit cost	5.5%	5.8%	6.3%
Expected return on plan assets	8.5%	8.8%	8.8%
Rate of compensation increase	4.0%	4.0%	4.0%

	NUI Postretirement Plan (1)	
	2005	2004
Discount rate – benefit obligation	5.5%	5.8%
Discount rate – net periodic benefit cost	5.8%	5.8%
Expected return on plan assets	3.0%	2.0%
Rate of compensation increase	-	-

(1) The NUI postretirement plan was terminated and eligible former participants became eligible to participate in the AGL postretirement plan on January 1, 2006.

For information on the discount rate assumptions used for our postretirement plans, see the discussion contained in this Note 4 under the caption "Pension Benefits."

We consider the same factors in determining and selecting our assumptions for the overall expected long-term rate of return on plan assets as those considered in determining and selecting the overall expected long-term rate of return on plan assets for our retirement plans. For purposes of measuring our accumulated postretirement benefit obligation, the assumed pre-Medicare and post-Medicare health care inflation rates are as follows

	AGL Postretirement Plan			
	Pre-medicare cost (pre-65 years old)		Post-medicare cost (post-65 years old)	
Assumed health care cost trend rates at December 31,	2006	2005	2006	2005
Health care costs trend rate assumed for next year	2.5%	2.5%	2.5%	2.5%
Rate to which the cost trend rate gradually declines	2.5%	2.5%	2.5%	2.5%
Year that the rate reaches the ultimate trend rate	N/A	N/A	N/A	N/A

	NUI Postretirement Plan (1)
Assumed health care cost trend rates at December 31,	2005
Health care costs trend rate assumed for next year	2.5%
Rate to which the cost trend rate gradually declines	2.5%
Year that the rate reaches the ultimate trend rate	N/A

(1) The NUI postretirement plan was terminated and eligible former participants became eligible to participate in the AGL postretirement plan on January 1, 2006

Effective January 2006, our health care trend rates for both the AGL Postretirement Plan and the NUI Postretirement Plan were capped at 2.5%. This cap limits the increase in our contributions to the annual change in the consumer price index (CPI). An annual CPI rate of 2.5% was assumed for future years.

Assumed health care cost trend rates impact the amounts reported for our health care plans. A one-percentage-point change in the assumed health care cost trend rates would have the following effects for the AGL Postretirement Plan and the NUI Postretirement Plan.

	AGL Postretirement Plan One-Percentage-Point	
In millions	Increase	Decrease
Effect on total of service and interest cost	$-	$-
Effect on accumulated postretirement benefit obligation	4	(4)

Our investment policies and strategies for our postretirement plans, including target allocation ranges, are similar to those for our retirement plans. We fund the plans annually; retirees contribute 20% of medical premiums, 50% of

the medical premium for spousal coverage and 100% of the dental premium. Our postretirement plans weighted average asset allocations for 2006 and 2005 and our target asset allocation ranges are as follows.

In millions	Target Asset allocation ranges	2006	2005
Equity	30%-80%	66%	52%
Fixed income	10%-40%	32%	46%
Real estate and other	10%-35%	-%	1%
Cash	0%-10%	2%	1%

The following table presents expected benefit payments covering the periods 2007 through 2016 for our retirement plans and postretirement health care plans. There will be benefit payments under these plans beyond 2016.

For the years ended Dec. 31, *(in millions)*	AGL Retirement Plan	NUI Retirement Plan	AGL Postretirement Plan
2007	$20	$7	$7
2008	20	6	7
2009	20	6	7
2010	20	6	7
2011	20	6	7
2012-2016	111	32	35

The following table presents the amounts not yet reflected in net periodic benefit cost and included in accumulated OCI as of December 31, 2006.

In millions	AGL Retirement Plan	NUI Retirement Plan	AGL Postretirement Plan
Transition asset	$-	$-	$1
Prior service credit	(9)	(14)	(25)
Net gain	104	1	16
Accumulated OCI	95	(13)	(8)
Net amount recognized in statement of financial position.	(65)	(14)	(32)
Cumulative employer contributions in excess of net periodic benefit cost (accrued) prepaid	$30	$(27)	$(40)

There were no other changes in plan assets and benefit obligations recognized in the AGL and NUI Retirement Plans or the AGL Postretirement Plan for the year ended December 31, 2006.

Employee Savings Plan Benefits

We sponsor the Retirement Savings Plus Plan (RSP), a defined contribution benefit plan that allows eligible participants to make contributions to their accounts up to specified limits. Under the RSP, we made matching contributions to participant accounts in the following amounts:

- $6 million in 2006
- $5 million in 2005
- $5 million in 2004

We also sponsor the Nonqualified Savings Plan (NSP), an unfunded, nonqualified plan similar to the RSP. The NSP provides an opportunity for eligible employees who could reach the maximum contribution amount in the RSP to contribute additional amounts for retirement savings. Our contributions to the NSP have not been significant in any year.

Note 5 - Stock-based and Other Incentive Compensation Plans

Stock-based Compensation Plans and Agreements

We currently sponsor the following stock-based compensation plans and agreements:

- The Long-Term Incentive Plan (1999) (LTIP) provides for the grant of incentive and nonqualified stock options, performance units and shares of restricted stock to key employees. The LTIP authorizes the issuance of up to 9.5 million shares of our common stock, of which 5,826,584 shares were available for issuance as of December 31, 2006. If our shareholders approve the 2007 Omnibus Performance Incentive Plan (the 2007 Plan) at the 2007 annual meeting of shareholders (Proposal 2 to our proxy statement), no further grants will be made under the LTIP except for reload options granted under the plan's outstanding options. This means that if the shareholders approve the 2007 Plan, approximately 2.3 million shares (representing the number of outstanding options under the LTIP as of December 31, 2006) will be available for issuance under the LTIP.
- A predecessor plan, the Long-Term Stock Incentive Plan (LTSIP), provides for the grant of incentive and nonqualified stock options, shares of restricted stock and stock appreciation rights (SARs) to key employees. Following shareholder approval of the LTIP, no further grants have been made under the LTSIP.
- The Officer Incentive Plan (Officer Plan) provides for the grant of nonqualified stock options and shares of restricted stock to new-hire officers. The Officer Plan authorizes the issuance of up to 600,000 shares of our common stock, of which 313,433 shares were available for issuance as of December 31, 2006.
- SARs have been granted to key employees under individual agreements that permit the holder to receive cash in an amount equal to the difference between the fair market value of a share of our common stock on the date of exercise and the SAR base value. A total of 26,863 SARs at a weighted average exercise price of $24.24 were vested and outstanding as of December 31, 2006. We recognize the intrinsic value of the SARs as compensation expense over the vesting period. Compensation expense for 2006, 2005 and 2004 was not material to the statement of operations.
- The 2006 Non-Employee Directors Equity Compensation Plan (2006 Directors Plan) provides for the grant of stock to non-employee directors as payment of their annual retainer and stock award upon initial election or appointment to the Board of Directors. The 2006 Directors Plan authorizes the issuance of up to 200,000 shares of our common stock, of which 200,000 shares were available for issuance as of December 31, 2006.
- A predecessor plan, the 1996 Non-Employee Directors Equity Compensation Plan (1996 Directors Plan) originally provided for the grant of nonqualified stock options and stock to non-employee directors as payment of their annual retainer and stock award upon initial election or appointment to the Board of Directors. In December 2002, the 1996 Directors Plan was amended to eliminate the granting of stock options. As a result, the 1996 Directors Plan now provides solely for the issuance of our common stock. The 1996 Directors Plan authorizes the issuance of up to 200,000 shares of our common stock, of which 59,241 shares were available for issuance as of December 31, 2006.
- The Employee Stock Purchase Plan (ESPP) is a nonqualified, broad-based employee stock purchase plan for eligible employees. The ESPP authorizes the issuance of up to 600,000 shares of our common stock, of which 440,458 shares were available for issuance as of December 31, 2006.

Effective January 1, 2006, we adopted SFAS 123(R), using the modified prospective application transition method; accordingly, financial results for the prior periods presented were not retroactively adjusted to reflect the effects of SFAS 123R.

Prior to January 1, 2006, we accounted for our share-based payment transactions in accordance with SFAS No. 123, as amended by SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure." This allowed us to follow APB 25 and related interpretations in accounting for our stock-based compensation plans under the intrinsic value method.

SFAS 123R requires us to measure and recognize stock-based compensation expense in our financial statements based on the estimated fair value at the date of grant for our share-based awards, which include performance shares and stock options. Performance share awards contain market conditions. Both performance share and stock option awards contain a service condition. In accordance

with SFAS 123R, we recognize compensation expense over the requisite service period for:

- awards granted on or after January 1, 2006 and
- unvested awards previously granted and outstanding as of January 1, 2006

In addition, we estimate forfeitures over the requisite service period when recognizing compensation expense. These estimates are adjusted to the extent that actual forfeitures differ, or are expected to materially differ, from such estimates.

In 2004 and 2005, we did not record compensation expense related to our stock option grants in our financial statements, which is consistent with the APB 25 requirements. However, at the end of each reporting period, we recorded compensation expense over the requisite service period for our other stock-based and cash unit awards. The following table provides additional information on compensation costs and income tax benefits related to our compensation awards. We recorded these amounts in our consolidated statements of income for the years ended December 31, 2006, 2005 and 2004.

In millions	2006	2005	2004
Compensation costs	$9	$5	$7
Income tax benefits	3	8	5

Prior to our adoption of SFAS 123R, benefits of tax deductions in excess of recognized compensation costs were reported as operating cash flows. SFAS 123R requires excess tax benefits to be reported as a financing cash inflow rather than as a reduction of taxes paid. For the year ended December 31, 2006, our cash flow for financing activities included an immaterial amount for benefits of tax deductions in excess of recognized compensation costs. For 2005 and 2004, we included $8 million and $5 million, respectively, of such benefits in cash flow provided by operating activities.

If stock-based compensation expense for the years ended December 31, 2004 and 2005 had been recorded based on the fair value of the awards at the grant dates consistent with the method prescribed by SFAS 123, which has been superseded by SFAS 123R, our net income and earnings per share for the years ended December 31, 2004 and 2005 would have been reduced to the amounts shown in the following table,

In millions, except per share amounts	2005	2004
Net income, as reported	$193	$153
Deduct: Total stock-based employee compensation expense determined under fair value-based method for all awards, net of related tax effect	(1)	(1)
Pro-forma net income	$192	$152
Earnings per share:		
Basic – as reported	$2.50	$2.30
Basic – pro-forma	$2.48	$2.28
Diluted – as reported	$2.48	$2.28
Diluted – pro-forma	$2.47	$2.26

Incentive and Nonqualified Stock Options

We grant incentive and nonqualified stock options with a strike price equal to the fair market value on the date of the grant. "Fair market value" is defined under the terms of the applicable plans as the most recent closing price per share of AGL Resources common stock as reported in *The Wall Street Journal*. Stock options generally have a three-year vesting period. Nonqualified options generally become fully exercisable not earlier than six months after the date of grant and generally expire 10 years after the date of grant. Participants realize value from option grants only to the extent that the fair market value of our common stock on the date of exercise of the option exceeds the fair market value of the common stock on the date of the grant. Compensation expense associated with stock options is generally recorded over the option vesting period; however, for unvested options that are granted to employees who are retirement-eligible, the remaining compensation expense is recorded in the current period rather than over the remaining vesting period.

As of December 31, 2006, we had $3 million of total unrecognized compensation costs related to stock options. These costs are expected to be recognized over the remaining average requisite service period of approximately two years. Cash received from stock option exercises for the year ended December 31, 2006 was $11 million, and the income tax benefit from stock option exercises was $3 million. The following tables summarize activity related to grants of stock options for key employees and non-employee directors.

Stock Options

	Number of options	Weighted average exercise price	Weighted average remaining life (in years)	Aggregate intrinsic value (in millions)
Outstanding – December 31, 2003	3,510,970	$22.25		
Granted	103,900	29.72		
Exercised	(1,050,053)	20.90		
Forfeited	(390,745)	22.44		
Outstanding – December 31, 2004	2,174,072	$23.23		
Granted	1,014,121	33.80		
Exercised	(846,465)	22.60		
Forfeited	(120,483)	32.38		
Outstanding – December 31, 2005	2,221,245	$27.79	6.8	
Granted	914,216	35.81	9.1	
Exercised	(543,557)	24.69	4.8	
Forfeited	(266,418)	34.93	8.4	
Outstanding – December 31, 2006	2,325,486	$30.85	7.2	$19
Exercisable – December 31, 2006	1,013,672	$25.45	5.3	$14

Unvested Stock Options

	Number of unvested options	Weighted average exercise price	Weighted average remaining vesting period (in years)	Weighted average fair value
Outstanding – December 31, 2005	945,556	$33.64	2.1	$4.72
Granted	914,216	35.81	2.1	4.79
Forfeited	(266,418)	34.93	1.4	4.95
Vested	(281,540)	32.96	-	4.58
Outstanding – December 31, 2006	1,311,814	$35.03	1.8	$4.75

Information about outstanding and exercisable options as of December 31, 2006, is as follows.

	Options outstanding			Options Exercisable	
Range of Exercise Prices	Number of options	Weighted average remaining contractual life (in years)	Weighted average exercise price	Number of options	Weighted average exercise price
$15.80 to $19.74	17,953	2.9	$17.92	17,953	$17.92
$19.75 to $23.69	449,825	3.4	21.05	449,825	21.05
$23.70 to $27.64	302,882	6.4	26.55	302,882	26.55
$27.65 to $31.59	52,818	6.2	29.05	47,317	29.03
$31.60 to $35.54	579,239	8.0	33.31	172,660	33.30
$35.55 to $39.49	922,769	9.0	35.86	23,035	36.38
Outstanding - Dec. 31, 2006	**2,325,486**	**7.2**	**$30.85**	**1,013,672**	**$25.45**

Summarized below are outstanding options that are fully exercisable.

Exercisable at:	Number of options	Weighted average exercise price
December 31, 2004	1,658,260	$22.04
December 31, 2005	1,275,689	$23.46
December 31, 2006	1,013,672	$25.45

In accordance with the fair value method of determining compensation expense, we used the Black-Scholes pricing model. Below are the ranges for per share value and information about the underlying assumptions used in developing the grant date value for each of the grants made during the years ended December 31, 2006, 2005 and 2004.

	2006	2005	2004
Expected life (years)	7	7	7
Risk-free interest rate % (1)	4.5 – 5.1	3.9 – 4.5	3.2 – 4.4
Expected volatility % (2)	14.2 – 15.9	17.1 - 17.3	17.4 – 18.2
Dividend yield % (3)	3.7 – 4.2	3.2 - 3.8	3.5 – 4.1
Fair value of options granted (4)	$4.55 – $6.18	$4.57– $6.01	$3.62 – $4.07

(1) US Treasury constant maturity – 7 years.
(2) Volatility is measured over 7 years, the expected life of the options, Weighted average for the years ended December 31, 2006, 2005 and 2004 were 15.8%, 17.3% and 17.8%, respectively.
(3) Weighted average dividend yields for the years ended December 31, 2006, 2005 and 2004 were 4.1%, 3.7% and 3.9%, respectively
(4) Represents per share value.

Intrinsic value for options is defined as the difference between the current market value and the grant price. Total intrinsic value of options exercised during the years ended December 31, 2006, 2005 and 2004 was $7 million, $12 million and $10 million, respectively. We use shares purchased under our share repurchase program to satisfy share-based exercises to the extent that repurchased shares are available. Otherwise, we issue new shares from our authorized common stock.

Performance Units

In general, a performance unit is an award of the right to receive (i) an equal number of shares of our common stock or (ii) cash, subject to the achievement of certain pre-established performance criteria. Performance units are subject to certain transfer restrictions and forfeiture upon termination of employment.

Restricted Stock Units In general, a restricted stock unit is an award that represents the opportunity to receive a specified number of shares of our common stock, subject to the achievement of certain pre-established performance criteria. In February 2006, we granted to a select group of officers a total of 64,700 restricted stock units (the 2006 restricted stock units) under the LTIP, of which 61,800 of these units were outstanding as of December 31, 2006. These restricted stock units have a 12-month performance measurement period related to a basic earnings per share goal. The performance measure was achieved during 2006. On January 30, 2007, these restricted stock units were converted to an equal number of shares of our common stock and are now subject to time-based vesting.

Performance Cash Units In general, a performance cash unit is an award that represents the opportunity to receive a cash award, subject to the achievement of certain pre-established performance criteria. We made two grants in January 2005 and 2006 subject to achieving certain performance criteria and the status of those grants is as follows:

Dollars in millions	Units	Measurement period	12 month paid	24 month paid	Accrued at December 31, 2006	Maximum aggregate payout
2005	23	12-36 months	$1	$-	$1	$3
2006	15	12-36 months	-	-	1	2

Stock and Restricted Stock Awards

In general, we refer to an award of our common stock that is subject to time-based vesting or achievement of performance measures as "restricted stock." Restricted stock awards are subject to certain transfer restrictions and forfeiture upon termination of employment.

Stock Awards Under the 1996 Directors Plan and 2006 Directors Plan (collectively, the Directors Plans), each non-employee director receives an annual retainer that is fixed from time to time by our Board of Directors. Effective as of the date of the 2007 annual shareholder meeting, the annual retainer will increase from $90,000 to $105,000, of which (1) $35,000 (the "Cash Portion") is payable in cash or, at the election of each director, in shares of our common stock or deferred under the 1998 Common Stock Equivalent Plan for Non-Employee Directors (CSE Plan), and (2) $70,000 (the "Equity Portion") is payable, at the election of each director, in shares of our common stock or deferred under the CSE Plan. During the 2006 service term, the annual retainer was $90,000, of which the Cash Portion was $30,000 and the Equity Portion was $60,000. Upon initial election to our Board of Directors, each non-employee director receives 1,000 shares of common stock as of the first day of his or her service. Shares issued under the Directors Plan are 100% vested and nonforfeitable as of the date of grant.

Restricted Stock Awards Restricted stock awards are subject to certain transfer restrictions and forfeiture upon termination of employment. The following table summarizes activity during the year ended December 31, 2006, related to restricted stock awards for our key employees.

Restricted Stock Awards	Shares of restricted stock	Weighted average remaining vesting period (in years)	Weighted average fair value
Outstanding – December 31, 2005	120,728	2.3	$34.33
Issued	198,395	2.6	35.68
Forfeited	(30,466)	1.5	34.44
Vested	(56,226)	-	34.21
Outstanding – December 31, 2006	232,431	2.4	$35.49

Employee Stock Purchase Plan

Under the ESPP, employees may purchase shares of our common stock in quarterly intervals at 85% of fair market value. Employee contributions under the ESPP may not exceed $25,000 per employee during any calendar year. As of December 31, 2006, our employees had purchased a total of 159,542 shares leaving 440,458 shares available for purchase. The ESPP expires January 31, 2015.

	2006	2005	2004
Shares purchased on the open market	45,361	40,927	35,789
Average per-share purchase price	$31.40	$30.52	$25.20
Purchase price discount	$252,752	$220,847	$159,144

Note 6 - Common Shareholders' Equity

Share Repurchases

In March 2001, our Board of Directors approved the purchase of up to 600,000 shares of our common stock to be used for issuances under the Officer Incentive Plan. In 2006, we purchased 32,801 shares. As of December 31, 2006, we had purchased a total 286,567 shares, leaving 313,433 shares available for purchase. In February 2006, our Board of Directors authorized a plan to purchase up to 8 million shares of our outstanding common stock over a five-year period. These purchases are intended to offset share issuances under our employee and non-employee director incentive compensation plans and our dividend reinvestment and stock purchase plans. Stock purchases under this program may be made in the open market or in private transactions at times and in amounts that we deem appropriate. There is no guarantee as to the exact number of shares that we will purchase, and we can terminate or limit the program at any time. We will hold the purchased shares as treasury shares. As of December 31, 2006, we had repurchased 1,027,500 shares at a weighted average price of $36.67.

Dividends

We derive a substantial portion of our consolidated assets, earnings and cash flow from the operation of regulated utility subsidiaries, whose legal authority to pay dividends or make other distributions to us is subject to regulation. Our common shareholders may receive dividends when declared at the discretion of our Board of Directors. Dividends may be paid in cash, stock or other form of payment, and payment of future dividends will depend on our future earnings, cash flow, financial requirements and other factors, some of which are noted below. In certain cases, our ability to pay dividends to our common shareholders is limited by the following:

- our ability to satisfy our obligations under certain financing agreements, including debt-to-capitalization and total shareholders' equity covenants
- our ability to satisfy our obligations to any preferred shareholders

Note 7 - Debt

Our issuance of various securities, including long-term and short-term debt, is subject to customary approval or authorization by state and federal regulatory bodies, including state public service commissions, the SEC and the FERC. On April 1, 2004, we received approval from the SEC, under the Public Utility Holding Act of 1935, as amended (PUHCA), for the renewal of our financing authority to issue securities through April 2007. In August 2005, the Energy Policy Act of 2005 (Energy Act) was enacted which repealed the PUHCA, effective February 8, 2006. The Energy Act granted the FERC financing authorization approvals that were previously required by the SEC under the PUHCA. The following table provides more information on our various securities.

In millions	Year(s) due	Int. rate (1)	Outstanding as of: Dec. 31, 2006	Dec. 31, 2005
Short-term debt				
Commercial paper (2)	2007	5.4%	$508	$485
Current portion of long-term debt	2007	7.0	11	-
Sequent line of credit (3)	2007	5.6	2	-
Pivotal Utility Holdings, Inc. line of credit (4)	2007	5.7	17	-
Capital leases	2007	4.9	1	1
SouthStar line of credit (5)	-	-	-	36
Total short-term debt (6)		**5.4%**	**$539**	**$522**
Long-term debt - net of current portion				
Medium-term notes	2012-2027	6.6-9.1%	$196	$208
Senior notes	2011-2034	4.5-7.1	1,150	975
Gas facility revenue bonds	2022-2033	3.6-5.7	199	199
Notes payable to Trusts	2037	8.2	77	232
Capital leases	2013	4.9	6	6
AGL Capital interest rate swaps	2011	9.0	(6)	(5)
Total long-term debt (6)		**6.2%**	**$1,622**	**$1,615**
Total debt (6)		**6.0%**	**$2,161**	**$2,137**

(1) As of December 31, 2006.
(2) The daily weighted average interest rate was 5.1% for 2006 and 3.6% for 2005.
(3) The daily weighted average interest rate was 5.5% for 2006.
(4) The daily weighted average interest rate was 5.7% for 2006.
(5) The daily weighted average interest rate was 6.8% for 2005.
(6) Weighted average interest rate, including interest rate swaps if applicable and excluding debt issuance and other financing-related costs.

Short-term Debt

Our short-term debt at December 31, 2006 and 2005 was composed of borrowings under our commercial paper program which consisted of short-term, unsecured promissory notes with maturities ranging from 2 to 38 days; current portions of our capital lease obligations and the current portion of our long-term medium-term notes; and lines of credit for SouthStar, Sequent, and Pivotal Utility Holdings, Inc. (Pivotal Utility).

Commercial Paper In August 2006, we replaced our previous Credit Facility with a new Credit Facility that supports our commercial paper program. Under the terms of the new Credit Facility, the aggregate principal amount available was increased from $850 million to $1 billion and we have the option to increase the aggregate principal amount available for borrowing to $1.25 billion on not more than three occasions during each calendar year. This credit facility expires August 31, 2011.

SouthStar Credit Facility In November of 2006, SouthStar closed a five-year $75 million unsecured credit facility. This line of credit will be used for working capital and general corporate needs. On December 31, 2006, there were no outstanding borrowings on this line of credit.

Sequent Line of Credit In 2006, we extended Sequent's two lines of credit through June 2007 and August 2007. These unsecured lines of credit, which total $45 million and bear interest at the federal funds effective rate plus 0.4%, are used solely for the posting of margin deposits for NYMEX transactions and are unconditionally guaranteed by us.

Pivotal Utility Line of Credit In August 2006, we extended the Pivotal Utility line of credit through August 2007. This line of credit supports Elizabethtown Gas' hedging program and bears interest at the federal funds effective rate plus 0.4%, is used solely for the posting of deposits and is unconditionally guaranteed by us. For more

information on Elizabethtown Gas' hedging program, see Note 2.

Long-term Debt

Our long-term debt matures more than one year from the date of issuance and consists of medium-term notes: Series A, Series B and Series C, which we issued under an indenture dated December 1, 1989; senior notes; gas facility revenue bonds; notes payable to Trusts; and capital leases. The notes are unsecured and rank on parity with all our other unsecured indebtedness. Our annual maturities of long-term debt are as follows:

Year	Amount *(in millions)*
2011	$294 (1)
2012	15
2013	230
2015	200
2016	175
2017	22
2021	30
2022	93
2024	20
2026	69
2027	54
2032	55
2033	40
2034	250
2037	77
Total	$1,624 (2)

(1) Includes the fair value of $6 million related to our interest rate swaps.
(2) Excludes $2 million of unamortized issuance costs related to our gas facility revenue bonds.

Medium-term notes The following table provides more information on our medium-term notes, which were issued to refinance portions of our existing short-term debt and for general corporate purposes. Our annual maturities of our medium-term notes are as follows:

Issue Date	Amount (in millions)	Interest rate	Maturity
Feb. 1991	$30	9.1%	Feb. 2021
June 1992	5	8.4	June 2012
June 1992	5	8.3	June 2012
June 1992	5	8.3	July 2012
April 1992	5	8.55	April 2022
April 1992	25	8.7	April 2022
April 1992	6	8.55	April 2022
May 1992	10	8.55	May 2022
July 1997	22	7.2	July 2017
Nov. 1996	30	6.55	Nov. 2026
July 1997	53	7.3%	July 2027
Total	$196		

In December 2006, we executed our option to redeem an $11 million medium-term note in January of 2007. The note had an interest rate of 7% and was previously scheduled to mature in January of 2015. The note was redeemed at par using proceeds from commercial paper.

Senior Notes The following table provides more information on our senior notes, which were issued to refinance portions of our existing short-term debt and medium-term notes, to finance acquisitions and for general corporate purposes. Our annual maturities of our senior notes are as follows:

Issue date	Amount (in millions)	Interest rate	Maturity
Feb. 2001	$300	7.125%	Jan 2011
July 2003	225	4.45	Apr 2013
Sep. 2004	250	6.0	Oct 2034
Dec. 2004	200	4.95	Jan 2015
June 2006	175	6.375%	Jul 2016
Total	$1,150		

In June 2006, we issued $175 million of 10-year senior notes at an interest rate of 6.375% and used the net proceeds of $173 million to repay the commercial paper. In March 2003, we entered into interest rate swaps of $100 million to effectively convert a portion of the fixed-rate interest obligation on the $300 million in Senior Notes due 2011 to a variable-rate obligation. We pay floating interest each January 14 and July 14 at six-month LIBOR plus 3.4%. The effective variable interest rate at December 31, 2006, was 9.0%. These interest rate swaps expire January 14, 2011, unless terminated earlier. For more information on our interest rate swaps, see Note 2.

The trustee with respect to all of the above-referenced senior notes is The Bank of New York Trust Company, N.A. (Bank of New York), pursuant to an indenture dated February 20, 2001. We fully and unconditionally guarantee all of our senior notes.

Gas Facility Revenue Bonds Pivotal Utility has $200 million of indebtedness pursuant to gas facility revenue bonds. We do not guarantee or provide any other form of security for the repayment of this indebtedness. Pivotal Utility is party to a series of loan agreements with the New Jersey Economic Development Authority (NJEDA) pursuant to which the NJEDA has issued a series of gas facility revenue bonds as follows:

Issue Date	Amount (in millions)	Interest rate	Maturity
July 1994	$47	(1)	Oct. 2022
July 1994	20	(1)	Oct. 2024
June 1992	39	(1)	June 2026
June 1992	55	5.7%	June 2032
July 1997	40	5.25%	Nov. 2033
Unamortized issuance costs	(2)		
Total	$199		

(1) Variable or adjusting rates.

In April 2005, we refinanced $20 million of our Gas Facility Revenue Bonds due October 1, 2024. The original bonds had a fixed interest rate of 6.4% per year and were refunded with $20 million of adjustable-rate gas facility revenue bonds. The maturity date of these bonds remains October 1, 2024. The new bonds were issued at an initial annual interest rate of 2.8% and initially have a 35-day auction period where the interest rate will adjust every 35 days. The interest rate at December 31, 2006 was 3.7%.

In May 2005, we refinanced an additional $47 million in Gas Facility Revenue Bonds due October 1, 2022 and bearing interest at an annual fixed rate of 6.35%. The new bonds were issued at an initial annual interest rate of 2.9% and initially have a 35-day auction period where the interest rate will adjust every 35 days. The maturity date remains October 1, 2022. The interest rate at December 31, 2006 was 3.6%.

The variable bonds contain a provision whereby the holder can "put" the bonds back to the issuer. In 1996, Pivotal Utility executed a long-term Standby Bond Purchase Agreement (SBPA) with a syndicate of banks, which was amended and restated on June 1, 2005. Under the terms of the SBPA, as further amended, the participating banks are obligated under certain circumstances to purchase variable bonds that are tendered by the holders thereof and not remarketed by the remarketing agent. Such obligation of the participating banks would remain in effect until the June 1, 2010 expiration of the SBPA, unless it is extended or earlier terminated.

Notes Payable to Trusts In June 1997, we established AGL Capital Trust I (Trust I), a Delaware business trust, of which AGL Resources owns all the common voting securities. Trust I issued and sold $75 million of 8.17% capital securities (liquidation amount $1,000 per capital security) to certain initial investors. Trust I used the proceeds to purchase 8.17% junior subordinated deferrable interest debentures issued by us. Trust I capital securities are subject to mandatory redemption at the time of the repayment of the junior subordinated debentures on June 1, 2037, or the optional prepayment by us after May 31, 2007.

In May 2001, AGL Capital Trust II (Trust II) issued and sold $150 million of 8.00% capital securities and used the proceeds to purchase $150 million principal amount of 8.00% junior subordinated deferrable interest debentures from us. In May 2006, we used the proceeds from the sale of commercial paper to redeem the $150 million of junior subordinated debentures and to pay a $5 million note representing our investment in the Trust, previously included in notes payable to trusts.

The trustee is the Bank of New York with respect to the 8.17% capital securities pursuant to an indenture dated June 11, 1997. We fully and unconditionally guarantee all our Trust I obligations for the capital securities.

Other Preferred Securities As of December 31, 2006, we had 10 million shares of authorized, unissued Class A junior participating preferred stock, no par value, and 10 million shares of authorized, unissued preferred stock, no par value.

Capital Leases Our capital leases consist primarily of a sale/leaseback transaction completed in 2002 by Florida City Gas related to its gas meters and other equipment and will be repaid over 11 years. Pursuant to the terms of the lease agreement, Florida City Gas is required to insure the leased equipment during the lease term. In addition, at the expiration of the lease term, Florida City Gas has the option to purchase the leased meters from the lessor at their fair market value.

Default Events

Our Credit Facility financial covenant requires us to maintain a ratio of total debt to total capitalization of no greater than 70%. As of December 31, 2006 this ratio was 57%. Our debt instruments and other financial obligations include provisions that, if not complied with, could require early payment, additional collateral support or similar actions. Our most important default events include:

- a maximum leverage ratio
- insolvency events and nonpayment of scheduled principal or interest payments
- acceleration of other financial obligations
- change of control provisions

We do not have any trigger events in our debt instruments that are tied to changes in our specified credit ratings or our stock price and have not entered into any transaction that requires us to issue equity based on credit ratings or other trigger events. We are currently in compliance with all existing debt provisions and covenants.

Note 8 - Commitments and Contingencies

Contractual Obligations and Commitments

We have incurred various contractual obligations and financial commitments in the normal course of our operating and financing activities. Contractual obligations include future cash payments required under existing contractual arrangements, such as debt and lease agreements. These obligations may result from both general financing activities and from commercial arrangements that are directly supported by related revenue-producing activities. We calculate any expected pension contributions using the projected unit credit cost method. Under this method, we were not required to make any pension contribution in 2006, but we voluntarily made a $5 million contribution in October 2006. The following table illustrates our expected future contractual cash obligations as of December 31, 2006.

		Payments due before December 31,			
In millions	**Total**	**2007**	**2008 & 2009**	**2010 & 2011**	**2012 & thereafter**
Interest charges (1)	$1,398	$99	$198	$177	$924
Pipeline charges, storage capacity and gas supply (2) (3) (4)	1,916	441	625	389	461
Long-term debt (5)	1,622	-	-	300	1,322
Short-term debt	539	539	-	-	-
PRP costs (6)	237	35	82	85	35
Operating leases (7)	170	32	47	33	57
ERC (6)	96	13	18	54	11
Total	$5,978	$1,159	$970	$1,039	$2,810

(1) Floating rate debt is based on the interest rate as of December 31, 2006 and the maturity of the underlying debt instrument.
(2) Charges recoverable through a PGA mechanism or alternatively billed to Marketers. Also includes demand charges associated with Sequent.
(3) A subsidiary of NUI entered into two 20-year agreements for the firm transportation and storage of natural gas during 2003 with annual aggregate demand charges of approximately $5 million. As a result of our acquisition of NUI and in accordance with SFAS No. 141, "Business Combinations," we valued the contracts at fair value and established a long-term liability that will be amortized over the remaining lives of the contracts.
(4) Amount includes SouthStar gas commodity purchase commitments of 1.4 Bcf at floating gas prices calculated using a forward natural gas price as of December 31, 2006, and is valued at $89 million.
(5) Includes $77 million of notes payable to Trusts redeemable in 2007.
(6) Includes charges recoverable through rate rider mechanisms.
(7) We have certain operating leases with provisions for step rent or escalation payments and certain lease concessions. We account for these leases by recognizing the future minimum lease payments on a straight-line basis over the respective minimum lease terms, in accordance with SFAS No. 13, "Accounting for Leases." However, this accounting treatment does not affect the future annual operating lease cash obligations as shown herein.

We also have incurred various financial commitments in the normal course of business. Contingent financial commitments represent obligations that become payable only if certain predefined events occur, such as financial guarantees, and include the nature of the guarantee and the maximum potential amount of future payments that could be required of us as the guarantor. The following table illustrates our expected contingent financial commitments as of December 31, 2006.

		Commitments due before Dec. 31,	
In millions	**Total**	**2007**	**2008 & thereafter**
Standby letters of credit, performance / surety bonds	$14	$12	$2

Rental Expense

We incurred $19 million, $25 million and $22 million in rental expense in 2006, 2005 and 2004, respectively.

Litigation

We are involved in litigation arising in the normal course of business. We believe the ultimate resolution of such litigation will not have a material adverse effect on our consolidated financial position, results of operations or cash flows.

In August 2006, the Office of Mineral Resources of the Louisiana Department of Natural Resources (Louisiana DNR) informed Jefferson Island that its mineral lease – which authorizes salt extraction to

create two new storage caverns – at Lake Peigneur had been terminated. The Louisiana DNR identified two bases for the termination: (1) failure to make certain mining leasehold payments in a timely manner, and (2) the absence of salt mining operations for six months.

In September 2006, Jefferson Island filed suit against the State of Louisiana to maintain its lease to complete an ongoing natural gas storage expansion project in Louisiana. The project would add two salt dome storage caverns under Lake Peigneur to the two caverns currently owned and operated by Jefferson Island. In its suit, Jefferson Island alleges that the Louisiana DNR accepted all leasehold payments without reservation and never provided Jefferson Island with notice and opportunity to cure, as required by state law. In its answer to the suit, the State denied that anyone with proper authority approved the late payments. As to the second basis for termination, the suit contends that Jefferson Island's lease with the State of Louisiana was amended in 2004 so that mining operations are no longer required to maintain the lease. The State's answer denies that the 2004 amendment was properly authorized. We continue to seek resolution of this dispute and we are optimistic that a settlement can be reached with the State of Louisiana that would allow us to proceed with the expansion. If we are unable to reach a settlement, we are not able to predict the outcome of the litigation. As of January 2007, our current estimate of costs incurred that would be considered unusable if the Louisiana DNR was successful in terminating our lease and causing us to cease the expansion project is approximately $8 million.

Environmental Remediation Costs

We own a former NUI remediation site in Elizabeth City, North Carolina that is subject to a remediation order by the North Carolina Department of Energy and Natural Resources. As of December 31, 2006, we have recorded a liability of $9 million related to this site.

There is one other site in North Carolina where investigation and remediation is likely, although no remediation order exists and we do not believe costs associated with this site can be reasonably estimated. In addition, there are as many as six other sites with which NUI had some association, although no basis for liability has been asserted, and accordingly we have not accrued any remediation liability. There are currently no cost recovery mechanisms for the environmental remediation sites in North Carolina.

Note 9 - Fair Value of Financial Instruments

The following table shows the carrying amounts and fair values of our long-term debt including any current portions included in our consolidated balance sheets.

In millions	Carrying amount (1)	Estimated fair value
As of December 31, 2006	$1,633	$1,716
As of December 31, 2005	1,615	1,784

(1) Includes $11 million of medium-term notes reported as short-term debt in our December 31, 2006 consolidated balance sheets.

The estimated fair values are determined based on interest rates that are currently available for issuance of debt with similar terms and remaining maturities.

Considerable judgment is required to develop the fair value estimates; therefore, the values are not necessarily indicative of the amounts that could be realized in a current market exchange. The fair value estimates are based on information available to management as of December 31, 2006. We are not aware of any subsequent factors that would significantly affect the estimated fair value amounts. For more information about the fair values of our interest rate swaps, see Note 2.

Note 10 - Income Taxes

We have two categories of income taxes in our statements of consolidated income: current and deferred. Current income tax expense consists of federal and state income tax less applicable tax credits related to the current year. Deferred income tax expense generally is equal to the changes in the deferred income tax liability and regulatory tax liability during the year.

Investment Tax Credits

Deferred investment tax credits associated with distribution operations are included as a regulatory liability in our consolidated balance sheets (see Note 3, Regulatory Assets and Liabilities). These investment tax credits are being amortized over the estimated life of the related properties as credits to income in accordance with regulatory requirements. We reduce income tax expense in our statements of consolidated income for the investment tax credits and other tax credits associated with our nonregulated subsidiaries. Components of income tax expense shown in the statements of consolidated income are as follows.

Income Tax Expense

The relative split between current and deferred taxes is due to a variety of factors including true ups of prior year tax returns, and most importantly, the timing of our property-related deductions. Additionally, 2006 was significantly impacted by our mark-to-market gains on energy risk management assets which are not recognized for tax purposes until realized.

In millions	2006	2005	2004
Current income taxes			
Federal	($4)	$84	$25
State	2	18	1
Deferred income taxes			
Federal	115	17	60
State	18	-	5
Amortization of investment tax credits	(2)	(2)	(1)
Total	$129	$117	$90

The reconciliations between the statutory federal income tax rate, the effective rate and the related amount of tax for the years ended December 31, 2006, 2005 and 2004 are presented in the following tables.

2006

In millions	Amount	% of pretax income
Computed tax expense at statutory rate	$119	35.0%
State income tax, net of federal income tax benefit	12	3.6
Amortization of investment tax credits	(2)	(0.5)
Flexible dividend deduction	(2)	(0.5)
Other -- net	2	0.2
Total income tax expense at effective rate	$129	37.8%

2005

In millions	Amount	% of pretax income
Computed tax expense at statutory rate	$109	35.0%
State income tax, net of federal income tax benefit	11	3.7
Amortization of investment tax credits	(2)	(0.6)
Flexible dividend deduction	(2)	(0.6)
Other - net	1	0.2
Total income tax expense at effective rate	$117	37.7%

2004

In millions	Amount	% of pretax income
Computed tax expense at statutory rate	$85	35.0%
State income tax, net of federal income tax benefit	9	3.5
Amortization of investment tax credits	(1)	(0.6)
Flexible dividend deduction	(2)	(0.6)
Other – net	(1)	(0.2)
Total income tax expense at effective rate	$90	37.1%

Accumulated Deferred Income Tax Assets and Liabilities

We report some of our assets and liabilities differently for financial accounting purposes than we do for income tax purposes. We report the tax effects of the differences in those items as deferred income tax assets or liabilities in our consolidated balance sheets. We measure the assets and liabilities using income tax rates that are currently in effect. Because of the regulated nature of the utilities' business, we recorded a regulatory tax liability in accordance with SFAS 109, which we are amortizing over approximately 30 years (see Note 3). Our deferred tax assets include $35 million related to an additional minimum pension liability, a decrease of $2 million from 2005.

As indicated in the following table, our deferred tax assets and liabilities include certain items we acquired from NUI. We have provided a valuation allowance for some of these items that reduce our net deferred tax assets to amounts we believe are more likely than not to be realized in future periods. With respect to our continuing operations, we have net operating losses in various jurisdictions. Components that give rise to the net accumulated deferred income tax liability are as follows.

	As of	
In millions	Dec. 31, 2006	Dec. 31, 2005
Accumulated deferred income tax liabilities		
Property -- accelerated depreciation and other property-related items	$520	$494
Mark to market	46	1
Other	22	38
Total accumulated deferred income tax liabilities	588	533
Accumulated deferred income tax assets		
Deferred investment tax credits	7	7
Deferred pension additional minimum liability	35	37
Net operating loss – NUI (1)	5	26
Capital loss carryforward	-	4
Alternative minimum tax credit	-	8
Other	-	37
Total accumulated deferred income tax assets	47	119
Valuation allowances (2)	(3)	(9)
Total accumulated deferred income tax assets, net of valuation allowance	44	110
Net accumulated deferred tax liability	$544	$423

(1) Expire in 2021.
(2) Valuation allowance is due to the net operating losses on NUI headquarters that are not usable in New Jersey.

Note 11 - Segment Information

Our four operating segments are as follows:

- Distribution operations consists primarily of
  - Atlanta Gas Light
  - Chattanooga Gas
  - Elizabethtown Gas
  - Elkton Gas
  - Florida City Gas
  - Virginia Natural Gas
- Retail energy operations consists of SouthStar
- Wholesale services consists of Sequent
- Energy investments consists primarily of
  - AGL Networks, LLC
  - Jefferson Island
  - Pivotal Propane

We treat corporate, our fifth segment, as a nonoperating business segment, and it currently includes AGL Resources, AGL Services Company, Pivotal Energy Development and the effect of intercompany eliminations. We eliminated intercompany sales for the years ended December 31, 2006, 2005 and 2004 from our statements of consolidated income.

We evaluate segment performance based primarily on the non-GAAP measure of EBIT, which includes the effects of corporate expense allocations. EBIT is a non-GAAP measure that includes operating income, other income, donations, minority interest in 2006, 2005 and 2004 and gains on sales of assets. Items we do not include in EBIT are financing costs, including interest and debt expense and income taxes, each of which we evaluate on a consolidated level. We believe EBIT is a useful measurement of our performance because it provides information that can be used to evaluate the effectiveness of our businesses from an operational perspective, exclusive of the costs to finance those activities and exclusive of income taxes, neither of which is directly relevant to the efficiency of those operations.

You should not consider EBIT an alternative to, or a more meaningful indicator of our operating performance than, operating income or net income as determined in accordance with GAAP. In addition, our EBIT may not be comparable to a similarly titled measure of another company. The reconciliations of EBIT to operating income and net income for the years ended December 31, 2006, 2005 and 2004 are presented below.

In millions	2006	2005	2004
Operating revenues	$2,621	$2,718	$1,832
Operating expenses	2,133	2,276	1,500
Operating income	488	442	332
Other expenses	(1)	(1)	-
Minority interest	(23)	(22)	(18)
EBIT	464	419	314
Interest expense	123	109	71
Earnings before income taxes	341	310	243
Income taxes	129	117	90
Net income	$212	$193	$153

Summarized income statement, balance sheet and capital expenditure information by segment as of and for the years ended December 31, 2006, 2005 and 2004 is shown in the following tables.

2006

In millions	Distribution operations	Retail energy operations	Wholesale services	Energy investments	Corporate and intercompany eliminations	Consolidated AGL Resources
Operating revenues from external parties	$1,467	$930	$182	$41	$1	$2,621
Intercompany revenues (1)	157	-	-	-	(157)	-
Total revenues	1,624	930	182	41	(156)	2,621
Operating expenses						
Cost of gas	817	774	43	5	(157)	1,482
Operation and maintenance	350	64	46	20	(7)	473
Depreciation and amortization	116	3	2	5	12	138
Taxes other than income taxes	33	1	1	1	4	40
Total operating expenses	1,316	842	92	31	(148)	2,133
Operating income (loss)	308	88	90	10	(8)	488
Minority interest	-	(23)	-	-	-	(23)
Other income (expense)	2	(2)	-	-	(1)	(1)
EBIT	$310	$63	$90	$10	$(9)	$464
Identifiable and total assets	$4,565	$298	$849	$373	$62	$6,147
Goodwill	$406	$-	$-	$14	$-	$420
Capital expenditures	$174	$9	$2	$23	$45	$253

2005

In millions	Distribution operations	Retail energy operations	Wholesale services	Energy investments	Corporate and intercompany eliminations	Consolidated AGL Resources
Operating revenues from external parties	$1,571	$996	$95	$56	$-	$2,718
Intercompany revenues (1)	182	-	-	-	(182)	-
Total revenues	1,753	996	95	56	(182)	2,718
Operating expenses						
Cost of gas	939	850	3	16	(182)	1,626
Operation and maintenance	372	58	39	17	(9)	477
Depreciation and amortization	114	2	2	5	10	133
Taxes other than income taxes	32	1	1	1	5	40
Total operating expenses	1,457	911	45	39	(176)	2,276
Operating income (loss)	296	85	50	17	(6)	442
Minority interest	-	(22)	-	-	-	(22)
Other income (expense)	3	-	(1)	2	(5)	(1)
EBIT	$299	$63	$49	$19	$(11)	$419
Identifiable and total assets	$4,788	$343	$1,058	$350	$(219)	$6,320
Goodwill	$406	$-	$-	$14	$-	$420
Capital expenditures	$215	$4	$1	$9	$38	$267

2004

In millions	Distribution operations	Retail energy operations	Wholesale services	Energy investments	Corporate and intercompany eliminations	Consolidated AGL Resources
Operating revenues	$926	$827	$54	$25	$-	$1,832
Intercompany revenues (1)	185	-	-	-	(185)	-
Total revenues	1,111	827	54	25	(185)	1,832
Operating expenses						
Cost of gas	471	695	1	12	(184)	995
Operation and maintenance	286	60	27	5	(1)	377
Depreciation and amortization	85	2	1	2	9	99
Taxes other than income taxes	23	-	1	1	4	29
Total operating expenses	865	757	30	20	(172)	1,500
Operating income (loss)	246	70	24	5	(13)	332
Earnings in equity interests	-	-	-	2	-	2
Minority Interest	-	(18)	-	-	-	(18)
Other income (expense)	1	-	-	-	(3)	(2)
EBIT	$247	$52	$24	$7	$(16)	$314
Identifiable assets	$4,383	$244	$696	$386	$(86)	$5,623
Investment in joint ventures	-	-	-	235	(221)	14
Total assets	$4,383	$244	$696	$621	$(307)	$5,637
Goodwill	$340	$-	$-	$14	$-	$354
Capital expenditures	$205	$4	$8	$36	$11	$264

(1) Intercompany revenues – Wholesale services records its energy marketing and risk management revenue on a net basis. Wholesale services total operating revenues include intercompany revenues of $531 million, $792 million and $369 million for the years ended December 31, 2006, 2005 and 2004, respectively.

Note 12 - Quarterly Financial Data (Unaudited)

Our quarterly financial data for 2006, 2005 and 2004 are summarized below. The variance in our quarterly earnings is the result of the seasonal nature of our primary business.

In millions, except per share amounts	March 31	June 30	Sept. 30	Dec. 31
2006				
Operating revenues	$1,044	$436	$434	$707
Operating income	228	60	90	110
Net income	110	19	36	47
Basic earnings per share	1.42	0.25	0.46	0.60
Diluted earnings per share	1.41	0.25	0.46	0.60
2005				
Operating revenues	$908	$430	$387	$993
Operating income	181	66	54	141
Net income	88	24	15	66
Basic earnings per share	1.15	0.31	0.19	0.86
Diluted earnings per share	1.14	0.30	0.19	0.85
2004				
Operating revenues	$651	$294	$262	$625
Operating income	133	53	46	100
Net income	66	21	20	46
Basic earnings per share	1.02	0.34	0.31	0.64
Diluted earnings per share	1.00	0.33	0.31	0.64

Our basic and diluted earnings per common share are calculated based on the weighted daily average number of common shares and common share equivalents outstanding during the quarter. Those totals differ from the basic and diluted earnings per share shown in the statements of consolidated income, which are based on the weighted average number of common shares and common share equivalents outstanding during the entire year.

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of AGL Resources Inc.:

We have completed integrated audits of AGL Resources Inc.'s 2006, 2005 and 2004 consolidated financial statements and of its internal control over financial reporting as of December 31, 2006 in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions on AGL Resources Inc.'s 2006, 2005, and 2004 consolidated financial statements and on its internal control over financial reporting as of December 31, 2006, based on our audits and the reports of other auditors, are presented below.

Consolidated financial statements and financial statement schedule

In our opinion, based on our audits and the report of other auditors, the consolidated financial statements listed in the index appearing under Item 15(a)(1) present fairly, in all material respects, the financial position of AGL Resources Inc. and its subsidiaries at December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, based on our audits and the report of other auditors, the 2006, 2005 and 2004 financial statement schedule information listed in the index appearing under Item 15(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We did not audit the 2004 financial statements of SouthStar Energy Services LLC, a joint venture in which a subsidiary of the Company has a non-controlling 70% financial interest, which statements reflect total revenues of $827 million for the year ended December 31, 2004. Those statements were audited by other auditors whose report thereon has been furnished to us, and our opinion expressed herein, insofar as it relates to the amounts included for SouthStar Energy Services LLC., is based solely on the report of the other auditors. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits and the report of other auditors provide a reasonable basis for our opinion.

As discussed in Notes 5 and 4, respectively, to the consolidated financial statements, AGL Resources Inc. and subsidiaries changed its method of accounting for stock based compensation plans as of January 1, 2006 and its method of accounting for defined benefit pension and other postretirement plans as of December 31, 2006.

Internal control over financial reporting

Also, in our opinion, management's assessment, included in Management's Report on Internal Control Over Financial Reporting appearing under Item 9A, that the Company maintained effective internal control over financial reporting as of December 31, 2006 based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control - Integrated Framework* issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all

material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP

Atlanta, Georgia
February 6, 2007

Report of Ernst & Young LLP, Independent Registered Public Accounting Firm

The Executive Committee and Members
SouthStar Energy Services LLC

We have audited the statements of income, changes in members' capital, and cash flow of SouthStar Energy Services, LLC for the year ended December 31, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of SouthStar Energy Services LLC at December 31, 2004, and the results of its operations and its cash flow for the year ended December 31, 2004 in conformity with U.S. generally accepted accounting principles.

/s/ Ernst & Young LLP

Atlanta, Georgia
February 4, 2005

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None

ITEM 9A. CONTROLS AND PROCEDURES

Conclusions Regarding the Effectiveness of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act). Based on this evaluation, our principal executive officer and our principal financial officer concluded that our disclosure controls and procedures were effective as of December 31, 2006 in providing a reasonable level of assurance that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods in SEC rules and forms, including a reasonable level of assurance that information required to be disclosed by us in

such reports is accumulated and communicated to our management, including our principal executive officer and our principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

Management's Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Based on our evaluation under the framework in *Internal Control — Integrated Framework* issued by COSO, our management concluded that our internal control over financial reporting was effective as of December 31, 2006 in providing reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Our management's assessment of the effectiveness of our internal control over financial reporting as of December 31, 2006 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report.

February 6, 2007

/s/ John W Somerhalder II
John W. Somerhalder II
President and Chief Executive Officer

/s/ Andrew W. Evans
Andrew W. Evans
Executive Vice President and Chief Financial Officer

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting identified in connection with the above-referenced evaluation by management of the effectiveness of our internal control over financial reporting that occurred during the fourth quarter ended December 31, 2006, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

ITEM 9B. OTHER INFORMATION.

None

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by this item with respect to directors will be set forth under the captions "Proposal I -Election of Directors", - "Corporate Governance - Ethics and Compliance Program," – "Committees of the Board" and "- Audit Committee" in the Proxy Statement for our 2007 Annual Meeting of Shareholders or in a subsequent amendment to this report. The information required by this item with respect to the executive officers is set forth at Part I, Item 4A of this report under the caption "Executive Officers of the Registrant." The information required by this item with respect to Section 16(a) beneficial ownership reporting compliance will be set forth under the caption "Section 16(a) Beneficial Ownership Reporting Compliance" in the Proxy Statement or subsequent amendment referred to above. All such information that is provided in the Proxy Statement is incorporated herein by reference.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this item will be set forth under the captions "Compensation and Management Development Committee Report," "Compensation and Management Development Committee Interlocks and Insider Participation," "Director Compensation," "Compensation Discussion and Analysis" and "Executive Compensation" in the Proxy Statement or subsequent amendment referred to in Item 10 above. All such information that is provided in the Proxy Statement is incorporated herein by reference, except for the information under the caption "Compensation and Management Development Committee Report" which is specifically not so incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this item will be set forth under the captions "Share Ownership" and "Executive Compensation -- Equity Compensation Plan Information" in the Proxy Statement or subsequent amendment referred to in Item 10 above. All such information that is provided in the Proxy Statement is incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

The information required by this item will be set forth under the captions "Corporate Governance – Director Independence" and "- Policy on Related Person Transactions" and "Certain Relationships and Related Transactions" in the Proxy Statement or subsequent amendment referred to in Item 10 above. All such information that is provided in the Proxy Statement is incorporated herein by reference.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this item will be set forth under the caption "Proposal 3 – Ratification of the Appointment of PricewaterhouseCoopers LLP as Our Independent Registered Public Accounting Firm for 2007" in the Proxy Statement or subsequent amendment to referred to in Item 10 above. All such information that is provided in the Proxy Statement is incorporated herein by reference.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) Documents Filed as Part of This Report.

(1) Financial Statements Included in Item 8 are the following financial statements:

- Consolidated Balance Sheets as of December 31, 2006 and 2005
- Statements of Consolidated Income for the years ended December 31, 2006, 2005, and 2004
- Statements of Consolidated Common Shareholders' Equity for the years ended December 31, 2006, 2005 and 2004
- Statements of Consolidated Cash Flows for the years ended December 31, 2006, 2005, and 2004
- Notes to Consolidated Financial Statements
- Reports of Independent Registered Public Accounting Firms

(2) Financial Statement Schedules

Financial Statement Schedule II. Valuation and Qualifying Accounts - Allowance for Uncollectible Accounts and Income Tax Valuations for Each of the Three Years in the Period Ended December 31, 2006

Schedules other than those referred to above are omitted and are not applicable or not required, or the required information is shown in the financial statements or notes thereto.

(3) Exhibits

Where an exhibit is filed by incorporation by reference to a previously filed registration statement or report, such registration statement or report is identified in parentheses.

3.1	Amended and Restated Articles of Incorporation filed November 2, 2005, with the Secretary of State of the state of Georgia (Exhibit 3.1, AGL Resources Inc. Form 8-K dated November 2, 2005).
3.2	Bylaws, as amended on October 26, 2006 (Exhibit 3.2, AGL Resources, Inc. Form 8-K dated November 1, 2006).
4.1.a	Specimen form of Common Stock certificate (Exhibit 4.1, AGL Resources Inc. Form 10-K for the fiscal year ended September 30, 1999).
4.1.b	Specimen AGL Capital Corporation 6.00% Senior Notes due 2034 (Exhibit 4.1, AGL Resources Inc. Form 8-K dated September 22, 2004).
4.1.c	Specimen AGL Capital Corporation 4.95% Senior Notes due 2015. (Exhibit 4.1, AGL Resources Inc. Form 8-K dated December 15, 2004).
4.1.d	Specimen form of Right certificate (Exhibit 1, AGL Resources Inc. Form 8-K filed March 6, 1996).
4.2.a	Indenture, dated as of December 1, 1989, between Atlanta Gas Light Company and Bankers Trust Company, as Trustee (Exhibit 4(a), Atlanta Gas Light Company registration statement on Form S-3, No. 33-32274).
4.2.b	First Supplemental Indenture dated as of March 16, 1992, between Atlanta Gas Light Company and NationsBank of Georgia, National Association, as Successor Trustee (Exhibit 4(a), Atlanta Gas Light Company registration statement on Form S-3, No. 33-46419).
4.2.c	Indenture, dated February 20, 2001 among AGL Capital Corporation, AGL Resources Inc. and The Bank of New York, as Trustee (Exhibit 4.2, AGL Resources Inc. registration statement on Form S-3, filed on September 17, 2001, No. 333-69500).
4.2.d	Specimen AGL Capital Corporation 6.375% Senior Notes due 2016 (incorporated herein by reference to Exhibit 4.1 of AGL Resources Inc. Form 8-K dated June 27, 2006).

4.3.a Guarantee of AGL Resources Inc. dated as of September 27, 2004 regarding the AGL Capital Corporation 6.00% Senior Note due 2034 (Exhibit 4.3, AGL Resources Inc. Form 8-K dated September 22, 2004).

4.3.b Guarantee of AGL Resources Inc. dated as of December 20, 2004 regarding the AGL Capital Corporation 4.95% Senior Note due 2015 (Exhibit 4.3, AGL Resources Inc. Form 8-K dated December 15, 2004).

4.3.c Form of Guarantee of AGL Resources Inc. dated as of June 30, 2006 regarding the AGL Capital Corporation 6.375% Senior Notes due 2016 (incorporated herein by reference to Exhibit 4.3 of AGL Resources Inc. Form 8-K dated June 27, 2006).

4.4.a Rights Agreement dated as of March 6, 1996 between AGL Resources Inc. and Wachovia Bank of North Carolina, N.A. as Rights Agent (Exhibit 1, AGL Resources Inc. Form 8-A dated March 6, 1996).

4.4.b Second Amendment to Rights Agreement dated as of June 5, 2002 between AGL Resources Inc. and Equiserve Trust Company, N.A. (Exhibit 1, AGL Resources Inc. Amendment No. 1 to Form 8-A dated June 2, 2002).

10.1 Director and Executive Compensation Contracts, Plans and Arrangements.

Director Compensation Contracts, Plans and Arrangements

10.1.a AGL Resources Inc. Amended and Restated 1996 Non-Employee Directors Equity Compensation Plan (Exhibit 10.1, AGL Resources Inc. Form 10-Q for the quarter ended September 30, 2002).

10.1.b First Amendment to the AGL Resources Inc. Amended and Restated 1996 Non-Employee Directors Equity Compensation Plan (Exhibit 10.1.o, AGL Resources Inc. Form 10-K for the fiscal year ended December 31, 2002).

10.1.c AGL Resources Inc. 2006 Non-Employee Directors Equity Compensation Plan (incorporated herein by reference to Annex C of the AGL Resources Inc. Proxy Statement for the Annual Meeting of Shareholders held May 3, 2006 filed on March 20, 2006).

10.1.d AGL Resources Inc. 1998 Common Stock Equivalent Plan for Non-Employee Directors (Exhibit 10.1.b, AGL Resources Inc. Form 10-Q for the quarter ended December 31, 1997).

10.1.e First Amendment to the AGL Resources Inc. 1998 Common Stock Equivalent Plan for Non-Employee Directors (Exhibit 10.5, AGL Resources Inc. Form 10-Q for the quarter ended March 31, 2000).

10.1.f Second Amendment to the AGL Resources Inc. 1998 Common Stock Equivalent Plan for Non-Employee Directors (Exhibit 10.4, AGL Resources Inc. Form 10-Q for the quarter ended September 30, 2002).

10.1.g Third Amendment to the AGL Resources Inc. 1998 Common Stock Equivalent Plan for Non-Employee Directors (Exhibit 10.5, AGL Resources Inc. Form 10-Q for the quarter ended September 30, 2002).

10.1.h Description of Directors' Compensation (Exhibit 10.1, AGL Resources Inc. Form 8-K dated December 1, 2004).

10.1.i Description of Director's Compensation with respect to the annual retainer and description of Director non-employee share-ownership guidelines (Item 1.01, AGL Resources Inc. Form 8-K dated December 7, 2005).

10.1.j Description of Director's Compensation with respect to the annual retainer and description of Director non-employee share-ownership guidelines (Item 1.01, AGL Resources Inc. Form 8-K dated October 26, 2006).

10.1.k Form of Stock Award Agreement for Non-Employee Directors (Exhibit 10.1.aj, AGL Resources Inc. Form 10-K for the fiscal year ended December 31, 2004).

10.1.l Form on Nonqualified Stock Option Agreement for Non-Employee Directors (Exhibit 10.1.ak, AGL Resources Inc. Form 10-K for the fiscal year ended December 31, 2004).

10.1.m Form of Director Indemnification Agreement, dated April 28, 2004, between AGL Resources Inc., on behalf of itself and the Indemnities named therein (Exhibit 10.3, AGL Resources Inc. Form 10-Q for the quarter ended June 30, 2004).

Executive Compensation Contracts, Plans and Arrangements.

10.1.n	AGL Resources Inc. Long-Term Stock Incentive Plan of 1990 (Exhibit 10(ii), Atlanta Gas Light Company Form 10-K for the fiscal year ended September 30, 1991).
10.1.o	First Amendment to the AGL Resources Inc. Long-Term Stock Incentive Plan of 1990 (Exhibit B to the Atlanta Gas Light Company Proxy Statement for the Annual Meeting of Shareholders held February 5, 1993).
10.1.p	Second Amendment to the AGL Resources Inc. Long-Term Stock Incentive Plan of 1990 (Exhibit 10.1.d, AGL Resources Inc. Form 10-K for the fiscal year ended September 30, 1997).
10.1.q	Third Amendment to the AGL Resources Inc. Long-Term Stock Incentive Plan of 1990 (Exhibit C to the Proxy Statement and Prospectus filed as a part of Amendment No. 1 to Registration Statement on Form S-4, No. 33-99826).
10.1.r	Fourth Amendment to the AGL Resources Inc. Long-Term Stock Incentive Plan of 1990 (Exhibit 10.1.f, AGL Resources Inc. Form 10-K for the fiscal year ended September 30, 1997).
10.1.s	Fifth Amendment to the AGL Resources Inc. Long-Term Stock Incentive Plan of 1990 (Exhibit 10.1.g, AGL Resources Inc. Form 10-K for the fiscal year ended September 30, 1997).
10.1.t	Sixth Amendment to the AGL Resources Inc. Long-Term Stock Incentive Plan of 1990 (Exhibit 10.1.a, AGL Resources Inc. Form 10-Q for the quarter ended March 31, 1998).
10.1.u	Seventh Amendment to the AGL Resources Inc. Long-Term Stock Incentive Plan of 1990 (Exhibit 10.1, AGL Resources Inc. Form 10-Q for the quarter ended December 31, 1998).
10.1.v	Eighth Amendment to the AGL Resources Inc. Long-Term Stock Incentive Plan of 1990 (Exhibit 10.1, AGL Resources Inc. Form 10-Q for the quarter ended March 31, 2000).
10.1.w	Ninth Amendment to the AGL Resources Inc. Long-Term Stock Incentive Plan 1990 (Exhibit 10.6, AGL Resources Inc. Form 10-Q for the quarter ended September 30, 2002).
10.1.x	AGL Resources Inc. Long-Term Incentive Plan (1999), as amended and restated as of January 1, 2002 (Exhibit 99.2, AGL Resources Inc. Form 10-Q for the quarter ended March 31, 2002).
10.1.y	First amendment to the AGL Resources Inc. Long-Term Incentive Plan (1999), as amended and restated (Exhibit 10.1.b, AGL Resources Inc. Form 10-K for the fiscal year ended December 31, 2004).
10.1.z	AGL Resources Inc. Officer Incentive Plan (Exhibit 10.2, AGL Resources Inc. Form 10-Q for the quarter ended June 30, 2001).
10.1.aa	Form of Incentive Stock Option Agreement, Nonqualified Stock Option Agreement and Restricted Stock Agreement for key employees (Exhibit 10.1, AGL Resources Inc. Form 10-Q for the quarter ended September 30, 2004).
10.1.ab	Form of Performance Unit Agreement for key employees (Exhibit 10.1.e, AGL Resources Inc. Form 10-K for the fiscal year ended December 31, 2004).
10.1.ac	Forms of Nonqualified Stock Option Agreement without the reload provision (LTIP and Officer Plan) (Exhibit 10.1, AGL Resources Inc. Form 8-K dated March 15, 2005).
10.1.ad	Form of Nonqualified Stock Option Agreement with the reload provision (Officer Plan) (Exhibit 10.2, AGL Resources Inc. Form 8-K dated March 15, 2005).
10.1.ae	Form of Restricted Stock Unit Agreement and Performance Cash Unit Agreement for key employees (Exhibit 10.1 and 10.2, respectively, AGL Resources Inc. Form 8-K dated February 24, 2006).
10.1.af	AGL Resources Inc. Nonqualified Savings Plan as amended and restated as of January 1, 2007.
10.1.ag	AGL Resources Inc. Executive Performance Incentive Plan dated February 2, 2002 (Exhibit 99.1, AGL Resources Inc. Form 10-Q for the quarter ended March 31, 2002).
10.1.ah	AGL Resources Inc. Annual Incentive Plan - 2006 (Exhibit 10.1, AGL Resources Inc. Form 8-K/A dated February 24, 2006).
10.1.ai	Description of Annual Incentive Compensation Arrangement for Douglas N. Schantz.

10.1.aj Continuity Agreement, dated December 1, 2003, by and between AGL Resources Inc., on behalf of itself and AGL Services Company (its wholly owned subsidiary) and Kevin P. Madden (Exhibit 10.1.w, AGL Resources Inc. Form 10-K for the fiscal year ended December 31, 2003).

10.1.ak Amendment to Continuity Agreement, dated February 24, 2006, by and between AGL Resources Inc., on behalf of itself and AGL Services Company (its wholly owned subsidiary) and Kevin P. Madden (Exhibit 10.6, AGL Resources Inc. Form 8-K/A dated February 24, 2006).

10.1.al Continuity Agreement, dated December 1, 2003, by and between AGL Resources Inc., on behalf of itself and AGL Services Company (its wholly owned subsidiary) and Paul R. Shlanta (Exhibit 10.1.z, AGL Resources Inc. Form 10-K for the fiscal year ended December 31, 2003).

10.1.am Amendment to Continuity Agreement, dated February 24, 2006, by and between AGL Resources Inc., on behalf of itself and AGL Services Company (its wholly owned subsidiary) and Paul R. Shlanta (Exhibit 10.7, AGL Resources Inc. Form 8-K/A dated February 24, 2006.

10.1.an Continuity Agreement, dated December 1, 2003, by and between AGL Resources Inc., on behalf of itself and AGL Services Company (its wholly owned subsidiary) and Melanie M. Platt (Exhibit 10.2, AGL Resources Inc. Form 10-Q for the quarter ended June 30, 2004).

10.1.ao Continuity Agreement, dated September 30, 2005, by and between AGL Resources Inc., on behalf of itself and AGL Services Company (its wholly owned subsidiary) and Andrew W. Evans (Exhibit 10.1, AGL Resources Inc. Form 8-K dated September 27, 2005).

10.1.ap Amendment to Continuity Agreement, dated February 24, 2006, by and between AGL Resources Inc., on behalf of itself and AGL Services Company (its wholly owned subsidiary) and Andrew W, Evans (Exhibit 10.5, AGL Resources Inc. Form 8-K/A dated February 24, 2006.

10.1.aq Continuity Agreement, dated January 1, 2006, by and between AGL Resources, Inc., on behalf of itself and AGL Services Company (its wholly owned subsidiary) and R. Eric Martinez, Jr. (Exhibit 10.4, AGL Resources Inc. Form 8-K/A dated February 24, 2006).

10.1.ar Continuity Agreement, dated March 3, 2006, by and between AGL Resources Inc., on behalf of itself and AGL Services Company (its wholly owned subsidiary) and John W. Somerhalder II (Exhibit 10.2 AGL Resources, Inc. Form 8-K dated March 8, 2006).

10.1.as Continuity Agreement, dated March 15, 2006, by and between AGL Resources Inc., on behalf of itself and AGL Services Company (its wholly owned subsidiary) and Douglas N. Shantz.

10.1.at Form of AGL Resources Inc. Executive Post Employment Medical Benefit Plan (Exhibit 10.1.d, AGL Resources Inc. Form 10-Q for the quarter ended June 30, 2003).

10.1.au Description of Compensation Agreement for Andrew W. Evans (Item 1.01, AGL Resources Inc. Form 8-K, dated September 27, 2005).

10.1.av Description of Compensation Agreement for D. Raymond Riddle (Item 1.01, AGL Resources Inc. Form 8-K/A Amendment No. 1, dated December 6, 2005).

10.1.aw Description of Compensation Agreements for Kevin P. Madden and R. Eric Martinez, Jr. (Item 1.01, AGL Resources Inc. Form 8-K/A Amendment No. 1, dated December 7, 2005).

10.1.ax Description of Compensation Agreement for each of Kevin P. Madden, R. Eric Martinez, Jr., Paul R. Shlanta and Andrew W. Evans (Item 1.01, AGL Resources Inc. Form 8-K, dated February 1, 2006).

10.1.ay Description of Compensation Agreement for each of John W. Somerhalder, Kevin P. Madden, R. Eric Martinez, Jr., Paul R. Shlanta and Andrew W. Evans (Item 1.01, AGL Resources Inc. Form 8-K, dated February 1, 2006).

10.1.az Description of Compensation Agreement for each of Andrew W. Evans and R. Eric Martinez, Jr. (Item 1.01, AGL Resources Inc. Form 8-K, dated May 2, 2006).

10.1.ba AGL Resources Inc. Share Repurchase Program, dated February 3, 2006 (Item 1.01 AGL Resources Inc. Form 8-K, dated February 1, 2006).

10.2 Guaranty Agreement, effective December 13, 2005, by and between Atlanta Gas Light Company and AGL Resources Inc.

10.3 Form of Commercial Paper Dealer Agreement between AGL Capital Corporation, as Issuer, AGL Resources Inc., as Guarantor, and the Dealers named therein, dated September 25, 2000 (Exhibit 10.79, AGL Resources Inc. Form 10-K for the fiscal year ended September 30, 2000).

10.4 Guarantee of AGL Resources Inc., dated October 5, 2000, of payments on promissory notes issued by AGL Capital Corporation (AGLCC) pursuant to the Issuing and Paying Agency Agreement dated September 25, 2000, between AGLCC and The Bank of New York (Exhibit 10.80, AGL Resources Inc. Form 10-K for the fiscal year ended September 30, 2000).

10.5 Issuing and Paying Agency Agreement, dated September 25, 2000, between AGL Capital Corporation and The Bank of New York. (Exhibit 10.81, AGL Resources Inc. Form 10-K for the fiscal year ended September 30, 2000).

10.6 Amended and Restated Master Environmental Management Services Agreement, dated July 25, 2002 by and between Atlanta Gas Light Company and The RETEC Group, Inc. (Exhibit 10.2, AGL Resources Inc. Form 10-Q for the quarter ended June 30, 2003). (Confidential treatment pursuant to 17 CFR Sections 200.80 (b) and 240.24-b has been granted regarding certain portions of this exhibit, which portions have been filed separately with the Commission).

10.7 Credit Agreement dated as of August 31, 2006, by and among AGL Resources Inc., AGL Capital Corporation, SunTrust Bank, as administrative agent, Wachovia Bank, National Association, as syndication agent, JPMorgan Chase Bank, N.A., The Bank of Tokyo-Mitsubishi UFJ, Ltd. and Calyon New York Branch, as co-documentation agents, and the several other banks and other financial institutions named therein (Exhibit 10, AGL Resources Inc. Form 8-K dated August 31, 2006).

10.8 SouthStar Energy Services LLC Agreement, dated April 1, 2004 by and between Georgia Natural Gas Company and Piedmont Energy Company (Exhibit 10, AGL Resources Inc. Form 10-Q for the quarter ended March 31, 2004).

14 AGL Resources Inc. Code of Ethics for its Chief Executive Officer and its Senior Financial Officers (Exhibit 14, AGL Resources Inc. Form 10-K for the year ended December 31, 2004).

21 Subsidiaries of AGL Resources Inc.

23.1 Consent of PricewaterhouseCoopers LLP, independent registered public accounting firm.

23.2 Consent of Ernst & Young LLP, independent registered public accounting firm.

24 Powers of Attorney (included on signature page hereto).

31.1 Certification of John W. Somerhalder II pursuant to Rule 13a – 14(a).

31.2 Certification of Andrew W. Evans pursuant to Rule 13a – 14(a).

32.1 Certification of John W. Somerhalder II pursuant to 18 U.S.C. Section 1350.

32.2 Certification of Andrew W. Evans pursuant to 18 U.S.C. Section 1350.

(b) Exhibits filed as part of this report.

See Item 15(a)(3).

(c) Financial statement schedules filed as part of this report.

See Item 15(a)(2).

SIGNATURES

In accordance with Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned; thereunto duly authorized, on January 31, 2007.

AGL RESOURCES INC.

By: /s/ John W. Somerhalder II
John W. Somerhalder II
President and Chief Executive Officer

Power of Attorney

KNOW ALL MEN BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints John W. Somerhalder II, Andrew W. Evans, Paul R. Shlanta and Bryan E. Seas, and each of them, his or her true and lawful attorneys-in-fact and agents, with full power of substitution and resubstitution, for him or her and in his or her name, place and stead, in any and all capacities, to sign any and all amendments to this Annual Report on Form 10-K for the year ended December 31, 2006, and to file the same, with all exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing requisite or necessary to be done, as fully to all intents and purposes as he or she might or could do in person, hereby ratifying and confirming all that said attorneys-in-fact and agents or any of them, or their or his substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated as of January 31, 2007.

Signatures	Title
/s/ John W. Somerhalder II John W. Somerhalder II	President and Chief Executive Officer (Principal Executive Officer)
/s/ Andrew W. Evans Andrew W. Evans	Executive Vice President and Chief Financial Officer (Principal Financial Officer)
/s/ Bryan E. Seas Bryan E. Seas	Vice President, Controller and Chief Accounting Officer (Principal Accounting Officer)
/s/ D. Raymond Riddle D. Raymond Riddle	Chairman of the Board
/s/ Thomas D. Bell, Jr. Thomas D. Bell, Jr.	Director
/s/ Charles R. Crisp Charles R. Crisp	Director
/s/ Michael J. Durham Michael J. Durham	Director
/s/ Arthur E. Johnson Arthur E. Johnson	Director
/s/ Wyck A. Knox, Jr. Wyck A. Knox, Jr.	Director
/s/ Dennis M. Love Dennis M. Love	Director
/s/ Charles H. McTier Charles H. McTier	Director
/s/ Dean R. O'Hare Dean R. O'Hare	Director
/s/ James A. Rubright James A. Rubright	Director
/s/ Felker W. Ward, Jr. Felker W. Ward, Jr.	Director
/s/ Bettina M. Whyte Bettina M. Whyte	Director
/s/ Henry C. Wolf Henry C. Wolf	Director

Schedule II

AGL Resources Inc. and Subsidiaries

VALUATION AND QUALIFYING ACCOUNTS - ALLOWANCE FOR UNCOLLECTIBLE ACCOUNTS AND INCOME TAX VALUATION FOR EACH OF THE THREE YEARS IN THE PERIOD ENDED DECEMBER 31, 2006.

In millions	Allowance for uncollectible accounts	Income tax valuation
Balance at December 31, 2003	$2	$-
Provisions charged to income in 2004	5	-
Accounts written off as uncollectible, net in 2004	(5)	-
Additional provisions due to NUI acquisition	4	8
Additional provisions due to consolidation of SouthStar	9	-
Balance at December 31, 2004	15	8
Provisions charged to income in 2005	17	-
Accounts written off as uncollectible, net in 2005	(17)	-
Additional valuation allowances	-	1
Balance at December 31, 2005	15	9
Provisions charged to income in 2006	22	-
Accounts written off as uncollectible, net in 2006	(22)	-
Decrease due to change in circumstances	-	(6)
Balance at December 31, 2006	$15	$3

FORM 10-K

NORTHERN ILLINOIS GAS CO /IL/ /NEW/ – N/A

Filed: February 23, 2007 (period: December 31, 2006)

Annual report which provides a comprehensive overview of the company for the past year

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EX−12.01 (EXHIBIT 12.01 − RATIO OF EARNINGS TO FIXED CHARGES)

EX−23.01 (EXHIBIT 23.01 − CONSENT OF PUBLIC ACCOUNTING FIRM)

EX−24.01 (EXHIBIT 24.01 − POWERS OF ATTORNEY)

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

FORM 10-K

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2006

or

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission File Number 1-7296

NORTHERN ILLINOIS GAS COMPANY
(Doing Business as NICOR GAS COMPANY)
(Exact name of registrant as specified in its charter)

Illinois (State of Incorporation)	**36-2863847** (I.R.S. Employer Identification Number)
1844 Ferry Road **Naperville, Illinois 60563-9600** (Address of principal executive offices)	**(630) 983-8888** (Registrant's telephone number)

Securities registered pursuant to Section 12(b) or 12(g) of the Act: None

The registrant meets the conditions set forth in General Instruction I(1)(a) and (b) of Form 10-K and is therefore filing this Form with the reduced disclosure format.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes [ ] No [X]

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes [ ] No [X]

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 and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [ ]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [X]

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

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

All shares of common stock are owned by Nicor Inc.

Nicor Gas Company

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* The Registrant meets the conditions set forth in General Instruction I(1)(a) and (b) of Form 10–K and is therefore omitting the information called for by the otherwise required item.

Source: NORTHERN ILLINOIS GA, 10-K, February 23, 2007

Nicor Gas Company

Glossary

ARO. Asset retirement obligation.

Chicago Hub. A venture of Nicor Gas, which provides natural gas storage and transmission–related services to marketers and other gas distribution companies.

Degree day. The extent to which the daily average temperature falls below 65 degrees Fahrenheit.
Normal weather for Nicor Gas' service territory, for purposes of this report, is considered to be 5,830 degree days per year for 2006 and 2005, and 6,000 degree days per year for 2004.

FASB. Financial Accounting Standards Board.

FERC. Federal Energy Regulatory Commission, the agency that regulates the interstate transportation of natural gas, oil and electricity.

FSP. FASB Staff Position.

ICC. Illinois Commerce Commission, the agency that establishes the rules and regulations governing utility rates and services in Illinois.

IRS. Internal Revenue Service.

LIFO. Last in, first out.

Mcf, MMcf, Bcf. Thousand cubic feet, million cubic feet, billion cubic feet.

MMBtus. Million British thermal units.

Nicor Gas. Northern Illinois Gas Company (doing business as Nicor Gas Company), a wholly owned public utility business and one of the nation's largest distributors of natural gas.

Nicor. Nicor Inc., the parent company of Nicor Gas.

PBR. Performance–based rate, a regulatory plan which ended on January 1, 2003, that provided economic incentives based on natural gas cost performance.

PGA. Nicor Gas' Purchased Gas Adjustment.

SEC. The United States Securities and Exchange Commission.

SFAS. Statement of Financial Accounting Standard.

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

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PART I

Item 1. Business

Nicor Gas, an Illinois corporation formed in 1954, is a wholly owned subsidiary of Nicor, a holding company. Certain terms used herein are defined in the glossary on page ii.

GENERAL

Nicor Gas, a regulated natural gas distribution utility, serves nearly 2.2 million customers in a service territory that encompasses most of the northern third of Illinois, excluding the city of Chicago. The company's service territory is diverse and its customer base has grown steadily over the years, providing the company with a well–balanced mix of residential, commercial and industrial customers. Residential customers typically account for 45 to 50 percent of natural gas deliveries, while commercial and industrial customers each typically account for 25 to 30 percent. See Operating Statistics on page 12 for operating revenues, deliveries and number of customers by customer classification. Nicor Gas had approximately 2,100 employees at year–end 2006.

Nicor Gas maintains franchise agreements with most of the communities it serves, allowing it to construct, operate and maintain distribution facilities in those communities. Franchise agreement terms range up to 50 years. Currently, about 20 percent of the agreements will expire within five years.

Customers have the option of purchasing their own gas supplies, with delivery of the gas by Nicor Gas. The larger of these transportation customers also have options that include the use of Nicor Gas' storage system and the ability to choose varying supply backup levels. The choice of transportation service as compared to gas sales service results in less revenue for Nicor Gas but has no direct impact on net operating results. Nicor Gas continues to deliver the natural gas, maintain its distribution system and respond to emergencies.

Nicor Gas also operates the Chicago Hub, which provides natural gas storage and transmission–related services to marketers and other gas distribution companies. The Chicago area is a major market hub for natural gas, and demand exists for storage and transmission–related services by marketers, other gas distribution companies and electric power–generation facilities. Nicor Gas' Chicago Hub addresses that demand. Effective in the fourth quarter of 2005, the rate order received by Nicor Gas provides that Chicago Hub revenues be passed directly through to customers as a credit to Nicor Gas' PGA rider.

SOURCES OF NATURAL GAS SUPPLY

Nicor Gas purchases natural gas supplies in the open market by contracting with producers and marketers. It also purchases transportation and storage services from interstate pipelines that are regulated by the FERC. When firm pipeline services are temporarily not needed, Nicor Gas may release the services in the secondary market under FERC–mandated capacity release provisions, with proceeds reducing the cost of gas charged to customers.

Peak–use requirements are met through utilization of company–owned storage facilities, pipeline transportation capacity, purchased storage services and other supply sources, arranged by either Nicor Gas or its transportation customers. Nicor Gas has been able to obtain sufficient supplies of natural gas to meet customer requirements. The company believes natural gas supply and pipeline capacity will be sufficiently available to meet market demands in the foreseeable future.

Natural gas supply. Nicor Gas maintains a diversified portfolio of natural gas supply contracts. Supply purchases are diversified by supplier, producing region, quantity, credit limits and available transportation. Gas supply pricing is generally tied to published price indices so as to approximate

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

current market prices. These supply contracts also may require the payment of fixed demand charges to ensure the availability of supplies on any given day.

The company also purchases gas supplies on the spot market to fulfill its supply requirements or to take advantage of favorable short–term pricing. Spot gas purchases accounted for about 40 percent of the company's total gas purchases in the last three years. The majority of such spot purchases are made during the summer months and are directed toward satisfying storage injection requirements.

As part of its purchasing practices, Nicor Gas maintains a price risk hedging strategy to reduce the risk of short–term price volatility. A disciplined approach is used to systematically forward hedge a predetermined portion of forecasted monthly volumes.

As noted previously, transportation customers purchase their own gas supplies. About one–half of the gas that the company delivers is purchased by transportation customers directly from producers and marketers.

Pipeline transportation. Nicor Gas is directly connected to eight interstate pipelines, providing access to most of the major natural gas producing regions in North America. The company's primary long–term transportation contracts are as follows (daily availability in MMBtus):

	Availability	Contract Expiration
Natural Gas Pipeline Company (NGPL)	968,000	Various dates through March 2012
Horizon Pipeline	300,000	May 2012
Tennessee Gas Pipeline Company (TGPC)	253,000	October 2009
Midwestern Gas Transmission Company	297,000	Various dates through October 2009
Northern Natural Gas Company	206,000	October 2008
ANR Pipeline	100,000	Various dates through March 2010
Texas Gas	47,000	March 2009

The company has rights of first refusal for contract extensions except for the TGPC contract. In addition to the above contracts, Nicor Gas enters into short–term winter only transportation contracts and contracts that enhance Nicor Gas' operational flexibility. The availability numbers shown above represent maximums during the winter heating season. In some cases, the contract levels are lower during the summer period.

Storage. Nicor Gas owns and operates eight underground natural gas storage facilities. This storage system is one of the largest in the gas distribution industry. With about 150 Bcf of annual storage capacity, the system is designed to meet about 50 percent of the company's estimated peak–day deliveries and approximately 30 percent of its normal winter deliveries. In addition to company–owned facilities, Nicor Gas has about 40 Bcf of purchased storage services under contracts with NGPL that expire in 2009, 2010 and 2012. This level of storage capability provides Nicor Gas with supply flexibility, improves the reliability of deliveries, and can mitigate the risk associated with seasonal price movements.

COMPETITION/DEMAND

Nicor Gas is the largest natural gas distributor in Illinois and, as a regulated monopoly, has the exclusive right to distribute natural gas in its service territory. Substantially all single–family homes in Nicor Gas' service territory are heated with natural gas. In the commercial and industrial markets, the company's natural gas services compete with other forms of energy, such as electricity, coal, propane and oil, based on such factors as price, service, reliability and environmental impact. In addition, the company has a rate that allows negotiation with potential bypass customers, and no such customer has bypassed the Nicor Gas system since the rate became effective in 1987. Nicor Gas also offers commercial and industrial customers alternatives in rates and service, increasing its ability to compete in these markets. Other significant factors that impact demand for natural gas include weather and economic conditions.

Natural gas deliveries are temperature–sensitive and seasonal since about one–half of all deliveries are used for space heating. Typically, about three–quarters of the deliveries and revenues occur from October through March. Fluctuations in weather have the potential to significantly impact year–to–year comparisons of operating income and cash flow. It is estimated that a 100 degree–day variation from normal (5,830 degree days annually) would impact Nicor Gas' net income by approximately $1.6 million.

Nicor Gas' large residential customer base provides for a relatively stable level of natural gas deliveries during weak economic conditions. The company's industrial and commercial customer base is well diversified, lessening the impact of industry–specific economic swings. However, management believes that declines since 2000 in natural gas deliveries to industrial customers may be permanent. In addition, during periods of high natural gas prices, deliveries of natural gas can be negatively affected by conservation and the use of alternative energy sources.

REGULATION

Nicor Gas is regulated by the ICC, which establishes the rules and regulations governing utility rates and services in Illinois. Those rules or regulations that may significantly affect business performance include the following:

- Base rates, which are set by the ICC, are designed to allow the company an opportunity to recover its costs and earn a fair return for investors. In the fourth quarter of 2005, the company received approval from the ICC for a base rate increase. For additional information about the rate order, see Item 7 – Management's Discussion and Analysis of Financial Condition and Results of Operations and Item 8 – Notes to the Consolidated Financial Statements – Note 14 – Rate proceeding.

- The company's ICC–approved tariffs provide that the cost of natural gas purchased for customers will be fully charged to customers without markup. Therefore, the company does not profit from the sale of natural gas. Rather, the company earns income from fixed monthly charges and from variable transportation charges for delivering natural gas to customer premises. Annually, the ICC initiates a review of the company's natural gas purchasing practices for prudence, and may disallow the pass–through of costs considered imprudent.

- As with the cost of natural gas, the company has a tariff that provides for the pass–through of prudently incurred environmental costs related to former manufactured gas plant sites. This pass–through is also subject to annual ICC review.

The ICC also has other rules that impact the company's operations. Changes in these rules can impact operating and capital costs.

A PBR plan for natural gas costs went into effect in 2000 and was terminated by the company effective January 1, 2003. Under the PBR plan, Nicor Gas' total gas supply costs were compared to a market–sensitive benchmark. Savings and losses relative to the benchmark were determined annually and shared equally with sales customers. The results of the PBR plan are currently under ICC review. Additional information on the plan and the ICC review are presented in Item 8 – Notes to the Consolidated Financial Statements – Note 16 – Contingencies – Performance–Based Rate Plan.

AVAILABLE INFORMATION

Nicor Gas files various reports with the SEC. These reports include the annual reports on Form 10–K, quarterly reports on Form 10–Q, current reports on Form 8–K and amendments to those reports filed or furnished pursuant to Section 15 (d) of the Securities Exchange Act of 1934. Nicor Gas makes all of these reports available without charge to the public on the investor relations section of the company's Internet site at www.nicor.com as soon as reasonably practicable after Nicor Gas files them with, or furnishes them to, the SEC.

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

Item 1A. Risk Factors

The following factors are the most significant factors that can impact year–to–year comparisons and may affect the future performance of the company. New risks may emerge and management cannot predict those risks or estimate the extent to which they may affect the company's financial performance.

Regulation of Nicor Gas, including changes in the regulatory environment in general, may adversely affect the company's results of operations, cash flows and financial condition.

Nicor Gas is regulated by the ICC, which has general regulatory power over practically all phases of the public utility business in Illinois, including rates and charges, issuance of securities, services and facilities, system of accounts, investments, safety standards and transactions with affiliated interests and other matters.

Nicor Gas is permitted by the ICC's PGA regulation to adjust the charge to its sales customers on a monthly basis to recover the company's prudently incurred actual costs to acquire the natural gas it delivers to them. The company's gas costs are subject to subsequent prudence reviews by the ICC for which the company makes annual filings. The annual prudence reviews for calendar years 1999–2006 are open for review and any disallowance of costs in those proceedings could adversely affect Nicor Gas' results of operations, cash flows and financial condition. See Item 7 – Management's Discussion and Analysis of Financial Condition and Results of Operations for further discussion of annual prudence reviews.

Most of Nicor Gas' other charges are changed only through a rate case proceeding with the ICC. The charges established in a rate case proceeding are based on an approved level of operating costs and investment in utility property and are designed to allow the company an opportunity to recover those costs and to earn a fair return on that investment. To the extent Nicor Gas' actual costs to provide utility service are higher than the levels approved by the ICC, Nicor Gas' results of operations, cash flows and financial condition could be adversely affected until such time as it files for and obtains ICC approval for new charges through a rate case proceeding.

Nicor Gas is also subject to rules and regulations pertaining to the integrity of its distribution system and environmental compliance. The company's results of operations, cash flows and financial condition could be adversely affected by any additional laws or regulations that are enacted that require significant increases in the amount of expenditures for system integrity and environmental compliance.

A change in the ICC's approved rate mechanisms for recovery of environmental remediation costs at former manufactured gas sites, or adverse decisions with respect to the prudence of costs actually incurred, could adversely affect the company's results of operations, cash flows and financial condition.

Current environmental laws may require the cleanup of coal tar at certain former manufactured gas plant sites. To date, Nicor Gas has identified about 40 properties for which it may in part be responsible. As of December 31, 2006, the company had recorded a liability of $19.9 million associated with certain remediation efforts. Management believes that any such costs that are not recoverable from other entities or from insurance carriers are recoverable through rates for utility services under ICC–approved mechanisms for the recovery of prudently incurred costs. A change in these rate recovery mechanisms, however, or a decision by the ICC that some or all of these costs were not prudently incurred, could adversely affect the company's results of operations, cash flows and financial condition. See Item 7 – Management's Discussion and Analysis of Financial Condition and Results of Operations for further discussion.

Source: NORTHERN ILLINOIS GA, 10-K, February 23, 2007

An adverse decision in the proceedings concerning Nicor Gas' PBR Plan could result in a refund obligation which could adversely affect the company's results of operations, cash flows and financial condition.

In 2000, Nicor Gas instituted a PBR plan for natural gas costs. Under the PBR plan, Nicor Gas' total gas supply costs were compared to a market–sensitive benchmark. Savings and losses relative to the benchmark were determined annually and shared equally with sales customers. The PBR plan was terminated effective January 1, 2003. There are allegations that Nicor Gas acted improperly in connection with the PBR plan, and the ICC and SEC are reviewing these allegations in pending proceedings. An adverse decision or decisions in these proceedings could result in a refund or other obligations which could adversely affect the company's results of operations, cash flows and financial condition. See Item 7 – Management's Discussion and Analysis of Financial Condition and Results of Operations for further discussion of the PBR proceeding and related matters.

Nicor Gas relies on direct connections to eight interstate pipelines and extensive underground storage capacity. If these pipelines or storage facilities were unable to deliver natural gas for any reason it could impair Nicor Gas' ability to meet its customers' full requirements.

Nicor Gas meets its customers' peak day, seasonal and annual gas requirements through deliveries of gas transported on interstate pipelines with which it or its gas suppliers have contracts and through withdrawals of gas from storage fields it owns or leases. Nicor Gas contracts with multiple pipelines for transportation services. If a pipeline were to fail to perform transportation or storage service, including as a result of war, acts or threats of terrorism or natural disaster, on a peak day or other day with high volume gas requirements, Nicor Gas' ability to meet all its customers' gas requirements may be impaired unless or until alternative arrangements for delivery of supply were put in place. Likewise, if a storage field owned by Nicor Gas, or a principal Nicor Gas–owned transmission or distribution pipeline used to deliver gas to the market, were to be out of service for any reason, including as a result of war, acts or threats of terrorism or natural disaster, this could impair Nicor Gas' ability to meet its customers' full requirements.

Fluctuations in weather have the potential to adversely affect the company's results of operations, cash flows and financial condition.

When weather conditions are milder than normal, Nicor Gas has historically delivered less natural gas, and consequently may earn less income. Nicor Gas' natural gas deliveries are temperature–sensitive and seasonal since about one–half of all deliveries are used for space heating. Typically, about three–quarters of the deliveries and revenues occur from October through March. Mild weather in the future could adversely affect the company's results of operations, cash flows and financial condition.

Natural gas commodity price changes may affect the company's operating costs and competitive position, which could adversely affect its results of operations, cash flows and financial condition.

Nicor Gas is sensitive to changes in natural gas prices. Natural gas prices historically have been volatile and may continue to be volatile in the future. The prices for natural gas are subject to a variety of factors that are beyond the company's control. These factors include, but are not limited to, the level of consumer demand for, and the supply of, natural gas, processing, gathering and transportation availability, the level of imports of, and the price of foreign natural gas, the price and availability of alternative fuel sources, weather conditions, political conditions or hostilities in natural gas producing regions.

Any changes in natural gas prices could affect the prices Nicor Gas charges, operating costs and the competitive position of products and services. In accordance with the ICC's PGA regulations, Nicor Gas adjusts its gas cost charges to sales customers on a monthly basis to account for changes in the price of natural gas. However, changes in natural gas prices can also impact certain operating expenses such as bad debt expense, company use gas and storage–related gas expenses, financing costs and customer service expenses, and these changes can only be reflected in Nicor Gas' charges to customers if approved

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

by the ICC in a rate case. Increases in natural gas prices can also have an adverse effect on natural gas distribution margin because such increases can result in lower customer demand.

Nicor Gas is subject to margin requirements in connection with the use of derivative financial instruments and these requirements could escalate if prices move adversely.

Nicor Gas' use of derivative instruments could adversely affect the company's results of operations.

Nicor Gas uses derivative instruments, including futures, options, forwards and swaps, either traded on exchanges or executed over–the–counter with natural gas merchants as well as financial institutions, to hedge natural gas price risk. Fluctuating natural gas prices can impact company use gas and storage–related gas expenses, as well as cash flows, causing earnings and financing costs of Nicor Gas to be impacted. The use of derivative instruments that are not perfectly matched to the exposure could adversely affect the company's results of operations, cash flows and financial condition. Also, when Nicor Gas' derivative instruments and hedging transactions fail to qualify for hedge accounting under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, the company's results of operations could be adversely affected.

Adverse decisions in lawsuits seeking a variety of damages allegedly caused by mercury spillage could adversely affect the company's results of operations, cash flows and financial condition.

Nicor Gas has incurred, and expects to continue to incur, costs related to its historical use of mercury in various kinds of equipment. Nicor Gas is a defendant in several private lawsuits, all in the Circuit Court of Cook County, Illinois, seeking a variety of damages (including bodily injury, property and punitive damages) allegedly caused by mercury spillage resulting from the removal of mercury–containing regulators. Adverse decisions regarding these claims or other mercury–related claims, to the extent they require the company to make payments in excess of amounts provided for in its financial statements, could adversely affect the company's results of operations, cash flows and financial condition.

Transporting and storing natural gas involves numerous risks that may result in accidents and other operating risks and costs that could adversely affect the company's results of operations, cash flows and financial condition.

Nicor Gas' activities involve a variety of inherent hazards and operating risks, such as leaks, accidents and mechanical problems, which could cause substantial financial losses. In addition, these risks could result in loss of human life, significant damage to property, environmental pollution and impairment of Nicor Gas' operations, which in turn could lead to substantial losses. In accordance with customary industry practice, Nicor Gas maintains insurance against some, but not all, of these risks and losses. The location of pipelines and storage facilities near populated areas, including residential areas, commercial business centers and industrial sites, could increase the level of damages resulting from these risks. The occurrence of any of these events if not fully covered by insurance could adversely affect Nicor Gas' results of operations, cash flows and financial condition.

An inability to access financial markets could affect the execution of Nicor Gas' business plan and could adversely affect the company's results of operations, cash flows and financial condition.

Nicor Gas relies on access both to short–term money markets and longer–term capital markets as a significant source of liquidity for capital and operating requirements not satisfied by the cash flows from its operations. Management believes that Nicor Gas will maintain sufficient access to these financial markets based upon current credit ratings. However, certain disruptions outside of Nicor Gas' control or events of default under its debt agreements may increase its cost of borrowing or restrict its ability to access one or more financial markets. Such disruptions could include an economic downturn, the bankruptcy of an unrelated energy company or downgrades to Nicor Gas' credit ratings. Restrictions on the company's ability to access financial markets may affect its ability to execute its business plan as

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

scheduled and could adversely affect the company's results of operations, cash flows and financial condition.

Nicor Gas has credit risk that could adversely affect the company's results of operations, cash flows and financial condition.

Nicor Gas extends credit to its counterparties. Despite what the company believes to be prudent credit policies and the maintenance of netting arrangements, the company is exposed to the risk that it may not be able to collect amounts owed to it. If the counterparty to such a transaction fails to perform and any collateral the company has secured is inadequate, it could experience financial losses.

The company is involved in legal or administrative proceedings before various courts and agencies that could adversely affect the company's results of operations, cash flows and financial condition.

The company is involved in legal or administrative proceedings before various courts and agencies with respect to general claims, rates, taxes, environmental, gas cost prudence reviews and other matters. Adverse decisions regarding these matters, to the extent they require the company to make payments in excess of amounts provided for in its financial statements, could adversely affect the company's results of operations, cash flows and financial condition. See Item 7 – Management's Discussion and Analysis of Financial Condition and Results of Operations for further discussion.

The risks described above should be carefully considered in addition to the other cautionary statements and risks described elsewhere, and the other information contained in this report and in Nicor Gas' other filings with the SEC, including its subsequent reports on Forms 10–Q and 8–K. The risks and uncertainties described above are not the only risks Nicor Gas faces although they are the most significant risks. See Item 7 – Management's Discussion and Analysis of Financial Condition and Results of Operations, Item 7A – Quantitative and Qualitative Disclosures about Market Risk, and Item 8 – Notes to the Consolidated Financial Statements – Note 8 – Income and Other Taxes and Note 16 – Contingencies for further discussion of these and other risks Nicor Gas faces.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

The company's properties are located in the territory described under Item 1 – Business, and are suitable, adequate and utilized in its operations.

The gas distribution, transmission and storage system includes approximately 34,000 miles of steel, plastic and cast iron main; approximately 2.0 million steel, plastic/aluminum composite, plastic and copper services connecting the mains to customers' premises; and eight underground storage fields. Other properties include buildings, land, motor vehicles, meters, regulators, compressors, construction equipment, tools, communication and computer equipment, software and office equipment.

Most of the company's distribution and transmission property, and underground storage fields are located on property owned by others and used by the company through easements, permits or licenses. The company owns most of the buildings housing its administrative offices and the land on which they sit.

Substantially all gas distribution properties are subject to the lien of the indenture securing Nicor Gas' First Mortgage Bonds.

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

Additional information about Nicor Gas' business is presented in Item 1A – Risk Factors, Item 7 – Management's Discussion and Analysis of Financial Condition and Results of Operations and Item 8 – Notes to the Consolidated Financial Statements.

Item 3. Legal Proceedings

See Item 8 – Notes to the Consolidated Financial Statements – Note 16 – Contingencies, which is incorporated herein by reference.

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

All of the outstanding common stock of Nicor Gas is owned by Nicor. There is no public trading market for the company's common stock. During 2006 and 2005, the company declared dividends on its common stock totaling approximately $49 million and $38 million, respectively.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The purpose of this financial review is to explain changes in Nicor Gas' operating results and financial condition from 2004 to 2006 and to discuss business trends that might affect Nicor Gas. Certain terms used herein are defined in the glossary on page ii. The discussion is organized into six sections – Summary, Results of Operations, Financial Condition and Liquidity, Outlook, Contingencies and Critical Accounting Estimates.

SUMMARY

Nicor Gas, a wholly owned subsidiary of Nicor, is one of the nation's largest natural gas distribution companies, and it is Nicor's primary business.

Results for 2006 were higher as compared to 2005 due mainly to higher operating income. Operating income increased $5.2 million in 2006 due to the positive effects of higher margin ($19.0 million pretax increase) and a first quarter pretax mercury–related recovery of $3.8 million. These positive factors were partially offset by higher operating and maintenance expenses ($13.6 million pretax increase) and higher depreciation expense ($5.6 million pretax increase). Higher margin was due to the impact of the base rate increase (approximately $36 million pretax) and higher demand unrelated to weather (approximately $5 million pretax increase), partially offset by the negative impact of warmer weather than in 2005 (approximately $17 million pretax decrease) and the passage of Chicago Hub revenues through the PGA effective with the rate order (approximately $8 million pretax decrease).

Results for 2005 were lower as compared with 2004 due mainly to lower operating income and a decrease in property sale gains. Operating income decreased $3.3 million in 2005 due primarily to higher operating and maintenance expenses ($20.0 million pretax increase) and higher depreciation expense ($5.7 million pretax increase). The adverse impact of these factors was partially offset by higher margin ($15.7 million pretax increase). Higher margin was largely driven by higher average rates (approximately $19 million pretax increase) due in part to the rate increase which became effective during the fourth quarter of 2005 (approximately $13 million pretax), and the positive impact of colder weather than in 2004 (approximately $4 million pretax increase), partially offset by lower demand unrelated to weather (approximately $6 million pretax decrease).

Rate proceeding. In 2005, Nicor Gas received approval from the ICC for a $54.2 million base rate increase which reflected an allowed rate of return on original–cost rate base of 8.85 percent, including a 10.51 percent cost of common equity. The order also included the authorization to pass all Chicago Hub

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

revenues directly through to customers as a credit to Nicor Gas' PGA rider and the shifting of certain storage–related costs from the PGA rider to base rates. In addition, rates were established using a 10–year average for weather as opposed to the previous use of a 30–year average. These rates were implemented in the fourth quarter of 2005. Because the order shifts certain items between base rates and Nicor Gas' PGA rider, the company estimated that, under normal weather conditions and demand as reflected in the rate case, the annual net revenue increase resulting from implementing the rate order would have been about $34.7 million under the tariffs that were placed into effect.

In October 2005, Nicor Gas and six other parties filed applications for rehearing of the final order of the rate case. In March 2006, the ICC issued its decision on rehearing in which it adjusted the amount of the annual net rate increase to $49.7 million from the $54.2 million that had been approved in the earlier order. The company estimates that because the revised order similarly shifts certain items between base rates and Nicor Gas' PGA rider, under normal weather conditions and demand as reflected in the rate case, the increase in annual net revenue decreased to $30.2 million from the estimated $34.7 million under the previous order. Rate changes resulting from the rehearing order were prospective and went into effect on April 11, 2006. Parties, including Nicor Gas, that appealed the ICC's rate case decision to the state appellate courts have since withdrawn their appeals. As a result, the ICC rate order is no longer subject to judicial review.

As a result of the rate order which became effective in the fourth quarter of 2005, certain storage–related costs have been recorded in operating and maintenance expense. Storage–related gas costs recorded in operating and maintenance expense during 2006 and 2005 totaled $21.4 million and $6.5 million, respectively. Storage–related gas costs incurred prior to the effective date of the rate order and recorded as cost of gas in 2005 totaled $11.1 million.

These factors are discussed in more detail in the Results of Operations section which follows.

RESULTS OF OPERATIONS

The following discussion summarizes the major items impacting Nicor Gas' operating income.

Operating revenues. Operating revenues are impacted by changes in natural gas costs, which are passed directly through to customers without markup, subject to ICC review.

For the year 2006, revenues decreased $457.3 million as compared to 2005 due to lower natural gas costs (approximately $300 million decrease) and the negative impact of warmer weather than the corresponding period in 2005 (approximately $250 million decrease), partially offset by higher demand unrelated to weather (approximately $35 million increase) and the impact of the base rate increase (approximately $36 million).

For the year 2005, revenues increased $545.7 million as compared with 2004 due primarily to higher natural gas costs (approximately $525 million increase) and the positive impact of colder weather than in 2004 (approximately $60 million increase), partially offset by lower demand unrelated to weather (approximately $70 million decrease). These results also reflect the impact of the rate order tariffs, which became effective during the fourth quarter of 2005, and increased revenues by approximately $13 million.

Margin. Nicor Gas utilizes a measure it refers to as "margin" to evaluate the operating income impact of revenues. Revenues include natural gas costs, which are passed directly through to customers without markup, subject to ICC review, and revenue taxes, for which Nicor Gas earns a small administrative fee. These items often cause significant fluctuations in revenues, and yet they have virtually no direct impact on operating income.

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

A reconciliation of revenues and margin follows (in millions):

	2006	2005	2004
Revenues	**$ 2,452.3**	$ 2,909.6	$ 2,363.9
Cost of gas	**(1,743.7)**	(2,212.4)	(1,695.0)
Revenue tax expense	**(144.4)**	(152.0)	(139.4)
Margin	**$ 564.2**	$ 545.2	$ 529.5

For the year 2006, margin increased $19.0 million from 2005 due primarily to the impact of the base rate increase (approximately $36 million) and higher demand unrelated to weather (approximately $5 million increase), partially offset by the negative impact of warmer weather than in 2005 (approximately $17 million decrease) and the passage of Chicago Hub revenues through the PGA effective with the rate order (approximately $8 million decrease).

For the year 2005, margin increased $15.7 million from 2004 due primarily to higher average rates (approximately $19 million increase) driven by the rate increase (approximately $13 million), and the positive impact of colder weather than in 2004 (approximately $4 million increase), partially offset by lower demand unrelated to weather (approximately $6 million decrease).

Operating and maintenance expense. The $13.6 million increase in operating and maintenance expense in 2006 as compared with the prior year reflects higher storage–related gas costs ($14.9 million increase) and company use gas ($9.9 million increase), partially offset by lower bad debt expense ($4.5 million decrease), net claims arising from normal operations ($4.5 million decrease) and payroll and benefit–related costs ($3.1 million decrease).

The $20.0 million increase in operating and maintenance expense in 2005 as compared with the prior year reflects higher bad debt expense ($12.1 million increase), company use gas ($4.0 million increase) and storage–related gas costs ($6.5 million increase in the fourth quarter). These increases were partially offset by lower net legal and claims expenses ($4.7 million decrease).

The rate order, which became effective in the fourth quarter of 2005, results in certain storage–related gas costs being charged to operating and maintenance expense. Prior to the effective date of the rate order, storage–related gas costs were charged to cost of gas and passed through to customers as part of the PGA rider.

Mercury–related costs (recoveries), net. Mercury–related costs (recoveries), net reflect the estimated costs, credits and recoveries associated with the company's mercury inspection and repair program. During the first quarter of 2006, a mercury–related recovery of $3.8 million was realized. This net recovery resulted from a settlement reached with an independent contractor of Nicor Gas. Net mercury–related costs (recoveries) were insignificant in 2005 and 2004. Additional information about the company's mercury inspection and repair program is presented in Item 8 – Notes to the Consolidated Financial Statements – Note 16 – Contingencies – Mercury.

Other income (expense), net. Pretax other income was $8.9 million, $4.0 million and $4.4 million in 2006, 2005 and 2004.

Property sale gains and losses vary from year–to–year depending upon property sales activity. During 2006, Nicor Gas realized a $3.3 million pretax gain on the sale of property. Property sale gains and losses were insignificant during 2005. During 2004, Nicor Gas realized a $5.9 million pretax gain on the sale of property. The company continues to assess its ownership of certain real estate holdings.

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

Interest income was $6.3 million, $4.3 million and $1.0 million in 2006, 2005 and 2004, respectively. The increase of $2.0 million in 2006 from 2005 was due primarily to higher interest rates and investment balances along with increased income from balances on deposit in the Nicor cash management pool. The increase of $3.3 million in 2005 from 2004 was due primarily to increased interest income from higher balances on deposit in the Nicor cash management pool.

In 2004, losses of $1.8 million were recorded related to the former PBR plan. Additional information related to the PBR plan is described in Item 8 – Notes to the Consolidated Financial Statements – Note 16 – Contingencies – Performance–Based Rate Plan.

Income tax expense. The effective income tax rate was 32.2 percent, 32.8 percent and 34.8 percent for 2006, 2005 and 2004, respectively. The decrease in the effective income tax rate in 2006 is primarily due to an increase in certain tax credits and permanent items, offset, in part, by higher pretax income (which causes a higher effective income tax rate since permanent differences and tax credits are a smaller share of pretax income). The decrease in the effective income tax rate in 2005 is primarily due to lower pretax income.

Interest expense. Interest expense for 2006 increased $2.3 million over the year–earlier period. This increase is primarily due to the impact of higher average interest rates ($1.7 million increase).

Interest expense for 2005 increased $4.8 million over the year–earlier period. This increase reflects higher estimated interest on income tax matters ($4.4 million increase) and the impact of higher average interest rates ($3.7 million increase), partially offset by the impact of lower average borrowing levels ($3.3 million decrease).

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

Nicor Gas Company

Operating Statistics

	2006	2005	2004
Operating revenues (millions)			
Sales			
Residential	$ **1,671.1**	$ 2,031.4	$ 1,625.5
Commercial	**373.9**	453.5	349.9
Industrial	**42.8**	61.8	49.3
	2,087.8	2,546.7	2,024.7
Transportation			
Residential	**32.0**	27.9	23.6
Commercial	**82.1**	73.1	69.9
Industrial	**41.0**	39.2	39.9
Other	**3.7**	11.7	14.0
	158.8	151.9	147.4
Other revenues			
Revenue taxes	**147.7**	156.4	143.5
Environmental cost recovery	**11.6**	21.0	20.6
Chicago Hub	**26.4**	11.5	7.9
Other	**20.0**	22.1	19.8
	205.7	211.0	191.8
	$ **2,452.3**	$ 2,909.6	$ 2,363.9
Deliveries (Bcf)			
Sales			
Residential	**185.9**	200.2	204.8
Commercial	**41.8**	44.7	44.3
Industrial	**5.0**	6.3	6.4
	232.7	251.2	255.5
Transportation			
Residential	**17.0**	18.9	16.6
Commercial	**80.4**	87.5	84.1
Industrial	**108.6**	113.0	117.0
	206.0	219.4	217.7
	438.7	470.6	473.2
Year–end customers (thousands) (1)			
Sales			
Residential	**1,807**	1,796	1,777
Commercial	**123**	120	117
Industrial	**7**	8	7
	1,937	1,924	1,901
Transportation			
Residential	**166**	157	148
Commercial	**57**	58	60
Industrial	**6**	6	6
	229	221	214
	2,166	2,145	2,115
Other statistics			
Degree days	**5,174**	5,783	5,637
Warmer than normal (2)	**(11%)**	(1%)	(6%)
Average gas cost per Mcf sold	$ **7.44**	$ 8.74	$ 6.56

(1) The company has redefined the customer count methodology in
2006 in conjunction with its new
customer care and billing system.

(2) Normal weather for Nicor Gas' service territory, for purposes of this
report, is considered to be 5,830
degree days per year for 2006 and 2005, and 6,000 degree days for
2004. On a 6,000 degree day basis,
2006 and 2005 would have been 14% and 4% warmer than normal,
respectively.

Source: NORTHERN ILLINOIS GA, 10-K, February 23, 2007

FINANCIAL CONDITION AND LIQUIDITY

The company believes it has access to adequate resources to meet its needs for capital expenditures, debt redemptions, dividend payments and working capital. These resources include net cash flow from operating activities, access to capital markets, lines of credit and short–term investments.

Operating cash flows. The company's business is highly seasonal and operating cash flow may fluctuate significantly during the year and from year–to–year due to factors such as weather, natural gas prices, the timing of collections from customers, natural gas purchasing, and storage and hedging practices. The company relies on short–term financing to meet seasonal increases in working capital needs. Cash requirements generally increase over the last half of the year due to increases in natural gas purchases, gas in storage and accounts receivable. During the first half of the year, positive cash flow generally results from the sale of gas in storage and the collection of accounts receivable. This cash is typically used to substantially reduce, or eliminate, short–term debt during the first half of the year.

Nicor Gas maintains a margin account related to financial derivative transactions. This margin account may cause large fluctuations in cash needs or sources in a relatively short period of time due to daily settlements resulting from changes in natural gas futures prices. The company manages these fluctuations with short–term borrowings and investments.

Net cash flow provided from operating activities was $334.5 million, $117.4 million and $284.3 million in 2006, 2005 and 2004, respectively. The increase in operating cash flow in 2006 compared to 2005 is due primarily to the impact of lower natural gas prices on working capital. The decrease in operating cash flow provided in 2005 compared to 2004 is due, in part, to the impact of higher gas prices on working capital, coupled with the partial repayment of the income tax refund received in 2003, as discussed below.

In 2003, Nicor Gas received an income tax refund of approximately $100 million attributable to a tax loss carryback associated with a change in tax accounting method (which increased its deferred income tax liability), subject to IRS review and approval as part of normal ongoing audits. Through December 31, 2004, the total current tax benefits previously recorded under this accounting method approximated $135 million (amounts recorded were offset by increases to the deferred tax liability with no net effect on reported net federal income tax expense). In 2005, the IRS revised the regulations pertaining to the aforementioned tax accounting method. The new regulations required repayment in 2005 and 2006 of amounts previously taken as current tax deductions. During 2006 and 2005, the company reclassified income tax expense from deferred to current and repaid approximately $135 million equally over those years.

Investing activities. Net cash flow used for investing activities was $155.0 million, $184.2 million and $73.2 million in 2006, 2005 and 2004, respectively. The decrease in 2006 from 2005 is primarily due to lower cash additions to property, plant and equipment. The increase in 2005 over 2004 reflects a higher level of withdrawals from the Nicor Gas cash management pool during the 2004 period. Nicor Gas also realized net proceeds of $3.6 million and $7.6 million on the sale of property during 2006 and 2004, respectively.

Capital expenditures are an internal measure utilized by management and represent cash additions to property, plant and equipment, adjusted for items including the accrual of work performed through period end and other non–cash items, contributions in aid of construction and expenditures associated with asset retirement obligations. Capital expenditures decreased approximately $22 million in 2006 versus 2005 due, in part, to the absence of expenditures related to the acquisition of a storage compressor in 2005 (approximately $9 million decrease) and a reduction in costs for information technology system improvements (approximately $8 million decrease). In April 2006, the company implemented a new customer care and billing system.

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

Capital expenditures for 2005 increased by approximately $11 million over 2004 due primarily to increased storage system expenditures attributable to the acquisition of the previously mentioned storage compressor (approximately $9 million increase).

Capital expenditures are expected to increase in 2007 by approximately $11 million versus 2006 due, in part, to higher expenditures associated with distribution system improvements and facility expansion, partially offset by lower spending on information technology.

Financing activities. Nicor Gas has credit ratings that are among the highest in the gas distribution industry. The current credit ratings for Nicor Gas are as follows:

	Standard & Poor's	Moody's	Fitch
Commercial Paper	A–1+	P–1	F–1+
Senior Secured Debt	AA	A1	AA–
Senior Unsecured Debt	AA–	A2	A+
Corporate Credit Rating	AA	n/a	n/a

In the second quarter of 2006, Standard and Poor's and Fitch reaffirmed their credit ratings of Nicor Gas. In July 2006, Moody's Investors Service ("Moody's") downgraded the company's senior secured (First Mortgage Bonds) rating to A1 from Aa3 and its senior unsecured debt rating to A2 from A1. Nicor Gas' Prime–1 commercial paper rating was not under review by Moody's. The company does not expect this downgrade to have a significant impact on its results of operations, cash flows or financial condition.

Nicor Gas' debt–related financial statistics at December 31 include:

	2006	2005	2004
Long–term obligations, net of current maturities, as a percent of capitalization	**43.1%**	40.7%	43.9%
Times interest earned, before income taxes	**2.9**	2.8	3.5

Long–term debt. The company typically uses the net proceeds from long–term debt for refinancing outstanding debt, for construction programs to the extent not provided by internally generated funds, and for general corporate purposes.

At December 31, 2006, Nicor Gas had the capacity to issue approximately $390 million of First Mortgage Bonds under the terms of its indenture, of which $75 million was available for issuance under a July 2001 shelf registration filing. Nicor Gas believes it is in compliance with its debt covenants and believes it will continue to remain so. The long–term debt agreements do not include ratings triggers or material adverse change provisions. Substantially all properties are subject to the lien of the indenture securing Nicor Gas' First Mortgage Bonds.

In December 2006, Nicor Gas, through a private placement, issued $50 million of First Mortgage Bonds at 5.85 percent, due in 2036. Proceeds from this issuance were applied to the maturity of the $50 million 5.55 percent First Mortgage Bond series, due in December 2006.

Short–term debt. In October 2006, Nicor Gas established a $400 million, 210–day seasonal revolver, which expires in May 2007, to replace the $400 million, 210–day seasonal revolver, which expired in April 2006. In September 2005, Nicor and Nicor Gas established a $600 million, five–year revolver, expiring September 2010. These facilities were established with major domestic and foreign banks and serve as backup for the issuance of commercial paper. The company had $350 million and $490 million of commercial paper borrowings outstanding at December 31, 2006 and 2005, respectively. The company believes it is in compliance with all debt covenants and believes it will continue to remain so.

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

The company expects that funding from commercial paper and related backup line–of–credit agreements will continue to be available in the foreseeable future and sufficient to meet estimated cash requirements.

Common stock. The company paid dividends of approximately $47 million, $37 million and $54 million in 2006, 2005 and 2004, respectively. Nicor Gas is restricted by the amount it can dividend to Nicor. Dividends are only allowed to the extent of Nicor Gas' retained earnings balance.

Other. Nicor Gas is restricted by regulation in the amount it can loan to affiliates. The balance of cash advances from Nicor Gas to an affiliate at any time shall not exceed the unused balance of funds actually available to that affiliate under its existing bank credit agreements or its commercial paper facilities with unaffiliated third parties. In addition, Nicor Gas may not extend cash advances to an affiliate if Nicor Gas has any outstanding short–term borrowings.

Off–balance sheet arrangements. The company does not have off–balance sheet arrangements that would have a material effect on its financial condition.

Contractual obligations. As of December 31, 2006, Nicor Gas had contractual obligations with payments due as follows (in millions):

Payments due by period	Less than 1 year	1–3 years	3–5 years	More than 5 years	Total
Purchase obligations	$ 767.0	$ 410.1	$ 48.6	$ 6.2	$ 1,231.9
Long–term debt	–	125.0	75.0	300.0	500.0
Fixed interest on long–term debt	30.7	52.8	42.6	302.7	428.8
Operating leases	1.1	2.0	1.7	9.2	14.0
Other long–term obligations	.5	1.0	.7	1.6	3.8
	$ 799.3	$ 590.9	$ 168.6	$ 619.7	$ 2,178.5

Purchase obligations consist primarily of natural gas purchase agreements, and natural gas transportation and storage contracts. Natural gas purchase agreements include obligations to purchase natural gas at future market prices, calculated using December 31, 2006 New York Mercantile Exchange futures prices. The company also has long–term obligations for postretirement benefits which are not included in the above table. Information regarding the company's obligations for postretirement benefits can be found in Item 8 – Notes to the Consolidated Financial Statements – Note 9 – Postretirement Benefits.

Operating leases are primarily for office space and equipment. Rental expense under operating leases was $1.1 million, $1.0 million and $1.0 million in 2006, 2005 and 2004, respectively. Other long–term obligations consist primarily of redeemable preferred stock.

Nicor Gas signed an agreement in the second quarter of 2006 to purchase approximately 16 Bcf of synthetic natural gas annually for a 20–year term beginning as early as 2010. Since the agreement is contingent upon various milestones to be achieved by the counterparty to the agreement and the fact that the counterparty can terminate, without penalty, prior to the realization of these milestones, the company's obligation under this agreement is not certain at this time.

OUTLOOK

Nicor Gas' outlook assumes normal weather for 2007, but excludes, among other things, any future impacts associated with the ICC's PBR plan/PGA review or other contingencies. While these items could materially affect 2007 earnings, they are currently not estimable.

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

Nicor Gas expects higher pretax operating results (after removing the $3.8 million impact of the 2006 mercury–related insurance recovery) due, in part, to increased natural gas deliveries attributable to normal weather and lower operating and maintenance expenses, partially offset by higher depreciation costs. Operating and maintenance expenses are expected to be lower due primarily to lower storage–related gas costs and natural gas and fuel costs to operate company equipment and facilities. The company estimates that a 100–degree day variation from normal weather would affect Nicor Gas' net income by approximately $1.6 million.

CONTINGENCIES

The following contingencies of Nicor Gas are in various stages of investigation or disposition. Although in some cases the company is unable to estimate the amount of loss reasonably possible in addition to any amounts already recognized, it is possible that the resolution of these contingencies, either individually or in aggregate, will require the company to take charges against, or will result in reductions in, future earnings. It is the opinion of management that the resolution of these contingencies, either individually or in aggregate, could be material to earnings in a particular period but is not expected to have a material adverse impact on Nicor Gas' liquidity or financial condition.

PBR plan. Nicor Gas' PBR plan for natural gas costs went into effect in 2000 and was terminated by the company effective January 1, 2003. Under the PBR plan, Nicor Gas' total gas supply costs were compared to a market–sensitive benchmark. Savings and losses relative to the benchmark were determined annually and shared equally with sales customers. The PBR is currently under ICC review. There are allegations that the company acted improperly in connection with the PBR plan, and the ICC and others are reviewing these allegations. On June 27, 2002, the Citizens Utility Board ("CUB") filed a motion to reopen the record in the ICC's proceedings to review the PBR plan (the "ICC Proceedings"). As a result of the motion to reopen, Nicor Gas, the Cook County State's Attorney Office ("CCSAO"), the staff of the ICC and CUB entered into a stipulation providing for additional discovery. The Illinois Attorney General's Office ("IAGO") has also intervened in this matter. In addition, the IAGO issued Civil Investigation Demands ("CIDs") to CUB and the ICC staff. The CIDs ordered that CUB and the ICC staff produce all documents relating to any claims that Nicor Gas may have presented, or caused to be presented, false information related to its PBR plan. The company has committed to cooperate fully in the reviews of the PBR plan.

In response to these allegations, on July 18, 2002, the Nicor Board of Directors appointed a special committee of independent, non–management directors to conduct an inquiry into issues surrounding natural gas purchases, sales, transportation, storage and such other matters as may come to the attention of the special committee in the course of its investigation. The special committee presented the report of its counsel ("Report") to Nicor's Board of Directors on October 28, 2002. A copy of the report is available at the Nicor website and has been previously produced to all parties in the ICC Proceedings.

In response, the Nicor Board of Directors directed the company's management to, among other things, make appropriate adjustments to account for, and fully address, the adverse consequences to ratepayers of the items noted in the Report, and conduct a detailed study of the adequacy of internal accounting and regulatory controls. The adjustments were made in prior years' financial statements resulting in a $24.8 million liability. Included in such $24.8 million liability is a $4.1 million loss contingency. A $1.8 million adjustment to the previously recorded liability, which is discussed below, was made in 2004 increasing the recorded liability to $26.6 million. In addition, Nicor Gas estimates that there is $26.9 million due to the company from the 2002 PBR plan year, which has not been recognized in the financial statements due to uncertainties surrounding the PBR plan. The net of these items and interest income on certain components results in a $1.0 million reimbursement the company plans to seek in testimony to be filed in compliance with the new scheduling order discussed below. By the end of 2003, the company completed steps to correct the weaknesses and deficiencies identified in the detailed study of the adequacy of internal controls.

Source: NORTHERN ILLINOIS GA, 10-K, February 23, 2007

Pursuant to the agreement of all parties, including the company, the ICC re–opened the 1999 and 2000 purchased gas adjustment filings for review of certain transactions related to the PBR plan and consolidated the reviews of the 1999–2002 purchased gas adjustment filings with the PBR plan review.

On February 5, 2003, the CCSAO and CUB filed a motion for $27 million in sanctions against the company in the ICC Proceedings. In that motion, CCSAO and CUB alleged that Nicor Gas' responses to certain CUB data requests were false. Also on February 5, 2003, CUB stated in a press release that, in addition to $27 million in sanctions, it would seek additional refunds to consumers. On March 5, 2003, the ICC staff filed a response brief in support of CUB's motion for sanctions. On May 1, 2003, the Administrative Law Judges issued a ruling denying CUB and CCSAO's motion for sanctions. CUB has filed an appeal of the motion for sanctions with the ICC, and the ICC has indicated that it will not rule on the appeal until the final disposition of the ICC Proceedings. It is not possible to determine how the ICC will resolve the claims of CCSAO, CUB or other parties to the ICC Proceedings.

In November 2003, the ICC staff, CUB, CCSAO and the IAGO filed their respective direct testimony in the ICC Proceedings. The ICC staff is seeking refunds to customers of approximately $108 million and CUB and CCSAO were jointly seeking refunds to customers of approximately $143 million. The IAGO direct testimony alleges adjustments in a range from $145 million to $190 million. The IAGO testimony as filed is presently unclear as to the amount which IAGO seeks to have refunded to customers. On February 27, 2004, the above referenced intervenors filed their rebuttal testimony in the ICC Proceedings. In such rebuttal testimony, CUB and CCSAO amended the alleged amount to be refunded to customers from approximately $143 million to $190 million. In December 2006, Nicor Gas withdrew its previously filed testimony. Nicor Gas anticipates refiling its direct testimony in compliance with the new scheduling order discussed below which it expects to be consistent with the findings of the special committee Report. Nicor Gas plans to seek a reimbursement of approximately $1 million as referenced above. In 2004, the evidentiary hearings on this matter were stayed in order to permit the parties to undertake additional third party discovery from Entergy–Koch Trading, LP ("EKT"), a natural gas, storage and transportation trader and consultant with whom Nicor did business under the PBR plan. In December 2006, the additional third party discovery from EKT was obtained and the Administrative Law Judges issued a scheduling order that provides for Nicor Gas to submit its direct testimony by April 13, 2007. No date has been set for evidentiary hearings on this matter.

During the course of the SEC investigation discussed below, the company became aware of additional information relating to the activities of individuals affecting the PBR plan for the period from 1999 through 2002, including information consisting of third party documents and recordings of telephone conversations from EKT. Review of additional information completed in 2004 resulted in the $1.8 million adjustment to the previously recorded liability referenced above.

Although the Report of the special committee's counsel did not find that there was criminal activity or fraud, a review of this additional information (which was not available to the independent counsel who prepared the Report) and re–interviews of certain Nicor Gas personnel in 2004 indicated that certain former Nicor Gas personnel may have engaged in potentially fraudulent conduct regarding the PBR plan in violation of company policy, and in possible violation of SEC rules and applicable law. Further, certain former Nicor Gas personnel also may have attempted to conceal their conduct in connection with an ICC review of the PBR plan. The company continues to cooperate with the SEC, the U.S. Attorney's office and the ICC on this matter. The company has reviewed all third party information it has obtained and will continue to review any additional third party information the company may obtain. The company terminated four employees in connection with this matter in 2004.

Nicor Gas is unable to predict the outcome of the ICC's review or the company's potential exposure thereunder. Because the PBR plan and historical gas costs are still under ICC review, the final outcome could be materially different than the amounts reflected in the company's financial statements as of December 31, 2006.

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

SEC and U.S. Attorney Inquiries. In 2002, the staff of the SEC informed the company that the SEC is conducting a formal inquiry regarding the PBR plan. A representative of the Office of the United States Attorney for the Northern District of Illinois also notified the company that that office was conducting an inquiry on the same matter that the SEC is investigating, and a grand jury was also reviewing this matter. In April 2004, Nicor was advised by the SEC Division of Enforcement that it intended to recommend to the SEC that it bring a civil injunctive action against Nicor, alleging that Nicor violated Sections 17(a) of the Securities Act of 1933 and Sections 10(b) and 13(a) of the Securities Exchange Act of 1934 and Rules 10b–5, 12b–20, 13a–1 and 13a–13 thereunder. On July 7, 2006, Nicor announced that it reached a tentative agreement with the SEC Staff in settlement of an anticipated civil action to which Nicor and the SEC will be parties. Under the terms of the tentative settlement, Nicor will be subject to disgorgement of one dollar, a monetary fine of $10 million and an injunction. Nicor will neither admit nor deny any wrongdoing. In July 2006, Nicor deposited the $10 million in escrow pending final approval of the tentative settlement by the SEC commissioners and entry of a final judgment by a federal court. The SEC Staff will submit the tentative settlement to the SEC commissioners for approval. The SEC commissioners have the authority to approve, modify or reject the tentative settlement. Nicor recorded a $10 million charge to its second quarter earnings in connection with this matter. As the tentative settlement is between Nicor and the SEC Staff, Nicor Gas has not recorded a liability associated with the outcome of the SEC matter. In December 2006, the U.S. Attorney advised that it is closing its separate inquiry and will not seek to prosecute the company or any individuals in connection with this matter.

Mercury. Future operating results may be impacted by adjustments to the company's estimated mercury liability or by related recoveries. Additional information about mercury contingencies is presented in Item 8 – Notes to the Condensed Consolidated Financial Statements – Note 16 – Contingencies – Mercury.

Manufactured gas plant sites. The company is conducting environmental investigations and remedial activities at former manufactured gas plant sites. Additional information about these sites is presented in Item 8 – Notes to the Condensed Consolidated Financial Statements – Note 16 – Contingencies – Manufactured Gas Plant Sites.

Other contingencies. The company is involved in legal or administrative proceedings before various courts and agencies with respect to general claims, rates, taxes, environmental, gas cost prudence reviews and other matters. See Item 8 – Notes to the Condensed Consolidated Financial Statements – Note 1 – Accounting Policies – Income taxes and Note 16 – Contingencies.

In addition, see Item 1A – Risk Factors and Item 7A – Quantitative and Qualitative Disclosures about Market Risk.

CRITICAL ACCOUNTING ESTIMATES

Nicor Gas prepares its consolidated financial statements in accordance with accounting principles generally accepted in the United States, which regularly require Nicor Gas' management to exercise judgment in the selection and application of accounting methods. The application of accounting methods includes making estimates using subjective assumptions and judgments about matters that are inherently uncertain.

The use of estimates and the selection of accounting policies affect Nicor Gas' reported results and financial condition. The company has adopted several significant accounting policies and is required to make significant accounting estimates that are important to understanding its financial statements. These significant policies and estimates are described throughout Item 8 – Notes to the Consolidated Financial Statements.

Although there are numerous areas in which Nicor Gas' management makes significant accounting estimates, it believes its critical estimates are those that require management's most difficult and subjective or complex judgments. Nicor Gas' management has a practice of reviewing its critical

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

accounting estimates and policy decisions with the audit committee of its board of directors. Its critical estimates typically involve loss contingencies, derivative instruments, pension and other postretirement benefits, credit risk, unbilled revenues and regulatory assets and liabilities because they are estimates which could materially impact Nicor Gas' financial statements.

Loss contingencies. Nicor Gas records contingent losses as liabilities when a loss is both probable and the amount or range of loss, including related legal defense costs, is reasonably estimable. When only a range of potential loss is estimable, the company records a liability for the minimum anticipated loss. Nicor Gas is involved in various legal and regulatory proceedings and is exposed to various loss contingencies. These loss contingencies are in some cases resolved in stages over time, estimates may change significantly from period to period, and the company's ultimate obligations may differ materially from its recorded amounts. Of particular note is the PBR plan contingency at Nicor Gas and the SEC inquiry described in Item 8 – Notes to the Consolidated Financial Statements – Note 16 – Contingencies.

Derivative instruments. The rules for determining whether a contract meets the definition of a derivative instrument or qualifies for hedge accounting treatment are numerous and complex. The treatment of a single contract may vary from period to period depending upon accounting elections, changes in management's assessment of the likelihood of future hedged transactions or new interpretations of accounting rules. As a result, management judgment is required in the determination of the appropriate accounting treatment. In addition, the estimated fair value of derivative instruments may change significantly from period to period depending upon market projections, and changes in hedge effectiveness may impact the accounting treatment. These determinations and changes in estimates may have a material impact on reported results.

Pension and other postretirement benefits. The company's cost of providing postretirement benefits is dependent upon various factors and assumptions, including life expectancies, the discount rate used in determining the projected benefit obligation, the expected long–term rate of return on plan assets, the long–term rate of compensation increase and anticipated health care costs. Changes in these assumptions typically do not have a significant impact on the expenses recorded from year to year. However, actual experience in any one period, particularly the actual return on plan assets, often varies significantly from these mostly long–term assumptions. When cumulatively significant, the gains and losses generated from such variances are amortized into operating income over the remaining service lives of employees covered by the plans (approximately 11 years for the pension plan and 14 years for the health care plan). Additional information is presented in Item 8 – Notes to the Consolidated Financial Statements – Note 9 – Postretirement Benefits, including plan asset investment allocation, estimated future benefit payments, general descriptions of the plans, significant assumptions, the impact of certain changes in assumptions, and significant changes in estimates.

The company's estimated postretirement benefit cost included in operating income was $5.5 million, $9.6 million and $9.1 million in 2006, 2005 and 2004, respectively. Nicor Gas expects to record postretirement benefit cost for 2007 of $4.6 million. Actuarial assumptions affecting 2007 include an expected rate of return on plan assets of 8.50 percent, consistent with the prior year, and a discount rate of 5.75 percent compared with 5.50 percent a year earlier. The 5.75 percent discount rate was based upon the Citigroup Pension Liability Index whose underlying average benefit duration approximates Nicor's.

Credit risk. Nicor Gas is required to estimate credit risk in establishing allowances for doubtful accounts. Actual credit losses could vary materially from Nicor Gas' estimates. Nicor Gas' allowance for doubtful accounts at December 31, 2006, 2005 and 2004 was $30.9 million, $30.1 million and $19.7 million, respectively, as presented on Schedule II in Item 15 – Exhibits and Financial Statement Schedules.

Unbilled revenues. Nicor Gas estimates revenues for natural gas deliveries not yet billed to customers from the last billing date to month–end ("unbilled revenues"). Unbilled revenue estimates are dependent upon a number of customer–usage factors which require management judgment, including weather factors. These revenue estimates are adjusted when actual billings occur, and variances in estimates can

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

be material. Estimated unbilled revenues for Nicor Gas at December 31, 2006, 2005 and 2004 were $158.9 million, $300.4 million and $204.4 million, respectively.

Regulatory assets and liabilities. Nicor Gas is regulated by the ICC, which establishes the rules and regulations governing utility rates and services in Illinois. As a rate–regulated company, Nicor Gas applies SFAS No. 71, *Accounting for the Effects of Certain Types of Regulation*, which allows Nicor Gas to recognize the economic effects of rate regulation and, accordingly, has recorded regulatory assets and liabilities. Regulatory assets represent probable future revenue associated with certain costs that are expected to be recovered from customers through rate riders or rate cases, upon approval by the ICC. Regulatory liabilities represent probable future reductions in revenues collected from ratepayers through a rate rider or base rates. If all or a portion of Nicor Gas' operations become no longer subject to the provisions of SFAS No. 71, a write–off of the net book value of its regulatory assets and liabilities would be required. Additional information on regulatory assets and liabilities is presented in Item 8 – Notes to the Consolidated Financial Statements – Note 1 – Accounting Policies.

NEW ACCOUNTING PRONOUNCEMENTS

In 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans,* Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, and SFAS No. 157, *Fair Value Measurements*. In 2004, the FASB issued SFAS No. 123 (revised 2004), *Share–Based Payment.* For more information, see Item 8 – Notes to the Consolidated Financial Statements – Note 2 – New Accounting Pronouncements.

CAUTION CONCERNING FORWARD–LOOKING STATEMENTS

This document includes certain forward–looking statements about the expectations of Nicor Gas. Although Nicor Gas believes these statements are based on reasonable assumptions, actual results may vary materially from stated expectations. Such forward–looking statements may be identified by the use of forward–looking words or phrases such as "anticipate," "believe," "expect," "intend," "may," "planned," "potential," "should," "will," "would," "project," "estimate," "ultimate", or similar phrases. Actual results may differ materially from those indicated in the company's forward–looking statements due to the direct or indirect effects of legal contingencies (including litigation) and the resolution of those issues, including the effects of an ICC review and an SEC inquiry, and undue reliance should not be placed on such statements.

Other factors that could cause materially different results include, but are not limited to, weather conditions; natural disasters; natural gas prices; fair value accounting adjustments; inventory valuation; health care costs; insurance costs or recoveries; legal costs; borrowing needs; interest rates; credit conditions; economic and market conditions; energy conservation; legislative and regulatory actions; tax rulings or audit results; asset sales; significant unplanned capital needs; future mercury–related charges or credits; changes in accounting principles, interpretations, methods, judgments or estimates; performance of major suppliers and contractors; labor relations; and acts of terrorism.

Readers are cautioned not to place undue reliance on these forward–looking statements, which speak only as of the date of this filing. Nicor Gas undertakes no obligation to publicly release any revision to these forward–looking statements to reflect events or circumstances after the date of this filing.

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

Nicor Gas is exposed to market risk in the normal course of its business operations, including the risk of loss arising from adverse changes in natural gas prices and interest rates. It is Nicor Gas' practice to manage these risks utilizing derivative instruments and other methods, as deemed appropriate.

Commodity price risk. With regard to commodity price risk, the company has established policies and procedures governing the management of such risks and the use of derivative instruments to hedge its exposure to such risks. Company management oversees compliance with such policies and procedures.

As a regulated utility, Nicor Gas' exposure to market risk caused by changes in commodity prices is substantially mitigated because of Illinois rate regulation allowing for the recovery of prudently incurred natural gas supply costs from customers. However, substantial changes in natural gas prices may impact Nicor Gas' earnings by increasing or decreasing the cost of gas used by the company, storage–related gas costs, bad debt expense, and other operating and financing expenses. The company purchases about 4 Bcf of natural gas annually for its own use and to cover storage–related gas costs. The level of natural gas prices may also impact customer gas consumption and therefore margin. The actual impact of natural gas price fluctuations on Nicor Gas' earnings is dependent upon several factors, including the company's hedging practices. At December 31, 2006, Nicor Gas had hedged its forecasted 2007 and a portion of its 2008 company use and storage–related gas costs through the use of fixed–price purchase and swap agreements.

Credit risk. Nicor Gas has a diversified customer base, which limits its exposure to concentrations of credit risk in any one industry or income class and believes that it maintains prudent credit policies. Additionally, the company offers options to help customers manage their bills, such as energy assistance programs for low–income customers and a budget payment plan that spreads gas bills more evenly throughout the year.

The company is also exposed to credit risk in the event a counterparty, customer or supplier defaults on a contract to pay for or deliver product at agreed–upon terms and conditions. To manage this risk, the company has established procedures to determine and monitor the creditworthiness of counterparties, to require guarantees or collateral back–up, and to limit its exposure to any one counterparty. Nicor Gas also, in some instances, enters into netting arrangements to mitigate counterparty credit risk.

Interest rate risk. Nicor Gas is exposed to changes in interest rates. The company manages its interest rate risk by issuing primarily fixed–rate long–term debt with varying maturities, refinancing certain debt and, at times, hedging the interest rate on anticipated borrowings. If market rates were to hypothetically increase by 10 percent from Nicor Gas' weighted–average floating interest rate on commercial paper, interest expense would have increased causing Nicor Gas' earnings to decrease by approximately $0.4 million in 2006. For further information about debt securities, interest rates and fair values, see Item 8 – Financial Statements – Consolidated Statements of Capitalization, and Item 8 – Notes to the Consolidated Financial Statements – Note 5 – Short–Term and Long–Term Debt and Note 7 – Fair Value of Financial Instruments.

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

Nicor Gas Company

Item 8. Financial Statements and Supplementary Data

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Source: NORTHERN ILLINOIS GA, 10-K, February 23, 2007

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholder of Northern Illinois Gas Company

We have audited the accompanying consolidated balance sheets and statements of capitalization of Northern Illinois Gas Company and subsidiary (the "Company") as of December 31, 2006 and 2005, and the related consolidated statements of operations, retained earnings, comprehensive income and cash flows for each of the three years in the period ended December 31, 2006. Our audits also included the financial statement schedule listed in the Index at Item 15(a)(2). We also have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that the Company maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control--Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for these financial statements and financial statement schedule, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on these financial statements and financial statement schedule, an opinion on management's assessment, and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Source: NORTHERN ILLINOIS GA, 10-K, February 23, 2007

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM (concluded)

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2006 and 2005, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein. Also, in our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the criteria established in *Internal Control--Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on the criteria established in *Internal Control--Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

As discussed in Note 2 to the consolidated financial statements, in 2006 the Company changed its method of accounting for defined benefit pension and other postretirement plans, and its method of accounting for share based payments. As discussed in Note 3 to the consolidated financial statements, in 2005 the Company changed its method of accounting for conditional asset retirement obligations.

/s/ DELOITTE & TOUCHE LLP

Chicago, Illinois
February 23, 2007

Nicor Gas Company

Consolidated Statements of Operations
(millions)

	Year ended December 31		
	2006	2005	2004
Operating revenues (includes revenue taxes of $147.7, $156.4, and $143.5, respectively)	**$ 2,452.3**	$ 2,909.6	$ 2,363.9
Operating expenses			
Cost of gas	**1,743.7**	2,212.4	1,695.0
Operating and maintenance	**267.2**	253.6	233.6
Depreciation	**160.1**	154.5	148.8
Taxes, other than income taxes	**163.1**	171.0	158.5
Income tax expense, net	**23.6**	24.6	31.7
Mercury–related costs (recoveries), net	**(3.6)**	.5	–
	2,354.1	2,816.6	2,267.6
Operating income	**98.2**	93.0	96.3
Other income (expense), net			
Property sale gains	**3.3**	.4	5.9
Interest income	**6.3**	4.3	1.0
Other income	**.8**	.8	.8
Other expense	**(1.5)**	(1.5)	(1.5)
Performance–based rate plan	–	–	(1.8)
Income tax expense on other income	**(4.2)**	(1.5)	(1.4)
	4.7	2.5	3.0
Interest expense			
Interest on debt, net of amounts capitalized	**38.6**	37.0	36.9
Other	**5.7**	5.0	.3
	44.3	42.0	37.2
Net income	**$ 58.6**	$ 53.5	$ 62.1

The accompanying notes are an integral part of these statements.

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

Nicor Gas Company

Consolidated Statements of Cash Flows
(millions)

	Year ended December 31		
	2006	2005	2004
Operating activities			
Net income	$ **58.6**	$ 53.5	$ 62.1
Adjustments to reconcile net income to net cash flow provided from operating activities:			
Depreciation	**160.1**	154.5	148.8
Deferred income tax expense (benefit)	**(48.6)**	(79.3)	20.2
Gain on sale of property, plant and equipment	**(3.3)**	(.4)	(5.9)
Changes in assets and liabilities:			
Receivables, less allowances	**278.2**	(270.9)	(104.4)
Gas in storage	**68.0**	(32.0)	18.1
Deferred/accrued gas costs	**(173.4)**	155.1	21.2
Pension benefits	**26.6**	(6.1)	(4.4)
Regulatory postretirement asset	**(113.5)**	–	–
Other assets	**37.6**	(1.1)	6.0
Accounts payable	**(77.2)**	137.7	101.4
Health care and other postretirement benefits	**89.1**	12.6	11.2
Other liabilities	**36.4**	(11.4)	5.2
Other items	**(4.1)**	5.2	4.8
Net cash flow provided from operating activities	**334.5**	117.4	284.3
Investing activities			
Additions to property, plant and equipment	**(164.3)**	(188.2)	(178.2)
Decrease in deposits in Nicor cash management pool	–	.1	97.4
Net proceeds from sale of property, plant and equipment	**3.6**	.8	7.6
Other investing activities	**5.7**	3.1	–
Net cash flow used for investing activities	**(155.0)**	(184.2)	(73.2)
Financing activities			
Proceeds from issuing long–term debt	**50.0**	–	–
Disbursements to retire long–term obligations	**(50.5)**	(.5)	(.5)
Commercial paper repayments with maturities over 90 days	–	–	(540.0)
Net issuances (repayments) of commercial paper with maturities of 90 days or less	**(140.0)**	115.0	340.0
Dividends paid	**(47.1)**	(37.1)	(54.1)
Other financing activities	**(.4)**	(.4)	–
Net cash flow provided from (used for) financing activities	**(188.0)**	77.0	(254.6)
Net increase (decrease) in cash and cash equivalents	**(8.5)**	10.2	(43.5)
Cash and cash equivalents, beginning of year	**10.2**	–	43.5
Cash and cash equivalents, end of year	$ **1.7**	$ 10.2	$ –
Supplemental information			
Income taxes paid, net	$ **84.9**	$ 102.6	$ 14.1
Interest paid, net of amounts capitalized	**36.1**	34.8	34.7

The accompanying notes are an integral part of these statements.

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

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Nicor Gas Company

Consolidated Balance Sheets
(millions)

	December 31 2006	December 31 2005
Assets		
Gas distribution plant, at cost	$ **4,157.1**	$ 4,043.2
Less accumulated depreciation	**1,576.4**	1,513.1
Gas distribution plant, net	**2,580.7**	2,530.1
Current assets		
Cash and cash equivalents	**1.7**	10.2
Receivables, less allowances of $30.9 and $30.1, respectively	**457.1**	753.0
Receivables – affiliates	**36.2**	18.5
Gas in storage, at last–in, first–out cost	**153.0**	221.0
Deferred income taxes	**25.1**	–
Other	**26.6**	53.1
Total current assets	**699.7**	1,055.8
Pension benefits	**161.0**	187.6
Other assets	**151.1**	46.8
Total assets	$ **3,592.5**	$ 3,820.3
Capitalization and Liabilities		
Capitalization		
Long–term obligations		
Long–term debt, net of unamortized discount	$ **497.5**	$ 445.8
Mandatorily redeemable preferred stock	**3.6**	4.1
Total long–term obligations	**501.1**	449.9
Preferred stock		
Non–redeemable preferred stock	**1.4**	1.4
Common equity		
Common stock	**76.2**	76.2
Paid–in capital	**108.1**	108.1
Retained earnings	**480.3**	470.7
Accumulated other comprehensive loss, net	**(3.2)**	(.3)
Total common equity	**661.4**	654.7
Total capitalization	**1,163.9**	1,106.0
Current liabilities		
Long–term obligations due within one year	**.5**	50.5
Short–term debt	**350.0**	490.0
Accounts payable	**466.5**	543.7
Accrued gas costs	**50.0**	223.3
Deferred income taxes	–	24.4
Derivative instruments	**51.1**	5.1
Dividends payable	**13.0**	11.0
Other	**64.9**	53.3
Total current liabilities	**996.0**	1,401.3
Deferred credits and other liabilities		
Regulatory retirement cost liability	**676.7**	631.7
Deferred income taxes	**281.7**	296.1

Health care and other postretirement benefits	**181.6**	101.6
Asset retirement obligation	**169.0**	164.0
Regulatory income tax liability	**53.8**	41.3
Unamortized investment tax credits	**29.6**	31.7
Other	**40.2**	46.6
Total deferred credits and other liabilities	**1,432.6**	1,313.0
Commitments and contingencies		
Total capitalization and liabilities	**$ 3,592.5**	$ 3,820.3

The accompanying notes are an integral part of these statements.

Source: NORTHERN ILLINOIS GA, 10-K, February 23, 2007

Nicor Gas Company

Consolidated Statements of Capitalization
(millions, except share data)

	December 31			
	2006		2005	
First Mortgage Bonds				
5.55% Series due 2006	$ –		$ 50.0	
5.875% Series due 2008	**75.0**		75.0	
5.37% Series due 2009	**50.0**		50.0	
6.625% Series due 2011	**75.0**		75.0	
7.20% Series due 2016	**50.0**		50.0	
5.80% Series due 2023	**50.0**		50.0	
6.58% Series due 2028	**50.0**		50.0	
5.90% Series due 2032	**50.0**		50.0	
5.90% Series due 2033	**50.0**		50.0	
5.85% Series due 2036	**50.0**		–	
	500.0		500.0	
Less: Amount due within one year	**–**		50.0	
Unamortized debt discount, net of premium	**2.5**		4.2	
	497.5	**42.8%**	445.8	40.3%
Preferred stock, cumulative, $100 par value, 800,000 shares authorized				
Mandatorily redeemable preferred stock, 4.48% and 5.00% series, 41,000 shares outstanding in 2006 and 46,000 shares outstanding in 2005	**4.1**		4.6	
Less: Amount due within one year	**.5**		.5	
	3.6	**.3**	4.1	.4
Nonredeemable preferred stock, 4.60% and 5.00% convertible series, 14,008 shares outstanding	**1.4**	**.1**	1.4	.1
Common equity				
Common stock, $5 par value, 25,000,000 shares authorized, 32,365 shares reserved for share–based awards and 15,232,414 shares outstanding	**76.2**		76.2	
Paid–in capital	**108.1**		108.1	
Retained earnings	**480.3**		470.7	
Accumulated other comprehensive loss, net				
Cash flow hedges	**(.1)**		–	
Unrecognized postretirement loss (includes $2.9 SFAS 158 transition amount)	**(3.1)**		–	
Minimum pension liability	**–**		(.3)	
Total common equity	**661.4**	**56.8**	654.7	59.2
Total capitalization	**$ 1,163.9**	**100.0%**	$ 1,106.0	100.0%

The accompanying notes are an integral part of these statements.

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

Nicor Gas Company

Consolidated Statements of Retained Earnings
(millions)

	Year ended December 31		
	2006	2005	2004
Balance at beginning of year	**$ 470.7**	$ 455.3	$ 442.3
Net income	**58.6**	53.5	62.1
Dividends declared on common stock	**(48.9)**	(38.0)	(49.0)
Dividends declared on preferred stock	**(.1)**	(.1)	(.1)
Balance at end of year	**$ 480.3**	$ 470.7	$ 455.3

Consolidated Statements of Comprehensive Income
(millions)

	Year ended December 31		
	2006	2005	2004
Net income	**$ 58.6**	$ 53.5	$ 62.1
Other comprehensive income (loss), before tax			
Loss on cash flow hedges	**(.1)**	–	–
Decrease to minimum pension liability	–	2.2	–
	(.1)	2.2	–
Related income tax expense	–	(.9)	–
Other comprehensive income (loss), net of tax	**(.1)**	1.3	–
Comprehensive income	**$ 58.5**	$ 54.8	$ 62.1

The accompanying notes are an integral part of these statements.

Source: NORTHERN ILLINOIS GA, 10-K, February 23, 2007

Notes to the Consolidated Financial Statements

Nicor Gas is one of the nation's largest distributors of natural gas, serving nearly 2.2 million customers in a service territory that encompasses most of the northern third of Illinois, excluding the city of Chicago.

1. ACCOUNTING POLICIES

General. Nicor Gas is a wholly owned subsidiary of Nicor. Nicor Gas and its affiliates reimburse each other for transactions between the companies.

Consolidation. The consolidated financial statements include the accounts of Nicor Gas and its wholly owned subsidiary. All significant intercompany balances and transactions have been eliminated.

Income statement presentation. The focus of Nicor Gas' income statement presentation is the regulatory treatment of revenues and expenses. Operating revenues and expenses (including income taxes) on which rate–regulated utility operating income is based, are those that ordinarily are included in the determination of utility revenue requirements.

Use of estimates. The preparation of the financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates that affect reported amounts. Actual results could differ from those estimates and such differences could be material. Accounting estimates requiring significant management judgment involve accruals for legal, regulatory and environmental loss contingencies, unbilled revenues, the allowance for doubtful accounts receivable, postretirement benefit assets and liabilities, asset retirement obligations, income taxes and related assets and liabilities, the identification and valuation of derivative instruments, and potential asset impairments.

Reclassifications. Certain reclassifications have been made to conform the prior years' financial statements to the current year's presentation.

Cash and cash equivalents. Cash equivalents are comprised of highly liquid investments with an initial maturity of three months or less. The carrying value of these investments approximates fair value because of their short maturity.

Regulatory assets and liabilities. Nicor Gas is regulated by the ICC, which establishes the rules and regulations governing utility rates and services in Illinois. As a rate–regulated company, Nicor Gas applies SFAS No. 71, *Accounting for the Effects of Certain Types of Regulation*, which allows Nicor Gas to recognize the economic effects of rate regulation and, accordingly, has recorded regulatory assets and liabilities. Regulatory assets represent probable future revenue associated with certain costs that are expected to be recovered from customers through rate riders or rate cases, upon approval by the ICC. Regulatory liabilities represent probable future reductions in revenues collected from ratepayers through a rate rider or base rates. If all or a portion of the company's operations become no longer subject to the provisions of SFAS No. 71, a write–off of net regulatory liabilities would be required.

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

The company had regulatory assets and liabilities at December 31 as follows (in millions):

	2006	2005
Regulatory assets		
Regulatory postretirement asset – current	$ **8.8**	$ –
Regulatory postretirement asset – noncurrent	**104.7**	–
Deferred environmental costs	**16.0**	15.1
Unamortized losses on reacquired debt	**17.6**	18.7
Deferred rate case costs	**3.0**	3.5
Other	**1.0**	.3
	$ **151.1**	$ 37.6
Regulatory liabilities		
Regulatory retirement cost liability – current	$ **8.0**	$ 9.0
Regulatory retirement cost liability – noncurrent	**676.7**	631.7
Accrued gas costs	**50.0**	223.3
Regulatory income tax liability	**53.8**	41.3
Other	**–**	1.8
	$ **788.5**	$ 907.1

The current portion of the regulatory postretirement asset is classified in current other assets and all other regulatory assets are classified in noncurrent other assets. The current portion of the regulatory retirement cost liability is classified in current other liabilities. Regulatory liabilities – Other is classified in noncurrent other liabilities.

The ICC does not presently allow Nicor Gas the opportunity to earn a return on its regulatory postretirement asset. The regulatory asset is expected to be recovered from ratepayers over a period of approximately 10 to 15 years. The regulatory assets related to debt are not included in rate base, but are recovered over the term of the debt through the rate of return authorized by the ICC.

Asset retirement obligations. The company records legal obligations associated with the retirement of long–lived assets in the period in which the obligation is incurred, if sufficient information exists to reasonably estimate the fair value of the obligation. The obligation is recorded as both a cost of the long–lived asset and a corresponding liability. Subsequently, the asset retirement cost is depreciated over the life of the asset on a straight–line basis and the asset retirement obligation is accreted to the expected settlement amount.

Subject to rate regulation, Nicor Gas continues to accrue all future asset retirement costs through depreciation over the lives of its assets even when a legal retirement obligation does not exist or insufficient information exists to determine the fair value of the obligation. Amounts charged to depreciation by Nicor Gas for future retirement costs in excess of the normal depreciation and accretion described above are classified as a regulatory retirement cost liability.

Derivative instruments. Fair values on derivatives are determined from quoted market prices and other external sources, where available, or are estimated using internal models. Estimates from internal models were not material to Nicor Gas' financial statements. Derivative instruments are classified as current or noncurrent other assets or liabilities as appropriate, except for the current liability, which is separately stated. Cash flows from derivative instruments are recognized in the consolidated statements of cash flows, and gains and losses are recognized in the consolidated statements of operations, in the same categories as the underlying transactions.

Cash flow hedge accounting may be elected only for highly effective hedges, based upon an assessment, performed at least quarterly, of the historical and probable future correlation of changes in the fair value of the derivative instrument to changes in the expected future cash flows of the hedged item. To the

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

extent cash flow hedge accounting is applied, the effective portion of any changes in the fair value of the derivative instruments is reported as a component of accumulated other comprehensive income or loss. Ineffectiveness, if any, is immediately recognized in operating income. The amount in accumulated other comprehensive income or loss is reclassified to earnings when the forecasted transaction occurs, even if the derivative instrument is sold, extinguished or terminated prior to the transaction occurring. If the forecasted transaction is no longer expected to occur, the amount in accumulated other comprehensive income or loss is immediately reclassified to earnings.

Derivative instruments, such as futures contracts, options and swap agreements, are utilized primarily in the procurement of natural gas for customers. These derivative instruments are reflected on the balance sheet at fair value. Realized gains or losses on such instruments are included in the cost of gas delivered and are passed directly through to customers, subject to ICC review, having no direct impact on earnings. Unrealized changes in the fair value of these derivative instruments are deferred as regulatory assets or liabilities and classified on the balance sheet as deferred or accrued gas costs, respectively.

At times, Nicor Gas enters into futures contracts, options, swap agreements and fixed–price purchase agreements to reduce the earnings impact of certain forecasted operating costs arising from fluctuations in natural gas prices. These derivative instruments are carried at fair value, unless they qualify for the normal purchases and normal sales exception, in which case they are carried at cost. For those instruments carried at fair value, hedge accounting was generally not elected and, accordingly, changes in such fair values were recorded in earnings as operating and maintenance expense. In late 2006, Nicor Gas hedged a portion of its forecasted 2008 natural gas purchases through the execution of swap agreements and has elected hedge accounting for such transactions. There was no ineffectiveness and the deferred gains and losses associated with these instruments were immaterial at December 31, 2006.

Credit risk. Nicor Gas has a diversified customer base and the company believes that it maintains prudent credit policies which mitigate customer receivable and derivative counterparty credit risk. The company is exposed to credit risk in the event a counterparty, customer or supplier defaults on a contract to pay for or deliver product at agreed–upon terms and conditions. To manage this risk, the company has established procedures to determine and monitor the creditworthiness of counterparties, to require guarantees or collateral back–up, and to limit its exposure to any one counterparty. Nicor Gas also, in some instances, enters into netting arrangements to mitigate counterparty credit risk. Credit losses are accrued as liabilities when probable and reasonably estimable.

Operating revenues and gas costs. Operating revenues are recognized when natural gas is delivered to customers. In accordance with ICC regulations and subject to its review, the cost of gas delivered is charged to customers without markup, although the timing of cost recovery can vary. Temporary undercollections and overcollections of gas costs are deferred or accrued as a regulatory asset or liability with a corresponding decrease or increase to cost of gas, respectively.

Legal defense costs. Nicor Gas accrues estimated legal defense costs associated with loss contingencies in the period in which it determines that such costs are probable of being incurred and are reasonably estimable.

Depreciation. Property, plant and equipment are depreciated over estimated useful lives on a straight–line basis. The composite depreciation rate is 4.1 percent, which includes all estimated future retirement costs.

Revenue taxes. Nicor Gas classifies revenue taxes billed to customers as operating revenues and related taxes incurred as operating expenses. Revenue taxes included in operating expense for 2006, 2005 and 2004 were $144.4 million, $152.0 million and $139.4 million, respectively.

Income taxes. Nicor Gas files a consolidated federal income tax return with Nicor. Income taxes are allocated to Nicor Gas based upon the tax liability which would have been incurred on a separate company basis. Deferred income taxes are provided at the current statutory income tax rate for temporary

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

differences between the tax basis of an asset or liability and its reported amount in the financial statements. Nicor Gas amortizes investment tax credits and regulatory income tax liabilities for deferred taxes in excess of the current statutory rate to income over the lives of the related properties.

2. NEW ACCOUNTING PRONOUNCEMENTS

Share–based payment. Key executives and managerial employees of Nicor Gas participate in Nicor's stock–based compensation plans. Effective January 1, 2006, Nicor adopted SFAS No. 123 (revised 2004), *Share–Based Payment* ("SFAS 123(R)"), using the modified–prospective transition method. Under such method, compensation cost recognized in 2006 includes: (a) compensation cost for all share–based equity awards granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, *Accounting for Stock–Based Compensation* ("SFAS 123") and (b) compensation cost for all share–based equity awards granted subsequent to January 1, 2006, based on the grant–date fair value estimated in accordance with the provisions of SFAS 123(R). In addition, liability awards will be adjusted to fair value at each quarter–end. In 2006, Nicor Gas recognized $2.6 million of compensation expense for stock–based compensation.

Prior to January 1, 2006, Nicor accounted for its stock–based compensation plans under the recognition and measurement provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* ("APB 25"), and related Interpretations, as permitted by SFAS 123. Under APB 25, Nicor Gas did not recognize compensation cost for stock options or employee stock purchase plan discounts, and certain liability awards were adjusted to intrinsic value. Results from prior periods have not been restated.

Defined benefit pension and other postretirement plans. In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*. This Statement requires an entity to immediately recognize the funded status of a defined benefit postretirement plan as an asset or liability in its balance sheet, and to recognize changes in that funded status through comprehensive income to the extent not recognized in net income pursuant to existing accounting rules. As a regulated utility, Nicor Gas expects continued rate recovery of the eligible costs of its defined benefit postretirement plans and, accordingly, associated changes in the plan's funded status have been deferred as a regulatory asset or liability until recognized in net income, instead of being recorded in comprehensive income.

On December 31, 2006, the company adopted the recognition provisions of SFAS No. 158. The incremental effect of applying SFAS No. 158 on individual line items of the December 31, 2006 balance sheet was as follows (in millions):

	Before application	Adjustments	After application
Current deferred income taxes	$ 22.2	$ 2.9	$ 25.1
Current other assets (1)	17.8	8.8	26.6
Pension benefits	197.4	(36.4)	161.0
Noncurrent other assets (1)	46.7	104.4	151.1
Current other liabilities	(55.8)	(9.1)	(64.9)
Noncurrent deferred income taxes	(297.0)	15.3	(281.7)
Health care and other postretirement benefits	(108.3)	(73.3)	(181.6)
Regulatory income tax liability	(38.3)	(15.5)	(53.8)
Accumulated other comprehensive loss, net	0.3	2.9	3.2

(1) "Adjustments" to these line items primarily represent the establishment of a regulatory asset.

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

This Statement will also require Nicor Gas to change its plan measurement date to December 31. Such provision is effective for Nicor Gas no later than December 31, 2008 and will be adopted prospectively at that time. The company has not yet determined the impact of adopting this provision.

Uncertain tax positions. In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*. This Interpretation sets forth a recognition threshold and valuation method to recognize and measure an income tax position taken, or expected to be taken, in a tax return. The evaluation is based on a two–step approach. The first step requires an entity to evaluate whether the tax position would "more likely than not," based upon its technical merits, be sustained upon examination by the appropriate taxing authority. The second step requires the tax position to be measured at the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement. In addition, previously recognized benefits from tax positions that no longer meet the new criteria would be derecognized. The application of this Interpretation will be considered a change in accounting principle with the cumulative effect of the change recorded to the opening balance of retained earnings in the period of adoption. This Interpretation will be effective for Nicor Gas on January 1, 2007. Upon adoption of this Interpretation, the company currently estimates the required cumulative effect adjustment to the opening balance of retained earnings to be a decrease of approximately $1 million to $3 million.

Fair value measurements. In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. This Statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. The Statement does not require any new fair value measurements, rather it provides guidance on how to perform fair value measurements as required or permitted under other accounting pronouncements. This Statement is effective for Nicor Gas no later than January 1, 2008 and is expected to be adopted prospectively at that time. The company is currently evaluating the Statement and the impact it may have on the company's results of operations and financial condition.

3. ASSET RETIREMENT OBLIGATIONS

In 2005, Nicor Gas adopted FASB Interpretation No.47, *Accounting for Conditional Asset Retirement Obligations* ("FIN 47"), which broadened the assessment of when assets contain measurable retirement obligations. Prior to adopting FIN 47, Nicor Gas recorded AROs related primarily to the required removal and/or disposal of mercury regulators.

Upon adoption, Nicor Gas recorded additional AROs associated with services, mains and other components of the distribution system and buildings of $160.2 million, increased the carrying value of the related assets by $59.8 million, increased accumulated depreciation by $26.2 million and reduced its regulatory liability for future retirement costs by $126.6 million. Nicor Gas has not recognized an ARO associated with gathering lines and storage wells because there is insufficient company or industry retirement history to reasonably estimate the fair value of the obligation. At December 31, 2005, a total ARO of $164.4 million was recorded.

The following table presents a reconciliation of the beginning and ending ARO for the year ended December 31, 2006 (in millions):

Beginning of period	**$ 164.4**
Liabilities incurred during the period	**2.2**
Liabilities settled during the period	**(3.2)**
Accretion	**9.5**
Revision in estimated cash flows	**(2.7)**
End of period	**$ 170.2**

Substantially all of the ARO is classified as a noncurrent liability. If the company had applied the provisions of FIN 47 to prior periods, it would have recorded an ARO of $152.5 million at December 31, 2004.

4. GAS IN STORAGE

Based on the average cost of gas purchased in December 2006 and 2005, the estimated replacement cost of inventory at December 31, 2006 and 2005 exceeded the LIFO cost by $449.9 million and $778.4 million, respectively.

During 2006, Nicor Gas liquidated LIFO layers totaling 10 Bcf at an average cost per Mcf of $6.81. For gas purchased in 2006, the company's average cost per Mcf was $0.28 lower than the LIFO liquidation rate. Applying LIFO cost in valuing the liquidations, as opposed to using the average gas purchase cost, had the effect of increasing the cost of gas in 2006 by $2.8 million. However, since the cost of gas, including inventory costs, is charged to customers without markup, these amounts had no impact on net income.

During 2004, Nicor Gas partially liquidated a LIFO layer at a cost per Mcf of $5.81. For gas purchased in 2004, the company's average cost per Mcf was $0.24 higher than the LIFO liquidation rate. Applying LIFO cost in valuing the liquidations, as opposed to using the average gas purchase cost, had the effect of decreasing the cost of gas in 2004 by $0.7 million. However, since the cost of gas, including inventory costs, is charged to customers without markup, these amounts had no impact on net income.

There was no liquidation of any LIFO layers during 2005.

5. SHORT–TERM AND LONG–TERM DEBT

In December 2006, Nicor Gas, through a private placement, issued $50 million of First Mortgage Bonds at 5.85 percent, due in 2036. Proceeds from this issuance were applied to the maturity of the $50 million 5.55 percent First Mortgage Bond series, due in December 2006. Substantially all gas distribution properties are subject to the lien of the indenture securing Nicor Gas' First Mortgage Bonds.

In October 2006, Nicor Gas established a $400 million, 210–day seasonal revolver, which expires in May 2007, to replace the $400 million, 210–day seasonal revolver, which expired in April 2006. In September 2005, Nicor and Nicor Gas established a $600 million, five–year revolver, expiring September 2010. These facilities were established with major domestic and foreign banks and serve as backup for the issuance of commercial paper. The company had $350 million and $490 million of commercial paper outstanding with a weighted–average interest rate of 5.4 percent and 4.1 percent at December 31, 2006 and 2005, respectively.

The company believes it is in compliance with all debt covenants.

The company incurred total interest expense of $45.0 million, $43.2 million, and $37.6 million in 2006, 2005 and 2004, respectively. Interest expense is reported net of amounts capitalized. Interest expense capitalized for the years ended December 31, 2006, 2005 and 2004 was $0.7 million, $1.1 million and $0.4 million, respectively.

6. ACCRUED UNBILLED REVENUES

Receivables include accrued unbilled revenues of $158.9 million and $300.4 million at December 31, 2006 and 2005, respectively. Nicor Gas accrues revenues for estimated deliveries to customers from the date of their last bill until the balance sheet date.

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

7. FAIR VALUE OF FINANCIAL INSTRUMENTS

The recorded amount of short–term investments and short–term borrowings approximates fair value because of the short maturity of the instruments. Long–term debt outstanding, including current maturities, is recorded at the principal balance outstanding, net of unamortized discounts. The principal balance of Nicor Gas' First Mortgage Bonds outstanding at December 31, 2006 and 2005 was $500 million. Based on quoted market interest rates, the fair value of the company's First Mortgage Bonds outstanding, including current maturities, was approximately $518 million and $525 million at December 31, 2006 and 2005, respectively.

Derivative financial instruments are recorded at fair value as determined primarily from actively quoted prices. The majority of derivative financial instruments are held for the purpose of hedging natural gas purchases for its customers, and their settlement is passed directly through to customers without markup, subject to ICC review. The gross asset and liability fair values of these instruments are reflected on the Consolidated Balance Sheets at December 31 as follows (in millions):

	2006	2005
Current other assets	**$ .3**	$ 25.7
Noncurrent other assets	**.1**	1.0
	$ .4	$ 26.7
Derivative instruments	**$ 48.0**	$ .8
Noncurrent other liabilities	**.7**	.1
	$ 48.7	$ .9

Nicor Gas maintains a margin account related to financial derivative transactions. At December 31, 2006 and 2005, the balance of this account was $13.0 million and $33.7 million, respectively, and was reflected on the Consolidated Balance Sheets as Receivables.

8. INCOME AND OTHER TAXES

The components of income tax expense (benefit) are presented below (in millions):

	2006	2005	2004
Current			
Federal	**$ 62.0**	$ 87.1	$ 11.7
State	**16.5**	20.4	3.0
	78.5	107.5	14.7
Deferred			
Federal	**(37.6)**	(64.0)	16.4
State	**(11.0)**	(15.3)	3.8
	(48.6)	(79.3)	20.2
Amortization of investment tax credits, net	**(2.1)**	(2.1)	(1.8)
Income tax expense, net	**$ 27.8**	$ 26.1	$ 33.1

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

The temporary differences which gave rise to the net deferred tax liability at December 31 were as follows (in millions):

	2006	2005
Deferred tax liabilities		
Property, plant and equipment	$ **287.6**	$ 350.3
Employee benefits	**14.8**	24.6
Other	**19.4**	21.1
	321.8	396.0
Deferred tax assets		
Unamortized investment tax credits	**19.5**	20.9
Alternative minimum tax credits	–	14.4
Other	**45.7**	40.2
	65.2	75.5
Net deferred tax liability	$ **256.6**	$ 320.5

For purposes of computing deferred income tax assets and liabilities, temporary differences associated with regulatory assets and liabilities have been netted against related offsetting temporary differences.

Differences between the federal statutory rate and the effective combined federal and state income tax rate are shown below:

	2006	2005	2004
Federal statutory rate	**35.0%**	35.0%	35.0%
State income taxes, net	**4.4**	4.6	5.2
Amortization of investment tax credits	**(2.6)**	(3.0)	(2.4)
Amortization of regulatory income tax liability	**(1.7)**	(2.3)	(2.0)
Medicare subsidy	**(2.1)**	(1.1)	–
Other, net	**(.8)**	(.4)	(1.0)
Effective combined federal and state income tax rate	**32.2%**	32.8%	34.8%

The decrease in the effective income tax rate in 2006 is primarily due to an increase in certain tax credits and permanent items, offset, in part, by higher pretax income (which causes a higher effective income tax rate since permanent differences and tax credits are a smaller share of pretax income). The decrease in the effective income tax rate in 2005 is primarily due to lower pretax income.

The company accrues tax and interest related to tax uncertainties. Tax uncertainties arise due to actual or potential disagreements about the tax treatment of specific items between the company and the governmental agency reviewing the company's tax returns. At December 31, 2006 and 2005, the company had accrued approximately $14 million and $9 million, respectively, for such uncertainties.

In 2003, Nicor Gas received an income tax refund of approximately $100 million attributable to a tax loss carryback associated with a change in tax accounting method (which increased its deferred income tax liability) subject to IRS review and approval as part of normal ongoing audits. Through December 31, 2004, the total current tax benefits previously recorded under this accounting method approximated $135 million (amounts recorded were offset by increases to the deferred tax liability with no net effect on reported net federal income tax expense). In 2005, the IRS revised the regulations pertaining to the aforementioned tax accounting method. The new regulations required repayment in 2005 and 2006 of amounts previously taken as current tax deductions. During 2006 and 2005, the company reclassified income tax expense from deferred to current and repaid approximately $135 million equally over those years.

Source: NORTHERN ILLINOIS GA, 10-K, February 23, 2007

9. POSTRETIREMENT BENEFITS

Nicor Gas maintains a noncontributory defined benefit pension plan covering substantially all employees hired prior to 1998. Pension benefits are based on years of service and highest average salary for management employees and job level for unionized employees. The benefit obligation related to collectively bargained benefits considers the company's past practice of regular benefit increases to reflect current wages. Nicor Gas also provides health care and life insurance benefits to eligible retired employees under a plan that includes a limit on the company's share of cost for employees hired after 1982. The company's postretirement benefit costs have historically been considered in rate proceedings in the period they are accrued. To the extent eligible employees perform services for non–regulated affiliates, such affiliates are charged for the cost of these benefits.

The following table sets forth the changes in the plans' benefit obligations and assets, and reconciles the October 1 funded status of the plans to the corresponding asset (liability) recorded on the balance sheet at December 31 (in millions):

	Pension benefits		Health care and other benefits	
	2006	2005	**2006**	2005
Change in benefit obligation				
Benefit obligation at beginning of period	**$ 284.4**	$ 282.6	**$ 192.5**	$ 184.7
Service cost	**9.4**	9.3	**2.4**	2.7
Interest cost	**14.9**	15.6	**10.3**	10.3
Actuarial (gain) loss	**(9.7)**	7.1	**.4**	4.9
Participant contributions	**–**	–	**.7**	.8
Benefits paid	**(27.7)**	(30.2)	**(12.6)**	(10.9)
Benefit obligation at end of period	**271.3**	284.4	**193.7**	192.5
Change in plan assets				
Fair value of plan assets at beginning of period	**424.0**	402.0	**6.9**	10.6
Actual return on plan assets	**36.0**	52.2	**.2**	1.0
Employer contributions	**–**	–	**6.0**	5.4
Participant contributions	**–**	–	**.7**	.8
Benefits paid	**(27.7)**	(30.2)	**(12.6)**	(10.9)
Fair value of plan assets at end of period	**432.3**	424.0	**1.2**	6.9
Funded status	**161.0**	139.6	**(192.5)**	(185.6)
Unrecognized net actuarial loss	**–**	44.9	**–**	88.5
Unrecognized prior service costs	**–**	3.1	**–**	(.7)
Other	**–**	–	**1.8**	(3.8)
Postretirement benefit asset (liability)	**$ 161.0**	$ 187.6	**$ (190.7)**	$ (101.6)

Amounts classified on the balance sheet as of December 31 consist of (in millions):

	Pension benefits		Health care and other benefits	
	2006	2005	**2006**	2005
Noncurrent assets	**$ 161.0**	$ 187.6	**$ –**	$ –
Current liabilities	**–**	–	**(9.1)**	–
Noncurrent liabilities	**–**	–	**(181.6)**	(101.6)
	$ 161.0	$ 187.6	**$ (190.7)**	$ (101.6)

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

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Changes in the funded status attributable to eligible employees performing work for a non–regulated affiliate that were recognized in accumulated other comprehensive income on December 31, 2006 were as follows (in millions):

	Pension benefits	Health care and other benefits
Net loss	$ **1.7**	$ **4.2**
Prior service cost	**.1**	**–**
	$ **1.8**	$ **4.2**

The associated amount in accumulated other comprehensive income at December 31, 2006 that is expected to be reclassed to net periodic benefit cost in 2007 is approximately $0.3 million.

The accumulated benefit obligation for pension benefits, a measure which excludes the effect of salary and wage increases, was $233.4 million and $246.1 million at October 1, 2006 and 2005, respectively.

In 2003, the company amended the retiree health care plan as it applies to non–unionized employees to improve consistency of benefits among participant groups and reduce the company's share of plan costs effective January 1, 2004. In 2004, further cost–sharing amendments, effective January 1, 2006, were made to the plan for all employees.

About one–fourth of the net periodic benefit cost or credit related to these plans has been capitalized as a cost of constructing gas distribution facilities and the remainder is included in gas distribution operating and maintenance expense. Net periodic benefit cost (credit) included the following components (in millions):

	Pension benefits			Health care and other benefits		
	2006	2005	2004	**2006**	2005	2004
Service cost	$ **9.4**	$ 9.3	$ 9.0	$ **2.4**	$ 2.7	$ 2.4
Interest cost	**14.9**	15.6	15.7	**10.3**	10.3	10.1
Expected return on plan assets	**(34.8)**	(33.2)	(31.7)	**(.2)**	(.9)	(1.0)
Recognized net actuarial loss	**.2**	1.6	2.0	**5.0**	4.9	4.6
Amortization of unrecognized transition obligation	**–**	–	–	**–**	–	.1
Amortization of prior service cost	**.5**	.6	.6	**(.1)**	(.1)	–
Net periodic benefit cost (credit)	$ **(9.8)**	$ (6.1)	$ (4.4)	$ **17.4**	$ 16.9	$ 16.2

Assumptions used to determine benefit obligations at October 1 included the following:

	Pension benefits		Health care and other benefits	
	2006	2005	**2006**	2005
Discount rate	**5.75%**	5.50%	**5.75%**	5.50%
Rate of compensation increase	**3.75**	3.75	**3.75**	3.75

The 2006 discount rate was determined by reference to the Citigroup Pension Liability index rate. Periodically, the company will perform bond matching studies, using non–callable, high quality bonds (AA– or better), whose cash flows match the timing and amount of future benefit payments of the plans. Such studies have historically yielded a single equivalent discount rate comparable to the Citigroup Pension Liability index rate.

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

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Assumptions used to determine net periodic benefit cost for the years ended December 31 included the following:

	Pension benefits			Health care and other benefits		
	2006	2005	2004	**2006**	2005	2004
Discount rate	**5.50%**	5.75%	6.00%	**5.50%**	5.75%	6.00%
Expected return on assets	**8.50**	8.50	8.50	**8.50**	8.50	8.50
Rate of compensation increase	**3.75**	4.00	4.00	**3.75**	4.00	4.00

Nicor Gas establishes its expected long–term return–on–asset assumption by considering historical and projected returns for each investment asset category. Projected returns are calculated with the assistance of independent firms via probability–based models. The company has elected to apply this assumption to the fair value of plan assets, rather than to a rolling–average fair value, in calculating the expected return on plan assets component of net periodic benefit cost. The assumed rate of return on assets can have a significant effect on the amounts reported for pension benefits. A one–percentage–point change in the assumed rate of return on assets would impact the net periodic pension credit by approximately $4 million.

Other assumptions used to determine the health care benefit obligation at October 1 were as follows:

	2006	2005
Health care cost trend rate	**9.5%**	9.5%
Rate to which the cost trend rate is assumed to decline (the ultimate rate)	**5.0%**	5.0%
Years to reach ultimate rate	**5**	5

Other assumptions used to determine the health care benefit cost for the years ended December 31 were as follows:

	2006	2005	2004
Health care cost trend rate	**9.5%**	9.5%	9.5%
Rate to which the cost trend rate is assumed to decline (the ultimate rate)	**5.0%**	5.0%	5.0%
Years to reach ultimate rate	**5**	4	4

Assumed health care cost trend rates can have a significant effect on the amounts reported for the health care plans. A one–percentage–point change in the assumed health care cost trend rates would have the following effects (in millions):

	One–percent	
	Increase	Decrease
Effect on total of service and interest cost components	$ 1.1	$ (.9)
Effect on benefit obligation	18.3	(15.6)

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 provides a prescription drug benefit as well as a potential federal subsidy to sponsors of certain retiree health care benefit plans whose prescription drug benefits are actuarially equivalent to the Medicare Part D benefit. Nicor Gas has determined that the prescription drug benefits of its plan are actuarially equivalent and accordingly have reflected the effects of the subsidy in its determination of the benefit obligation and annual net periodic benefit cost beginning with the October 1, 2004 valuation.

The company's investment objective relating to pension plan assets is to have a high probability of meeting its obligations without additional cash contributions. The company's investment strategy is to maintain an asset mix near its target asset allocation and to rebalance the portfolio monthly if the actual allocation deviates from the target by two or more percentage points. The following table sets forth the target allocation and actual percentage of plan assets by asset category:

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

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Asset category	Target allocation	Percentage of plan assets at October 1 2006	2005
Equity securities	69%	**69%**	69%
Debt securities	31	**31**	31
	100%	**100%**	100%

The company does not expect to contribute to its pension plan in 2007 but does expect to contribute about $11.6 million to its other postretirement benefit plan in 2007. The following table sets forth the benefit payments from the plans expected over the next 10 years (in millions):

Twelve months ending October 1	Pension benefits	Health care and other benefits	Expected Medicare subsidy
2007	$ 18.6	$ 11.6	$ (1.3)
2008	17.4	12.2	(1.4)
2009	19.0	13.0	(1.5)
2010	19.8	13.7	(1.6)
2011	21.4	14.3	(1.7)
2012–2016	136.4	77.8	(9.2)

Nicor Gas also has a separate unfunded supplemental retirement plan. The supplemental retirement plan is noncontributory with defined benefits and plan costs of $0.3 million, $2.5 million and $1.9 million in 2006, 2005 and 2004, respectively. The projected benefit obligation associated with the plan was $2.4 million and $2.6 million at December 31, 2006 and 2005, respectively.

The company also sponsors defined contribution plans covering substantially all employees. These plans provide for employer matching contributions. The total cost of these plans was $4.8 million, $4.8 million and $4.5 million in 2006, 2005 and 2004, respectively.

10. DIVIDEND AND OTHER RESTRICTIONS

Nicor Gas is restricted by regulation in the amount it can dividend or loan to affiliates. Dividends are allowed only to the extent of Nicor Gas' retained earnings balance. For restrictions regarding cash deposits from or advances to affiliates, see Note 12 – Related Party Transactions.

11. BUSINESS SEGMENT INFORMATION

Revenues are comprised principally of natural gas sales bundled with delivery, delivery–only (transportation) services and revenue taxes, as follows (in millions):

	2006	2005	2004
Bundled sales	**$ 2,087.8**	$ 2,546.7	$ 2,024.7
Transportation	**158.8**	151.9	147.4
Revenue taxes	**147.7**	156.4	143.5
Other	**58.0**	54.6	48.3
	$ 2,452.3	$ 2,909.6	$ 2,363.9

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

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12. RELATED PARTY TRANSACTIONS

In the ordinary course of business, under the terms of an agreement approved by the ICC, Nicor Gas enters into transactions with Nicor and its other wholly owned subsidiaries for the use of facilities and services. The charges for these transactions are cost–based, except where the charging party has a prevailing price for which the facility or service is provided to the general public. In addition, Nicor charges Nicor Gas and its other wholly owned subsidiaries for the cost of corporate overheads. Corporate overheads are allocated to Nicor's subsidiaries based upon a formula approved by the ICC. For the years ended December 31, 2006, 2005 and 2004, Nicor Gas had net charges to affiliates of $7.4 million, $6.6 million and $9.1 million, respectively.

Nicor Gas participates in a cash management system with other subsidiaries of Nicor. By virtue of making deposits or advances to Nicor, Nicor Gas is exposed to credit risk to the extent it is unable to secure the return of such deposits for any reason. Such deposits are due on demand. There are ICC regulations addressing the amount and circumstances in which Nicor Gas can deposit with the cash management pool or advance to affiliates. In addition, Nicor Gas may not extend cash advances to an affiliate if Nicor Gas has any outstanding short–term borrowings. Nicor Gas' practice also provides that the balance of cash deposits or advances from Nicor Gas to an affiliate at any time shall not exceed the unused balance of funds actually available to that affiliate under its existing bank credit agreements or its commercial paper facilities with unaffiliated third parties. Nicor Gas' positive cash deposits, if any, may be applied by Nicor to offset negative balances of other Nicor subsidiaries and vice versa.

Nicor Gas had no deposits in the Nicor cash management pool at December 31, 2006 and 2005, respectively, due primarily to the seasonal cash requirements of the business. For the years ended December 31, 2006, 2005 and 2004, Nicor Gas recorded interest income of $2.3 million, $1.8 million and $0.1 million, respectively, from deposits in the Nicor cash management pool, at a rate of interest equal to the higher of Nicor's commercial paper rate or a market rate of return on a short–term investment.

Nicor Solutions, a wholly owned business of Nicor, offers utility–bill management products to customers of Nicor Gas. Under these products, Nicor Solutions pays Nicor Gas for the utility bills issued to the utility–bill management customers. For the years ended December 31, 2006, 2005 and 2004 Nicor Gas recorded revenues of $76.0 million, $83.7 million and $79.6 million, respectively, associated with the payments Nicor Solutions makes to Nicor Gas on behalf of its customers.

Nicor Advanced Energy, a wholly owned business of Nicor that began operations in 2006, presently operates in northern Illinois offering an alternative to the utility as a natural gas supplier. As a natural gas supplier, Nicor Advanced Energy pays Nicor Gas for inventory imbalance charges, delivery charges and applicable taxes. Nicor Gas recorded net revenues of $0.6 million from Nicor Advanced Energy in 2006.

Nicor Gas enters into routine transactions with Nicor Enerchange, a wholly owned wholesale natural gas marketing business of Nicor, for the purchase and sale of natural gas, transportation and storage services. Such transactions are governed by terms of an ICC order. For the years ended December 31, 2006, 2005 and 2004, net charges from Nicor Enerchange were $34.5 million, $30.3 million and $26.8 million, respectively. Additionally, Nicor Enerchange administers the Chicago Hub for Nicor Gas in accordance with an agreement approved by the ICC. For the years ended December 31, 2006, 2005 and 2004, charges from Nicor Enerchange were $0.8 million, $0.9 million and $1.2 million, respectively.

Horizon Pipeline, a 50–percent–owned joint venture of Nicor, charged Nicor Gas $10.3 million during the year ended December 31, 2006, and $10.4 million in both 2005 and 2004 for natural gas transportation under rates that have been accepted by the FERC.

EN Engineering, a 50–percent–owned joint venture of Nicor, charged Nicor Gas $4.2 million and $4.4 million for engineering and corrosion services rendered in 2006 and 2005, respectively. In 2004, Nicor Technologies, a subsidiary of Nicor, charged Nicor Gas $4.0 million for these services.

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

In addition, certain related parties may acquire regulated utility services at rates approved by the ICC.

13. COMMITMENTS

As of December 31, 2006, Nicor Gas had purchase commitments with payments due as follows (in millions):

	Purchase obligations	Operating leases	Other long–term obligations
2007	$ 11.3	$ 1.1	$ .5
2008	10.4	1.1	.5
2009	10.4	.9	.5
2010	10.4	.8	.5
2011	10.4	.9	.2
After 2011	3.7	9.2	1.6
	$ 56.6	$ 14.0	$ 3.8

Purchase obligations consist of a natural gas transportation agreement and property, plant and equipment purchases. Operating leases are primarily for office space and equipment. Rental expense under operating leases was $1.1 million, $1.0 million and $1.0 million in 2006, 2005 and 2004, respectively. Other long–term obligations consist primarily of redeemable preferred stock.

14. RATE PROCEEDING

In 2005, Nicor Gas received approval from the ICC for a $54.2 million base rate increase which reflected an allowed rate of return on original–cost rate base of 8.85 percent, including a 10.51 percent cost of common equity. The order also included the authorization to pass all Chicago Hub revenues directly through to customers as a credit to Nicor Gas' PGA rider and the shifting of certain storage–related costs from the PGA rider to base rates. In addition, rates were established using a 10–year average for weather as opposed to the previous use of a 30–year average. These rates were implemented in the fourth quarter of 2005.

In October 2005, Nicor Gas and six other parties filed applications for rehearing of the final order of the rate case. In March 2006, the ICC issued its decision on rehearing in which it adjusted the amount of the annual net rate increase to $49.7 million from the $54.2 million that had been approved in the earlier order. Rate changes resulting from the rehearing order were prospective and went into effect on April 11, 2006. Parties, including Nicor Gas, that appealed the ICC's rate case decision to the state appellate courts have since withdrawn their appeals. As a result, the ICC rate order is no longer subject to judicial review.

As a result of the rate order which became effective in the fourth quarter of 2005, certain storage–related costs have been recorded in operating and maintenance expense. Storage–related gas costs recorded in operating and maintenance expense during 2006 and 2005 totaled $21.4 million and $6.5 million, respectively. Storage–related gas costs incurred prior to the effective date of the rate order and recorded as cost of gas in 2005 totaled $11.1 million.

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

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15. GUARANTEES AND INDEMNITIES

In certain instances, Nicor Gas has undertaken to indemnify current property owners and others against costs associated with the effects and/or remediation of contaminated sites for which the company may be responsible under applicable federal or state environmental laws, generally with no limitation as to the amount. Aside from liabilities recorded in connection with coal tar cleanup, as discussed in Note 16 – Contingencies – Manufactured Gas Plant Sites, Nicor Gas believes that the likelihood of payment under these indemnifications is either remote, or the fair value of the indemnification is immaterial, and no liability has been recorded for these indemnifications.

Nicor Gas has also indemnified, to the fullest extent permitted under the laws of the State of Illinois and any other applicable laws, its present and former directors, officers and employees against expenses they may incur in connection with litigation they are a party to by reason of their association with the company. There is generally no limitation as to the amount. While the company does not expect to incur significant costs under these indemnifications, it is not possible to estimate the maximum potential payments.

16. CONTINGENCIES

The following contingencies of Nicor Gas are in various stages of investigation or disposition. Although in some cases the company is unable to estimate the amount of loss reasonably possible in addition to any amounts already recognized, it is possible that the resolution of these contingencies, either individually or in aggregate, will require the company to take charges against, or will result in reductions in, future earnings. It is the opinion of management that the resolution of these contingencies, either individually or in aggregate, could be material to earnings in a particular period but is not expected to have a material adverse impact on Nicor Gas' liquidity or financial condition.

PBR Plan. Nicor Gas' PBR plan for natural gas costs went into effect in 2000 and was terminated by the company effective January 1, 2003. Under the PBR plan, Nicor Gas' total gas supply costs were compared to a market–sensitive benchmark. Savings and losses relative to the benchmark were determined annually and shared equally with sales customers. The PBR plan is currently under ICC review. There are allegations that the company acted improperly in connection with the PBR plan, and the ICC and others are reviewing these allegations. On June 27, 2002, the Citizens Utility Board ("CUB") filed a motion to reopen the record in the ICC's proceedings to review the PBR plan (the "ICC Proceedings"). As a result of the motion to reopen, Nicor Gas, the Cook County State's Attorney Office ("CCSAO"), the staff of the ICC and CUB entered into a stipulation providing for additional discovery. The Illinois Attorney General's Office ("IAGO") has also intervened in this matter. In addition, the IAGO issued Civil Investigation Demands ("CIDs") to CUB and the ICC staff. The CIDs ordered that CUB and the ICC staff produce all documents relating to any claims that Nicor Gas may have presented, or caused to be presented, false information related to its PBR plan. The company has committed to cooperate fully in the reviews of the PBR plan.

In response to these allegations, on July 18, 2002, the Nicor Board of Directors appointed a special committee of independent, non–management directors to conduct an inquiry into issues surrounding natural gas purchases, sales, transportation, storage and such other matters as may come to the attention of the special committee in the course of its investigation. The special committee presented the report of its counsel ("Report") to Nicor's Board of Directors on October 28, 2002.

In response, the Nicor Board of Directors directed the company's management to, among other things, make appropriate adjustments to account for, and fully address, the adverse consequences to ratepayers of the items noted in the Report, and conduct a detailed study of the adequacy of internal accounting and regulatory controls. The adjustments were made in prior years' financial statements resulting in a $24.8 million liability. Included in such $24.8 million liability is a $4.1 million loss contingency. A $1.8 million adjustment to the previously recorded liability, which is discussed below, was made in 2004

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

increasing the recorded liability to $26.6 million. In addition, Nicor Gas estimates that there is $26.9 million due to the company from the 2002 PBR plan year, which has not been recognized in the financial statements due to uncertainties surrounding the PBR plan. The net of these items and interest income on certain components results in a $1.0 million reimbursement the company plans to seek in testimony to be filed in compliance with the scheduling order discussed below. By the end of 2003, the company completed steps to correct the weaknesses and deficiencies identified in the detailed study of the adequacy of internal controls.

Pursuant to the agreement of all parties, including the company, the ICC re–opened the 1999 and 2000 purchased gas adjustment filings for review of certain transactions related to the PBR plan and consolidated the reviews of the 1999–2002 purchased gas adjustment filings with the PBR plan review.

On February 5, 2003, the CCSAO and CUB filed a motion for $27 million in sanctions against the company in the ICC Proceedings. In that motion, CCSAO and CUB alleged that Nicor Gas' responses to certain CUB data requests were false. Also on February 5, 2003, CUB stated in a press release that, in addition to $27 million in sanctions, it would seek additional refunds to consumers. On March 5, 2003, the ICC staff filed a response brief in support of CUB's motion for sanctions. On May 1, 2003, the Administrative Law Judges issued a ruling denying CUB and CCSAO's motion for sanctions. CUB has filed an appeal of the motion for sanctions with the ICC, and the ICC has indicated that it will not rule on the appeal until the final disposition of the ICC Proceedings. It is not possible to determine how the ICC will resolve the claims of CCSAO, CUB or other parties to the ICC Proceedings.

In November 2003, the ICC staff, CUB, CCSAO and the IAGO filed their respective direct testimony in the ICC Proceedings. The ICC staff is seeking refunds to customers of approximately $108 million and CUB and CCSAO were jointly seeking refunds to customers of approximately $143 million. The IAGO direct testimony alleges adjustments in a range from $145 million to $190 million. The IAGO testimony as filed is presently unclear as to the amount which IAGO seeks to have refunded to customers. On February 27, 2004, the above referenced intervenors filed their rebuttal testimony in the ICC Proceedings. In such rebuttal testimony, CUB and CCSAO amended the alleged amount to be refunded to customers from approximately $143 million to $190 million. In December 2006, Nicor Gas withdrew its previously filed testimony. Nicor Gas anticipates refiling its direct testimony in compliance with the new scheduling order discussed below which it expects to be consistent with the findings of the special committee Report. Nicor Gas plans to seek a reimbursement of approximately $1 million as referenced above. In 2004, the evidentiary hearings on this matter were stayed in order to permit the parties to undertake additional third party discovery from Entergy–Koch Trading, LP ("EKT"), a natural gas, storage and transportation trader and consultant with whom Nicor did business under the PBR plan. In December 2006, the additional third party discovery from EKT was obtained and the Administrative Law Judges issued a scheduling order that provides for Nicor Gas to submit its direct testimony by April 13, 2007. No date has been set for evidentiary hearings on this matter.

During the course of the SEC investigation discussed below, the company became aware of additional information relating to the activities of individuals affecting the PBR plan for the period from 1999 through 2002, including information consisting of third party documents and recordings of telephone conversations from EKT. Review of additional information completed in 2004 resulted in the $1.8 million adjustment to the previously recorded liability referenced above.

Although the Report of the special committee's counsel did not find that there was criminal activity or fraud, a review of this additional information (which was not available to the independent counsel who prepared the Report) and re–interviews of certain Nicor Gas personnel in 2004 indicated that certain former Nicor Gas personnel may have engaged in potentially fraudulent conduct regarding the PBR plan in violation of company policy, and in possible violation of SEC rules and applicable law. Further, certain former Nicor Gas personnel also may have attempted to conceal their conduct in connection with an ICC review of the PBR plan. The company has reviewed all third party information it has obtained and will continue to review any additional third party information the company may obtain. The company terminated four employees in connection with this matter in 2004.

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

Nicor Gas is unable to predict the outcome of the ICC's review or the company's potential exposure thereunder. Because the PBR plan and historical gas costs are still under ICC review, the final outcome could be materially different than the amounts reflected in the company's financial statements as of December 31, 2006.

SEC and U.S. Attorney Inquiries. In 2002, the staff of the SEC Division of Enforcement ("SEC Staff") informed the company that the SEC is conducting a formal inquiry regarding the PBR plan. A representative of the Office of the United States Attorney for the Northern District of Illinois (the "U.S. Attorney") also notified the company that that office was conducting an inquiry on the same matter that the SEC is investigating, and a grand jury was also reviewing this matter. In April 2004, Nicor was advised by the SEC Staff that it intended to recommend to the SEC that it bring a civil injunctive action against Nicor, alleging that Nicor violated Sections 17(a) of the Securities Act of 1933 and Sections 10(b) and 13(a) of the Securities Exchange Act of 1934 and Rules 10b–5, 12b–20, 13a–1 and 13a–13 thereunder. On July 7, 2006, Nicor announced that it reached a tentative agreement with the SEC Staff in settlement of an anticipated civil action to which Nicor and the SEC will be parties. Under the terms of the tentative settlement, Nicor will be subject to disgorgement of one dollar, a monetary fine of $10 million and an injunction. Nicor will neither admit nor deny any wrongdoing. In July 2006, Nicor deposited the $10 million in escrow pending final approval of the tentative settlement by the SEC commissioners and entry of a final judgment by a federal court. The SEC Staff will submit the tentative settlement to the SEC commissioners for approval. The SEC commissioners have the authority to approve, modify or reject the tentative settlement. Nicor recorded a $10 million charge to its second quarter earnings in connection with this matter. As the tentative settlement is between Nicor and the SEC Staff, Nicor Gas has not recorded a liability associated with the outcome of the SEC matter. In December 2006, the U.S. Attorney advised that it is closing its separate inquiry and will not seek to prosecute the company or any individuals in connection with this matter.

Mercury. Nicor Gas has incurred, and expects to continue to incur, costs related to its historical use of mercury in various kinds of company equipment.

Nicor Gas is a defendant in several private lawsuits, all in the Circuit Court of Cook County, Illinois, seeking a variety of unquantified damages (including bodily injury and property damages) allegedly caused by mercury spillage resulting from the removal of mercury–containing regulators. Under the terms of a class action settlement agreement, Nicor Gas will continue, until 2007, to provide medical screening to persons exposed to mercury from its equipment, and will use reasonable efforts to remove any remaining inside residential mercury regulators by March of 2006. Nicor Gas believes it is in compliance with its obligations under the settlement agreement. The class action settlement permitted class members to "opt out" of the settlement and pursue their claims individually. Nicor Gas is currently defending claims brought by 14 households.

As of December 31, 2006, Nicor Gas had remaining an estimated liability of $13.2 million. This represents management's best estimate of future costs based on an evaluation of currently available information, including potential liabilities relating to remaining lawsuits after taking into account an agreement of a subcontractor's insurer to assume certain of these potential liabilities. Actual costs may vary from this estimate. The company will continue to reassess its estimated obligation and will record any necessary adjustment, which could be material to operating results in the period recorded.

Nicor Gas continues to pursue recovery from insurers and independent contractors that had performed work for the company. When received, these recoveries are recorded as a reduction to operating expense. Nicor Gas received approximately $3.8 million, net of legal fees, from an independent contractor in the first quarter of 2006. Amounts recovered during 2004 and 2005 were immaterial. On October 25, 2004, the Circuit Court of Cook County, Illinois entered judgment in favor of Nicor and Nicor Gas and against various insurers in the amount of $10.2 million with respect to one of Nicor's and Nicor Gas' mercury–related insurance claims. The insurers filed an appeal of the judgment. On November 29, 2005, the First

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

District Appellate Court reversed the Circuit Court's judgment in favor of Nicor and Nicor Gas and remanded the case to the Circuit Court for proceedings consistent with the Appellate Court's decision. On November 30, 2006, the Illinois Supreme Court upheld the decision of the Appellate Court and remanded the case to the trial court. In January 2007, an agreement in principle to settle this matter was reached with the lead insurers that would result in an additional net insurance recovery of approximately $0.7 million.

The final disposition of these mercury–related matters is not expected to have a material adverse impact on the company's financial condition.

Manufactured Gas Plant Sites. Manufactured gas plants were used in the 1800's and early to mid 1900's to produce manufactured gas from coal, creating a coal tar byproduct. Current environmental laws may require the cleanup of coal tar at certain former manufactured gas plant sites.

To date, Nicor Gas has identified about 40 properties for which it may have some responsibility. Most of these properties are not presently owned by the company. Nicor Gas and Commonwealth Edison Company ("ComEd") are parties to an interim agreement to cooperate in cleaning up residue at many of these properties. Under the interim agreement, mutually agreed costs are to be evenly split between Nicor Gas and ComEd until such time as they are finally allocated either through negotiation or arbitration. On April 17, 2006, Nicor Gas initiated arbitration to determine the final allocations of these costs between Nicor Gas and ComEd. The ultimate outcome of this arbitration is not presently determinable. Information regarding preliminary site reviews has been presented to the Illinois Environmental Protection Agency for certain properties. More detailed investigations and remedial activities are complete, in progress or planned at many of these sites. The results of the detailed site–by–site investigations determine the extent additional remediation is necessary and provide a basis for estimating additional future costs. As of December 31, 2006, the company had recorded a liability in connection with these matters of $17.7 million. In accordance with ICC authorization, the company has been recovering, and expects to continue to recover, these costs from its customers, subject to annual prudence reviews.

In December 2001, a purported class action lawsuit was filed against Exelon Corporation, ComEd and Nicor Gas in the Circuit Court of Cook County alleging, among other things, that the cleanup of a former manufactured gas plant site in Oak Park, Illinois was inadequate. Since then, additional lawsuits have been filed related to this same former manufactured gas plant site. These lawsuits seek, in part, unspecified damages for property damage, nuisance, and various personal injuries that allegedly resulted from exposure to contaminants allegedly emanating from the site, injunctive relief to compel the defendants to engage in various clean–up activities and punitive damages. An agreement in principle to settle the purported class action lawsuit has been reached and, as of December 31, 2006, the company has a $2.25 million liability recorded in connection with this matter. The proposed class action settlement was approved by the trial court. An appeal was filed by one objector and conclusion of the proposed settlement will depend on the resolution of that appeal. In accordance with ICC authorization, the company expects to recover costs of such settlement from its customers, subject to an annual prudence review. Management cannot predict the outcome of certain other pending lawsuits relating to the Oak Park site or the company's potential exposure thereto and has not recorded a liability associated with those other pending matters.

In April 2002, Nicor Gas was named as a defendant, together with ComEd, in a lawsuit brought by the Metropolitan Water Reclamation District of Greater Chicago (the "MWRDGC") under the Federal Comprehensive Environmental Response, Compensation and Liability Act seeking recovery of past and future remediation costs and a declaration of the level of appropriate cleanup for a former manufactured gas plant site in Skokie, Illinois now owned by the MWRDGC. In January 2003, the suit was amended to include a claim under the Federal Resource Conservation and Recovery Act. The suit was filed in the United States District Court for the Northern District of Illinois. Management cannot predict the outcome of this litigation or the company's potential exposure thereto and has not recorded a liability associated with this contingency.

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

Since costs and recoveries relating to the cleanup of manufactured gas plant sites are passed directly through to customers in accordance with ICC regulations, subject to an annual ICC prudence review, the final disposition of manufactured gas plant matters is not expected to have a material impact on the company's financial condition or results of operations.

Other. In addition to the matters set forth above, the company is involved in legal or administrative proceedings before various courts and agencies with respect to general claims, rates, taxes, environmental, gas cost prudence reviews and other matters. Although unable to determine the ultimate outcome of these other contingencies, management believes that these amounts are appropriately reflected in the financial statements, including the recording of appropriate liabilities when reasonably estimable.

17. QUARTERLY RESULTS (UNAUDITED)

Summarized quarterly financial data is presented below (in millions):

	Quarter ended			
	Mar. 31	June 30	Sept. 30	Dec. 31
2006				
Operating revenues	**$ 1,210.8**	**$ 338.1**	**$ 226.7**	**$ 676.7**
Operating income	**42.7**	**13.3**	**7.2**	**35.0**
Net income (loss)	**30.2**	**8.2**	**(1.6)**	**21.8**
2005				
Operating revenues	$ 1,078.8	$ 372.2	$ 241.5	$ 1,217.0
Operating income	43.2	11.5	3.8	34.5
Net income (loss)	32.5	3.6	(5.4)	22.8

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The company carried out an evaluation under the supervision and with the participation of the company's management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the company's disclosure controls and procedures as of the end of the most recent fiscal quarter of the period covered by this Annual Report on Form 10–K (the "Evaluation").

In designing and evaluating the disclosure controls and procedures, management recognizes that any disclosure controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost–benefit relationship of possible disclosure controls and procedures. Based on the Evaluation, the company's Chief Executive Officer and Chief Financial Officer concluded that the company's disclosure controls and procedures, as of the end of the most recent fiscal quarter covered by this Annual Report on Form 10–K, were effective at the reasonable assurance level to ensure that information required to be disclosed by the company in reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in United States Securities and Exchange Commission rules and forms.

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

Management's Report on Internal Control Over Financial Reporting

Internal control over financial reporting refers to the process designed by, or under the supervision of, the company's Chief Executive Officer and Chief Financial Officer, and effected by the company's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles, and includes those policies and procedures that:

1. Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the company;

2. Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and

3. Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk. Management is responsible for establishing and maintaining adequate internal control over financial reporting for the company.

Management has used the framework set forth in the report entitled "Internal Control—Integrated Framework" published by the Committee of Sponsoring Organizations of the Treadway Commission to evaluate the effectiveness of the company's internal control over financial reporting. Management has concluded that the company's internal control over financial reporting was effective as of December 31, 2006. Deloitte & Touche LLP, an independent registered public accounting firm, has issued an attestation report on management's assessment of the company's internal control over financial reporting.

There has been no change in the company's internal controls over financial reporting during the company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting. In the second quarter of 2006, the company disclosed that it had completed the implementation of a new customer care and billing system.

Item 9B. Other Information

None.

Source: NORTHERN ILLINOIS GA, 10-K, February 23, 2007

Item 14. Principal Accountant Fees and Services

The following is a summary of the fees billed to Nicor Gas by Deloitte & Touche LLP for professional services rendered for the years ended December 31, 2006 and 2005 (in millions):

Fee Category	2006	2005
Audit fees	$ 1.5	$ 1.5
Audit–related fees	.1	.1
Total fees	$ 1.6	$ 1.6

Audit Fees. Consists of fees for professional services rendered for the audit of Nicor Gas' financial statements, and the review of the interim financial statements included in quarterly reports, and in connection with statutory and regulatory filings.

Audit–Related Fees. Consists of fees for assurance and related services that are reasonably related to the performance of the audit of Nicor Gas' financial statements and are not reported under "Audit Fees". These services include employee benefit plan audits and consultations concerning financial accounting and reporting standards.

Audit Committee Pre–Approval Policies and Procedures

In accordance with the Sarbanes–Oxley Act of 2002, the Audit Committee's policy is to pre–approve all audit and non–audit services provided by Deloitte & Touche LLP. On an ongoing basis, management of Nicor Gas defines and communicates specific projects and categories of service for which the advance approval of the Audit Committee is requested. The Audit Committee reviews these requests and advises management if the Committee approves the engagement of Deloitte & Touche LLP. On a periodic basis, Nicor Gas' management reports to the Audit Committee the actual spending for such projects and services compared to the approved amounts. In 2006, all services provided by Deloitte & Touche LLP were approved in advance by the Committee.

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

PART IV

Item 15. Exhibits and Financial Statement Schedules

a)

1) Financial Statements:

See Item 8, Financial Statements and Supplementary Data, filed herewith, for a list of financial statements.

2) Financial Statement Schedules:

Schedule Number		Page
	Report of Independent Registered Public Accounting Firm	23
II	Valuation and Qualifying Accounts	52

Schedules other than those listed are omitted because they are not applicable.

3) Exhibits Filed:

See Exhibit Index filed herewith.

Source: NORTHERN ILLINOIS GA, 10-K, February 23, 2007

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Nicor Gas Company

Schedule II

VALUATION AND QUALIFYING ACCOUNTS
(millions)

Description	Balance at beginning of period	Additions: Charged to costs and expenses	Additions: Charged to other accounts	Deductions	Balance at end of period
2006					
Allowance for doubtful accounts receivable	**$ 30.1**	**$ 38.1**	**$ –**	**$ 37.3 (a)**	**$ 30.9**
Accrued mercury–related costs	**17.5**	**–**	**–**	**4.3 (b)**	**13.2**
Accrued manufactured gas plant environmental costs	**19.5**	**–**	**12.7 (c)**	**12.3 (b)**	**19.9**
2005					
Allowance for doubtful accounts receivable	$ 19.7	$ 42.6	$ –	$ 32.2 (a)	$ 30.1
Accrued mercury–related costs	20.2	–	–	2.7 (b)	17.5
Accrued manufactured gas plant environmental costs	36.8	–	0.6 (c)	17.9 (b)	19.5
2004					
Allowance for doubtful accounts receivable	$ 19.4	$ 32.5	$ –	$ 32.2 (a)	$ 19.7
Accrued mercury–related costs	21.9	–	–	1.7 (b)	20.2
Accrued manufactured gas plant environmental costs	33.2	–	18.8 (c)	15.2 (b)	36.8

(a) Accounts receivable written off, net of recoveries.
(b) Expenditures, other adjustments.
(c) Accrual of estimated future remediation costs that are deferred as regulatory assets.

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

Signatures

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

		Nicor Gas Company
Date February 23, 2007		/s/ KAREN K. PEPPING
		Karen K. Pepping
		Vice President and Controller
		(Principal Accounting Officer and
		Duly Authorized Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on February 23, 2007.

Signature		Title
/s/ RUSS M. STROBEL		
Russ M. Strobel		Chairman, President and
(Principal Executive Officer)		Chief Executive Officer
/s/ RICHARD L. HAWLEY		
Richard L. Hawley		Executive Vice President and
(Principal Financial Officer)		Chief Financial Officer
/s/ KAREN K. PEPPING		
Karen K. Pepping		Vice President and Controller
(Principal Accounting Officer)		
ROBERT M. BEAVERS, JR.*		Director
BRUCE P. BICKNER*		Director
JOHN H. BIRDSALL, III*		Director
THOMAS A. DONAHOE*		Director
RAYMOND A. JEAN*		Director
BRENDA J. GAINES*		Director
DENNIS J. KELLER*		Director
R. EDEN MARTIN*		Director
GEORGIA R. NELSON*		Director
JOHN RAU*		Director
JOHN F. RIORDAN*		Director
	*	By /s/ RICHARD L. HAWLEY
		Richard L. Hawley
		(Attorney–in–fact)

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Supplemental Information

Supplemental Information to be Furnished With Reports Filed Pursuant to Section 15(d) of the Act by Registrants Which Have Not Registered Securities Pursuant to Section 12 of the Act:

No annual report or proxy material has been sent to security holders as Nicor Gas is a wholly owned subsidiary of Nicor Inc.

Source: NORTHERN ILLINOIS GA, 10-K, February 23, 2007

Exhibit Index

Exhibit Number		Description of Document
3.01	*	Restated Articles of Incorporation of the company as filed with the Illinois Secretary of State on July 21, 2006. (File No. 1–7296, Form 10–Q for June 30, 2006, Exhibit 3.01.)
3.02	*	By–Laws of the company as amended by the company's Board of Directors on January 15, 2004. (File No. 1–7296, Form 10–K for 2003, Exhibit 3.03.)
4.01	*	Indenture of Commonwealth Edison Company to Continental Illinois National Bank and Trust Company of Chicago, Trustee, dated as of January 1, 1954. (File No. 1–7296, Form 10–K for 1995, Exhibit 4.01.)
4.02	*	Indenture of Adoption of the company to Continental Illinois National Bank and Trust Company of Chicago, Trustee, dated February 9, 1954. (File No. 1–7296, Form 10–K for 1995, Exhibit 4.02.)
4.03	*	Supplemental Indenture, dated February 15, 1998, of the company to Harris Trust and Savings Bank, Trustee, under Indenture dated as of January 1, 1954. (File No. 1–7296, Form 10–K for 1997, Exhibit 4.19.)
4.04	*	Supplemental Indenture, dated February 1, 1999, of the company to Harris Trust and Savings Bank, Trustee, under Indenture dated as of January 1, 1954. (File No. 1–7296, Form 10–K for 1998, Exhibit 4.19.)
4.05	*	Supplemental Indenture, dated February 1, 2001, of the company to BNY Midwest Trust Company, Trustee, under Indenture dated as of January 1, 1954. (File No. 1–7296, Form 10–K for 2000, Exhibit 4.17.)
4.06	*	Supplemental Indenture, dated May 15, 2001, of the company to BNY Midwest Trust Company, Trustee, under Indenture dated as of January 1, 1954. (File No. 1–7296, Form 10–Q for June 2001, Exhibit 4.01.)
4.07	*	Supplemental Indenture, dated August 15, 2001, of the company to BNY Midwest Trust Company, Trustee, under Indenture dated as of January 1, 1954. (File No. 1–7296, Form 10–Q for September 2001, Exhibit 4.01.)
4.08	*	Supplemental Indenture, dated December 1, 2003, of the company to BNY Midwest Trust Company, Trustee, under Indenture dated as of January 1, 1954. (File No. 1–7296, Form 10–K for 2003, Exhibit 4.09.)
4.09	*	Supplemental Indenture, dated December 1, 2003, of the company to BNY Midwest Trust Company, Trustee, under Indenture dated as of January 1, 1954. (File No. 1–7296, Form 10–K for 2003, Exhibit 4.10.)
4.10	*	Supplemental Indenture, dated December 1, 2003, of the company to BNY Midwest Trust Company, Trustee, under Indenture dated as of January 1, 1954. (File No. 1–7296, Form 10–K for 2003, Exhibit 4.11.)
4.11		Supplemental Indenture, dated December 1, 2006, of Nicor Gas to BNY Midwest Trust Company, Trustee, under Indenture dated as of January 1, 1954.

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

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Exhibit Number		Description of Document
10.01	*	Directors' Deferred Compensation Plan. (File No. 1–7296, Form 10–K for December 31, 1983, Northern Illinois Gas Company, Exhibit 10.10.)
10.02	*	Amendment and Restatement of Nicor Gas Supplementary Retirement Plan. (File No. 1–7297, Form 10–Q for March 2000, Nicor Inc., Exhibit 10.01.)
10.03	*	Directors Compensation. (File No. 1–7296, Form 8–K for September 21, 2005, Northern Illinois Gas Company.)
10.04	*	5–Year Credit Agreement dated as of September 13, 2005. (File No. 1–7296, Form 10–Q for September 30, 2005, Northern Illinois Gas Company, Exhibit 10.03.)
10.05	*	First Amendment to the Northern Illinois Gas Company Supplemental Retirement Plan. (File No. 1–7296, Form 10–K for December 31, 2005, Northern Illinois Gas Company, Exhibit 10.05.)
10.06	*	2006 Nicor Gas Annual Incentive Compensation Plan for Officers. (File No. 1–7296, Form 10–Q for March 31, 2006, Northern Illinois Gas Company, Exhibit 10.01.)
10.07	*	1993 Interim Cooperative Agreement between Commonwealth Edison Company and Northern Illinois Gas Company. (File No. 1–7296, Form 10–Q for March 31, 2006, Northern Illinois Gas Company, Exhibit 10.02.)
10.08	*	Amendment No. 1 to the 1993 Interim Cooperative Agreement. (File No. 1–7296, Form 10–Q for March 31, 2006, Northern Illinois Gas Company, Exhibit 10.03.)
10.09	*	Amendment No. 2 to the 1993 Inteirm Cooperative Agreement. (File No. 1–7296, Form 10–Q for March 31, 2006, Northern Illinois Gas Company, Exhibit 10.04.)
10.10	*	Amendment No. 3 to the 1993 Interim Cooperative Agreement. (File No. 1–7296, Form 10–Q for March 31, 2006, Northern Illinois Gas Company, Exhibit 10.05.)
10.11	*	210–Day Credit Agreement dated as of October 26, 2006. (File No. 1–7296, Form 10–Q for September 30, 2006, Northern Illinois Gas Company, Exhibit 10.01.)
10.12	*	Second Amendment to the 5–Year Credit Agreement dated as of October 26, 2006. (File No. 1–7296, Form 10–Q for September 30, 2006, Northern Illinois Gas Company, Exhibit 10.02.)
12.01		Computation of Consolidated Ratio of Earnings to Fixed Charges.
23.01		Consent of Independent Registered Public Accounting Firm.
24.01		Powers of Attorney.
31.01		Rule 13a–14(a)/15d–14(a) Certification.
31.02		Rule 13a–14(a)/15d–14(a) Certification.
32.01		Section 1350 Certification.
32.02		Section 1350 Certification.

* These exhibits have been previously filed with the Securities and Exchange Commission as exhibits to registration statements or to other filings with the Commission and are incorporated herein as exhibits by reference. The file number and exhibit number of each such exhibit, where applicable, are stated, in parentheses, in the description of such exhibit.

Source: NORTHERN ILLINOIS GA, 10-K, February 23, 2007

When recorded return to:

Nicor Gas
Attn: Dave Behrens
1844 Ferry Road
Naperville, IL 60653–9600

Space Above this Line Reserved for Recorder's Use Only

Supplemental Indenture

MADE AS OF DECEMBER 1, 2006, TO BE EFFECTIVE DECEMBER 15, 2006

NORTHERN ILLINOIS GAS COMPANY

TO

BNY MIDWEST TRUST COMPANY

TRUSTEE UNDER INDENTURE DATED AS OF

JANUARY 1, 1954

AND

SUPPLEMENTAL

INDENTURES THERETO

FIRST MORTGAGE BONDS

5.85% SERIES DUE DECEMBER 15, 2036

Prepared by Andrew Kling, Schiff Hardin LLP, 6600 Sears Tower, 233 S. Wacker Drive, Chicago, IL 60606

THIS SUPPLEMENTAL INDENTURE, made as of the 1st day of December, 2006 and effective the 15th day of December, 2006, between NORTHERN ILLINOIS GAS COMPANY, a corporation organized and existing under the laws of the State of Illinois (hereinafter called the "**Company**"), and BNY MIDWEST TRUST COMPANY, an Illinois trust company (hereinafter called the "**Trustee**"), as successor Trustee under an Indenture dated as of January 1, 1954, as supplemented by Supplemental Indentures dated, respectively, February 9, 1954, April 1, 1956, June 1, 1959, July 1, 1960, June 1, 1963, July 1, 1963, August 1, 1964, August 1, 1965, May 1, 1966, August 1, 1966, July 1, 1967, June 1, 1968, December 1, 1969, August 1, 1970, June 1, 1971, July 1, 1972, July 1, 1973, April 1, 1975, April 30, 1976, April 30, 1976, July 1, 1976, August 1, 1976, December 1, 1977, January 15, 1979, December 1, 1981, March 1, 1983, October 1, 1984, December 1, 1986, March 15, 1988, July 1, 1988, July 1, 1989, July 15, 1990, August 15, 1991, July 15, 1992, February 1, 1993, March 15, 1993, May 1, 1993, July 1, 1993, August 15, 1994, October 15, 1995, May 10, 1996, August 1, 1996, June 1, 1997, October 15, 1997, February 15, 1998, June 1, 1998, February 1, 1999, February 1, 2001, May 15, 2001, August 15, 2001, December 15, 2001 and December 1, 2003, such Indenture dated as of January 1, 1954, as so supplemented, being hereinafter called the "**Indenture**."

WITNESSETH:

WHEREAS, the Indenture provides for the issuance from time to time thereunder, in series, of bonds of the Company for the purposes and subject to the limitations therein specified; and

WHEREAS, the Company desires, by this Supplemental Indenture, to create an additional series of bonds to be issuable under the Indenture, such bonds to be designated "First Mortgage Bonds, 5.85% Series due December 15, 2036" (hereinafter called the "**bonds of this Series**"), and the terms and provisions to be contained in the bonds of this Series or to be otherwise applicable thereto to be as set forth in this Supplemental Indenture; and

WHEREAS, the forms, respectively, of the bonds of this Series, and the Trustee's certificate to be endorsed on all bonds of this Series, are to be substantially as follows:

Source: NORTHERN ILLINOIS GA, 10-K, February 23, 2007

(FORM OF FACE OF BOND)

NO. RU–___________ $_______

Ill. Commerce Commission No. 6395 CUSIP No._____

NORTHERN ILLINOIS GAS COMPANY

First Mortgage Bond, 5.85% Series due December 15, 2036

NORTHERN ILLINOIS GAS COMPANY, an Illinois corporation (hereinafter called the "**Company**"), for value received, hereby promises to pay to or registered assigns, the sum of Dollars, on the 15th day of December, 2036, and to pay to the registered owner hereof interest on said sum from the date hereof until said sum shall be paid, at the rate of five and eighty five hundredths per centum (5.85%) per annum, payable semi–annually on the first day of June and the first day of December in each year. Both the principal of and the interest on this bond shall be payable at the office or agency of the Company in the City of Chicago, State of Illinois, or, at the option of the registered owner, at the office or agency of the Company in the Borough of Manhattan, The City and State of New York, in any coin or currency of the United States of America which at the time of payment is legal tender for the payment of public and private debts. Any installment of interest on this bond may, at the Company's option, be paid by mailing checks for such interest payable to or upon the written order of the person entitled thereto to the address of such person as it appears on the registration books.

So long as there is no existing default in the payment of interest on this bond, the interest so payable on any interest payment date will be paid to the person in whose name this bond is registered on May 15 or November 15 (whether or not a business day), as the case may be, next preceding such interest payment date. If and to the extent that the Company shall default in the payment of interest due on such interest payment date, such defaulted interest shall be paid to the person in whose name this bond is registered on the record date fixed, in advance, by the Company for the payment of such defaulted interest.

Additional provisions of this bond are set forth on the reverse hereof.

This bond shall not be entitled to any security or benefit under the Indenture or be valid or become obligatory for any purpose unless and until it shall have been authenticated by the execution by the Trustee, or its successor in trust under the Indenture, of the certificate endorsed hereon.

IN WITNESS WHEREOF, Northern Illinois Gas Company has caused this bond to be executed in its name by its Vice President, manually or by facsimile signature, and has caused its corporate seal to be impressed hereon or a facsimile thereof to be imprinted hereon and to be attested by its Assistant Secretary, manually or by facsimile signature.

Dated: December 15, 2006

Source: NORTHERN ILLINOIS GA, 10-K, February 23, 2007

	NORTHERN ILLINOIS GAS COMPANY BY: ______________________ *Vice President*
ATTEST: ______________________ *Assistant Secretary*	

(FORM OF TRUSTEE'S CERTIFICATE OF AUTHENTICATION)

This bond is one of the bonds of the series designated therein, referred to and described in the within–mentioned Supplemental Indenture dated as of December 1, 2006, effective December 15, 2006.

BNY MIDWEST TRUST COMPANY,
TRUSTEE

BY:______________________
Authorized Officer

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

(FORM OF REVERSE SIDE OF BOND)

This bond is one, of the series hereinafter specified, of the bonds issued and to be issued in series from time to time under and in accordance with and secured by an Indenture dated as of January 1, 1954, to BNY Midwest Trust Company, as Trustee, as supplemented by certain indentures supplemental thereto, executed and delivered to the Trustee; and this bond is one of a series of such bonds, designated "Northern Illinois Gas Company First Mortgage Bonds, 5.85% Series due December 15, 2036 (herein called "**bonds of this Series**"), the issuance of which is provided for by a Supplemental Indenture dated as of December 1, 2006, effective December 15, 2006 (hereinafter called the "**Supplemental Indenture**"), executed and delivered by the Company to the Trustee. The term "**Indenture**", as hereinafter used, means said Indenture dated as of January 1, 1954, and all indentures supplemental thereto (including, without limitation, the Supplemental Indenture) from time to time in effect. Reference is made to the Indenture for a description of the property mortgaged and pledged, the nature and extent of the security, the rights of the holders and registered owners of said bonds, of the Company and of the Trustee in respect of the security, and the terms and conditions governing the issuance and security of said bonds.

With the consent of the Company and to the extent permitted by and as provided in the Indenture, modifications or alterations of the Indenture or of any supplemental indenture and of the rights and obligations of the Company and of the holders and registered owners of the bonds may be made, and compliance with any provision of the Indenture or of any supplemental indenture may be waived, by the affirmative vote of the holders and registered owners of not less than sixty–six and two–thirds per centum (66 2/3%) in principal amount of the bonds then outstanding under the Indenture, and by the affirmative vote of the holders and registered owners of not less than sixty–six and two–thirds per centum (66 2/3%) in principal amount of the bonds of any series then outstanding under the Indenture and affected by such modification or alteration, in case one or more but less than all of the series of bonds then outstanding under the Indenture are so affected, but in any case excluding bonds disqualified from voting by reason of the Company's interest therein as provided in the Indenture; subject, however, to the condition, among other conditions stated in the Indenture, that no such modification or alteration shall be made which, among other things, will permit the extension of the time or times of payment of the principal of or the interest or the premium, if any, on this bond, or the reduction in the principal amount hereof or in the rate of interest or the amount of any premium hereon, or any other modification in the terms of payment of such principal, interest or premium, which terms of payment are unconditional, or, otherwise than as permitted by the Indenture, the creation of any lien ranking prior to or on a parity with the lien of the Indenture with respect to any of the mortgaged property, all as more fully provided in the Indenture.

The bonds of this Series may be called for redemption by the Company, as a whole at any time or in part from time to time, at a redemption price equal to 100% of the principal amount of the bonds of this Series to be redeemed plus accrued and unpaid interest on the principal amount being redeemed to the date of redemption and the Make–Whole Amount (as defined in the Supplemental Indenture) applicable thereto.

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

Notice of each redemption shall be mailed to all registered owners not less than thirty nor more than forty–five days before the redemption date.

In case of certain completed defaults specified in the Indenture, the principal of this bond may be declared or may become due and payable in the manner and with the effect provided in the Indenture.

No recourse shall be had for the payment of the principal of or the interest or the premium, if any, on this bond, or for any claim based hereon, or otherwise in respect hereof or of the Indenture, to or against any incorporator, stockholder, officer or director, past, present or future, of the Company or of any predecessor or successor corporation, either directly or through the Company or such predecessor or successor corporation, under any constitution or statute or rule of law, or by the enforcement of any assessment or penalty, or otherwise, all such liability of incorporators, stockholders, directors and officers being waived and released by the registered owner hereof by the acceptance of this bond and being likewise waived and released by the terms of the Indenture, all as more fully provided therein.

This bond is transferable by the registered owner hereof, in person or by duly authorized attorney, at the office or agency of the Company in the City of Chicago, State of Illinois, or, at the option of registered owner, at the office or agency of the Company in the Borough of Manhattan, The City and State of New York, upon surrender and cancellation of this bond; and thereupon a new registered bond or bonds without coupons of the same aggregate principal amount and series will, upon the payment of any transfer tax or taxes payable, be issued to the transferee in exchange herefor. The Company shall not be required to exchange or transfer this bond if this bond or a portion hereof has been selected for redemption.

The security represented by this certificate has not been registered under the Securities Act of 1933, as amended (the "**Securities Act**"), or qualified under any state securities laws and may not be transferred, sold or otherwise disposed of except while a registration statement is in effect or pursuant to an available exemption from registration under the Securities Act and applicable state securities laws.

(END OF BOND FORM)

and

WHEREAS, all acts and things necessary to make this Supplemental Indenture, when duly executed and delivered, a valid, binding and legal instrument in accordance with its terms, and for the purposes herein expressed, have been done and performed, and the execution and delivery of this Supplemental Indenture have in all respects been duly authorized;

NOW, THEREFORE, in consideration of the premises and of the sum of one dollar paid by the Trustee to the Company, and for other good and valuable consideration, the receipt of which is hereby acknowledged, for the purpose of securing the due and punctual payment of the principal of and the interest and premium, if any, on all bonds which shall be issued under the Indenture, and for the purpose of securing the faithful performance and observance of all the covenants and conditions set forth in the Indenture and in all indentures supplemental thereto, the Company by these presents does grant, bargain, sell, transfer, assign, pledge, mortgage, warrant

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

and convey unto BNY Midwest Trust Company, as Trustee, and its successor or successors in the trust hereby created, all property, real and personal (other than property expressly excepted from the lien and operation of the Indenture), which, at the actual date of execution and delivery of this Supplemental Indenture, is solely used or held for use in the operation by the Company of its gas utility system and in the conduct of its gas utility business and all property, real and personal, used or useful in the gas utility business (other than property expressly excepted from the lien and operation of the Indenture) acquired by the Company after the actual date of execution and delivery of this Supplemental Indenture or (subject to the provisions of Section 16.03 of the Indenture) by any successor corporation after such execution and delivery, and it is further agreed by and between the Company and the Trustee as follows:

ARTICLE I.

BONDS OF THIS SERIES

Section 1. The bonds of this Series shall, as hereinbefore recited, be designated as the Company's "First Mortgage Bonds, 5.85% Series due December 15, 2036". The bonds of this Series which may be issued and outstanding shall not exceed $50,000,000 in aggregate principal amount, exclusive of bonds of such series authenticated and delivered pursuant to Section 4.12 of the Indenture.

Section 2. The bonds of this Series shall be registered bonds without coupons, and the form of such bonds, and of the Trustee's certificate of authentication to be endorsed on all bonds of this Series, shall be substantially as hereinbefore recited, respectively.

Section 3. The bonds of this Series shall be issued in the denomination of $1,000,000 each and in such integral multiple or multiples thereof as shall be determined and authorized by the Board of Directors of the Company or by any officer of the Company authorized by the Board of Directors to make such determination, the authorization of the denomination of any bond to be conclusively evidenced by the execution thereof on behalf of the Company. The bonds of this Series shall be numbered RU–1 and consecutively upwards, or in such other appropriate manner as shall be determined and authorized by the Board of Directors of the Company.

All bonds of this Series shall be dated December 15, 2006 except that each bond issued on or after the first payment of interest thereon shall be dated as of the date of the interest payment date thereof to which interest shall have been paid on the bonds of such series next preceding the date of issue, unless issued on an interest payment date to which interest shall have been so paid, in which event such bonds shall be dated as of the date of issue; provided, however, that bonds issued on or after November 15 and before the next succeeding December 1 or on or after May 15 and before the next succeeding June 1 shall be dated the next succeeding interest payment date if interest shall have been paid to such date. All bonds of this Series shall mature December 15, 2036 and shall bear interest at the rate of 5.85% per annum until the principal thereof shall be paid. Such interest shall be calculated on the basis of a 360–day year consisting of twelve 30–day months and shall be payable semi–annually on the first day of June and the first day of December in each year, beginning June 1, 2007. So long as there is no existing default in the payment of interest on the bonds of this Series, such interest shall be

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

payable to the person in whose name each such bond is registered on the November 15 or May 15 (whether or not business day), as the case may be, next preceding the respective interest payment dates; provided, however, if and to the extent that the Company shall default in the payment of interest due on such interest payment date, such defaulted interest shall be paid to the person in whose name each such bond is registered on the record date fixed, in advance, by the Company for the payment of such defaulted interest. Interest will accrue on overdue interest installments at the rate of 5.85% per annum.

The principal of and interest and premium, if any, on the bonds of this Series shall be payable in any coin or currency of the United States of America which at the time of payment is legal tender for the payment of public and private debts, and shall be payable at the office or agency of the Company in the City of Chicago, State of Illinois, or, at the option of the registered owner, at the office or agency of the Company in the Borough of Manhattan, The City and State of New York. Any installment of interest on the bonds may, at the Company's option, be paid by mailing checks for such interest payable to or upon the written order of the person entitled thereto to the address of such person as it appears on the registration books. The bonds of this Series shall be registrable, transferable and exchangeable in the manner provided in Sections 4.08 and 4.09 of the Indenture, at either of such offices or agencies.

Section 4. The bonds of this Series, upon the mailing of notice and in the manner provided in Section 7.01 of the Indenture (except that no published notice shall be required for the bonds of this Series) and with the effect provided in Section 7.02 thereof, shall be redeemable at the option of the Company, as a whole at any time or in part from time to time, at a redemption price equal to 100% of the principal amount of the bonds of this Series to be redeemed plus accrued and unpaid interest of the principal amount being redeemed to the date of redemption plus the Make–Whole Amount applicable thereto. **"Make–Whole Amount"** means, with respect to any bond of this Series, an amount equal to the excess, if any, of the Discounted Value of the Remaining Scheduled Payments with respect to the Called Principal of such bond of this Series over the amount of such Called Principal, *provided* that the Make–Whole Amount may in no event be less than zero. For the purposes of determining the Make–Whole Amount, the following terms have the following meanings:

"Called Principal" means, with respect to any bond of this Series, the principal of such bond of this Series that is to be redeemed.

"Discounted Value" means, with respect to the Called Principal of any bond of this Series, the amount obtained by discounting all Remaining Scheduled Payments with respect to such Called Principal from their respective scheduled due dates to the Settlement Date with respect to such Called Principal, in accordance with accepted financial practice and at a discount factor (applied on the same periodic basis as that on which interest on the bond of this Series is payable) equal to the Reinvestment Yield with respect to such Called Principal.

"Reinvestment Yield" means, with respect to the Called Principal of any bond of this Series, .50% over the yield to maturity implied by (i) the yields reported as of 10:00 a.m. (New York City time) on the second Business Day preceding the Settlement Date with respect to such Called Principal, on the display designated as "Page PX1" (or such other display as may replace Page PX1) on Bloomberg Financial Markets (**"Bloomberg"**) or, if Page PX1 (or its

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successor screen on Bloomberg) is unavailable, the Telerate Access Service screen which corresponds most closely to Page PX1 for the most recently issued actively traded U.S. Treasury securities having a maturity equal to the Remaining Average Life of such Called Principal as of such Settlement Date, or (ii) if such yields are not reported as of such time or the yields reported as of such time are not ascertainable (including by way of interpolation), the Treasury Constant Maturity Series Yields reported, for the latest day for which such yields have been so reported as of the second Business Day preceding the Settlement Date with respect to such Called Principal, in Federal Reserve Statistical Release H.15 (519) (or any comparable successor publication) for actively traded U.S. Treasury securities having a constant maturity equal to the Remaining Average Life of such Called Principal as of such Settlement Date. Such implied yield will be determined, if necessary, by (a) converting U.S. Treasury bill quotations to bond equivalent yields in accordance with accepted financial practice and (b) interpolating linearly between (1) the actively traded U.S. Treasury security with the maturity closest to and greater than such Remaining Average Life and (2) the actively traded U.S. Treasury security with the maturity closest to and less than such Remaining Average Life. The Reinvestment Yield shall be rounded to the number of decimal places as appears in the interest rate of the applicable bond of this Series.

"Remaining Average Life" means, with respect to any Called Principal, the number of years (calculated to the nearest one–twelfth year) obtained by dividing (i) such Called Principal into (ii) the sum of the products obtained by multiplying (a) the principal component of each Remaining Scheduled Payment with respect to such Called Principal by (b) the number of years (calculated to the nearest one–twelfth year) that will elapse between the Settlement Date with respect to such Called Principal and the scheduled due date of such Remaining Scheduled Payment.

"Remaining Scheduled Payments" means, with respect to the Called Principal of any bond of this Series, all payments of such Called Principal and interest thereon that would be due after the Settlement Date with respect to such Called Principal if no payment of such Called Principal were made prior to its scheduled due date, *provided* that if such Settlement Date is not a date on which interest payments are due to be made under the terms of the bond of this Series, then the amount of the next succeeding scheduled interest payment will be reduced by the amount of interest accrued to such Settlement Date and required to be paid on such Settlement Date pursuant to the terms of this Supplemental Indenture.

"Settlement Date" means, with respect to the Called Principal of any bond of this Series, the date on which such Called Principal is to be redeemed.

Section 5. No sinking fund is to be provided for the bonds of this Series.

ARTICLE II.

MISCELLANEOUS PROVISIONS

Section 1. This Supplemental Indenture is executed by the Company and the Trustee pursuant to provisions of Section 4.02 of the Indenture and the terms and conditions hereof shall be deemed to be a part of the terms and conditions of the Indenture for any and all purposes. The

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

Indenture, as heretofore supplemented and as supplemented by this Supplemental Indenture, is in all respects ratified and confirmed.

Section 2. This Supplemental Indenture shall bind and, subject to the provisions of Article XVI of the Indenture, inure to the benefit of the respective successors and assigns of the parties hereto.

Section 3. Although this Supplemental Indenture is made as of December 1, 2006, effective December 15, 2006, it shall be effective only from and after the actual time of its execution and delivery by the Company and the Trustee on the date indicated by their respective acknowledgements hereto.

Section 4. This Supplemental Indenture may be simultaneously executed in any number of counterparts, and all such counterparts executed and delivered, each as an original, shall constitute but one and the same instrument.

* * *

Signature Page Follows

Source: NORTHERN ILLINOIS GA, 10-K, February 23, 2007

IN WITNESS WHEREOF, Northern Illinois Gas Company has caused this Supplemental Indenture to be executed in its name by its President, a Vice President, or Treasurer, and its corporate seal to be hereunto affixed and attested by its Assistant Secretary, and BNY Midwest Trust Company, as Trustee under the Indenture, has caused this Supplemental Indenture to be executed in its name by one of its Assistant Vice Presidents, and its seal to be hereunto affixed and attested by one of its Assistant Secretaries, all as of the day and year first above written.

NORTHERN ILLINOIS GAS COMPANY BY: /s/ GERALD P. O'CONNOR Gerald P. O'Connor Vice President Finance and Treasurer	
	ATTEST: BY: /s/ NEIL J. MALONEY Neil J. Maloney Assistant General Counsel and Assistant Secretary
BNY MIDWEST TRUST COMPANY, *as Trustee* BY: /s/ L GARCIA Name: L. Garcia Title: Assistant Vice President	
	ATTEST: BY: /s/ D.G. DONOVAN Name: D. G. DONOVAN Title: ASSISTANT SECRETARY

STATE OF ILLINOIS } SS:
COUNTY OF DUPAGE }

I, Dawn M. Opon, a Notary Public in the State aforesaid, DO HEREBY CERTIFY that Gerald P. O'Connor, Vice President Finance and Treasurer of Northern Illinois Gas Company, an Illinois corporation, one of the parties described in and which executed the foregoing instrument, and Neil J. Maloney, Assistant General Counsel and Assistant Secretary of said corporation, who are both personally known to me to be the same persons whose names are subscribed to the foregoing instrument as such Vice President Finance and Treasurer and Assistant General Counsel and Assistant Secretary, respectively, and who are both personally known to me to be the Vice President Finance and Treasurer and Assistant General Counsel and Assistant Secretary, respectively, of said corporation, appeared before me this day in person and severally acknowledged that they signed, sealed, executed and delivered said instrument as their free and voluntary act as such Vice President Finance and Treasurer and Assistant General Counsel and Assistant Secretary, respectively, of said corporation, and as the free and voluntary act of said corporation, for the uses and purposes therein set forth.

GIVEN under my hand and notarial seal this 1st day of December, 2006 A.D.

	/s/ DAWN M. OPON
	Notary Public

My Commission expires March 31st, 2010.

STATE OF ILLINOIS } SS:
COUNTY OF COOK }

I, A. Hernandez, a Notary Public in and for the said County, in the State aforesaid, DO HEREBY CERTIFY that L. Garcia, Assistant Vice President of BNY Midwest Trust Company, an Illinois trust company, one of the parties described in and which executed the foregoing instrument, and D.G. Donovan, an Assistant Secretary of said trust company, who are both personally known to me to be the same persons whose names are subscribed to the foregoing instrument as such Assistant Vice President and Assistant Secretary, respectively, and who are both personally known to me to be an Assistant Vice President and an Assistant Secretary, respectively, of said trust company, appeared before me this day in person and severally acknowledged that they signed, sealed, executed and delivered said instrument as their free and voluntary act as such Assistant Vice President and Assistant Secretary, respectively, of said trust company, and as the free and voluntary act of said trust company, for the uses and purposes therein set forth.

GIVEN under my hand and notarial seal this 5th day of December, 2006 A.D.

	/s/ A. HERNANDEZ
	Notary Public

My Commission expires July 8, 2010.

RECORDING DATA

This Supplemental Indenture was recorded on December 8, 11 and 13, 2006, in the office of the Recorder of Deeds in certain counties in the State of Illinois, as follows:

County	Document No.
Cook	0634231132
Adams	200207661
Boone	2006R13647
Bureau	2006–R07190
Carroll	2006R–5189
Champaign	2006R33801
DeKalb	2006–022746
DeWitt	217551
DuPage	R2006–235746
Ford	237644
Grundy	472045
Hancock	2006–3829
Henderson	163193
Henry	20–0610664
Iroquois	06R5743
JoDaviess	332228
Kane	2006K133305
Kankakee	2006030672
Kendall	200600039633
Lake	2006–00019905
LaSalle	2006–30915
Lee	2006008204
Livingston	576019
McHenry	2006R0089834
McLean	2006–00034217
Mercer	354534
Ogle	0612757
Piatt	327574
Pike	06–4002
Rock Island	2006–29338
Stephenson	20060081732
Tazewell	200600028016
Vermilion	06–15773
Whiteside	10283–2006
Will	2006R203956
Winnebago	0673599
Woodford	608607

Nicor Gas Company
Form 10–K
Exhibit 12.01

Nicor Gas Company
Computation of Consolidated Ratio of Earnings to Fixed Charges
(thousands)

	Year Ended December 31				
	2006	2005	2004	2003	2002
Earnings available to cover fixed charges:					
Net income	**$ 58,656**	$ 53,476	$ 62,106	$ 83,000	$109,139
Add: Income tax expense	**27,814**	26,128	33,108	48,035	64,325
Fixed charges	**45,041**	43,203	37,555	37,047	36,711
Allowance for funds used during construction and other	**(614)**	(1,038)	(363)	(220)	(395)
	$130,897	$121,769	$132,406	$167,862	$209,780
Fixed charges:					
Interest on debt	**$ 37,665**	$ 36,487	$ 35,606	$ 33,934	$ 33,037
Other interest charges and amortization of debt discount, premium, and expense, net	**7,376**	6,716	1,949	3,113	3,674
	$ 45,041	$ 43,203	$ 37,555	$ 37,047	$ 36,711
Ratio of earnings to fixed charges	**2.91**	2.82	3.53	4.53	5.71

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference in Registration Statement No. 333–65486 on Form S–3 of our report, dated February 23, 2007, relating to the financial statements and financial statement schedule of Northern Illinois Gas Company (which expresses an unqualified opinion and includes an explanatory paragraph related to changes, in 2006, in method of accounting for defined benefit pension and other postretirement plans, and method of accounting for share based payments as discussed in Note 2 and a change, in 2005, in the method of accounting for conditional asset retirement obligations as discussed in Note 3), and management's report on the effectiveness of internal control over financial reporting, appearing in this Annual Report on Form 10–K of Northern Illinois Gas Company for the year ended December 31, 2006.

/s/ DELOITTE & TOUCHE LLP

Chicago, Illinois
February 23, 2007

POWER OF ATTORNEY

The undersigned, a Director, Officer, or Director and Officer of Nicor Inc. and Northern Illinois Gas Company (doing business as Nicor Gas Company), Illinois corporations, hereby authorizes any officer of Nicor Inc. and each of them, to execute in the name and on behalf of the undersigned as such Director, Officer, or Director and Officer, the 2006 Annual Report on Form 10–K of Nicor Inc. and Nicor Gas Company (and any amendments thereto) to be filed pursuant to the Securities Exchange Act of 1934.

Date: January 24, 2007

/s/ ROBERT M. BEAVERS, JR.
Robert M. Beavers, Jr.

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

POWER OF ATTORNEY

The undersigned, a Director, Officer, or Director and Officer of Nicor Inc. and Northern Illinois Gas Company (doing business as Nicor Gas Company), Illinois corporations, hereby authorizes any officer of Nicor Inc. and each of them, to execute in the name and on behalf of the undersigned as such Director, Officer, or Director and Officer, the 2006 Annual Report on Form 10–K of Nicor Inc. and Nicor Gas Company (and any amendments thereto) to be filed pursuant to the Securities Exchange Act of 1934.

Date: January 24, 2007

/s/ BRUCE P. BICKNER
Bruce P. Bickner

POWER OF ATTORNEY

The undersigned, a Director, Officer, or Director and Officer of Nicor Inc. and Northern Illinois Gas Company (doing business as Nicor Gas Company), Illinois corporations, hereby authorizes any officer of Nicor Inc. and each of them, to execute in the name and on behalf of the undersigned as such Director, Officer, or Director and Officer, the 2006 Annual Report on Form 10-K of Nicor Inc. and Nicor Gas Company (and any amendments thereto) to be filed pursuant to the Securities Exchange Act of 1934.

Date: January 24, 2007

/s/ JOHN H. BIRDSALL, III
John H. Birdsall, III

POWER OF ATTORNEY

The undersigned, a Director, Officer, or Director and Officer of Nicor Inc. and Northern Illinois Gas Company (doing business as Nicor Gas Company), Illinois corporations, hereby authorizes any officer of Nicor Inc. and each of them, to execute in the name and on behalf of the undersigned as such Director, Officer, or Director and Officer, the 2006 Annual Report on Form 10–K of Nicor Inc. and Nicor Gas Company (and any amendments thereto) to be filed pursuant to the Securities Exchange Act of 1934.

Date: January 24, 2007

/s/ THOMAS A. DONAHOE
Thomas A. Donahoe

POWER OF ATTORNEY

The undersigned, a Director, Officer, or Director and Officer of Nicor Inc. and Northern Illinois Gas Company (doing business as Nicor Gas Company), Illinois corporations, hereby authorizes any officer of Nicor Inc. and each of them, to execute in the name and on behalf of the undersigned as such Director, Officer, or Director and Officer, the 2006 Annual Report on Form 10-K of Nicor Inc. and Nicor Gas Company (and any amendments thereto) to be filed pursuant to the Securities Exchange Act of 1934.

Date: January 24, 2007

/s/ RAYMOND A. JEAN
Raymond A. Jean

POWER OF ATTORNEY

The undersigned, a Director, Officer, or Director and Officer of Nicor Inc. and Northern Illinois Gas Company (doing business as Nicor Gas Company), Illinois corporations, hereby authorizes any officer of Nicor Inc. and each of them, to execute in the name and on behalf of the undersigned as such Director, Officer, or Director and Officer, the 2006 Annual Report on Form 10–K of Nicor Inc. and Nicor Gas Company (and any amendments thereto) to be filed pursuant to the Securities Exchange Act of 1934.

Date: January 24, 2007

/s/ BRENDA J. GAINES
Brenda J. Gaines

POWER OF ATTORNEY

The undersigned, a Director, Officer, or Director and Officer of Nicor Inc. and Northern Illinois Gas Company (doing business as Nicor Gas Company), Illinois corporations, hereby authorizes any officer of Nicor Inc. and each of them, to execute in the name and on behalf of the undersigned as such Director, Officer, or Director and Officer, the 2006 Annual Report on Form 10–K of Nicor Inc. and Nicor Gas Company (and any amendments thereto) to be filed pursuant to the Securities Exchange Act of 1934.

Date: January 24, 2007

/s/ DENNIS J. KELLER
Dennis J. Keller

POWER OF ATTORNEY

The undersigned, a Director, Officer, or Director and Officer of Nicor Inc. and Northern Illinois Gas Company (doing business as Nicor Gas Company), Illinois corporations, hereby authorizes any officer of Nicor Inc. and each of them, to execute in the name and on behalf of the undersigned as such Director, Officer, or Director and Officer, the 2006 Annual Report on Form 10–K of Nicor Inc. and Nicor Gas Company (and any amendments thereto) to be filed pursuant to the Securities Exchange Act of 1934.

Date: January 24, 2007

/s/ R. EDEN MARTIN
R. Eden Martin

POWER OF ATTORNEY

The undersigned, a Director, Officer, or Director and Officer of Nicor Inc. and Northern Illinois Gas Company (doing business as Nicor Gas Company), Illinois corporations, hereby authorizes any officer of Nicor Inc. and each of them, to execute in the name and on behalf of the undersigned as such Director, Officer, or Director and Officer, the 2006 Annual Report on Form 10-K of Nicor Inc. and Nicor Gas Company (and any amendments thereto) to be filed pursuant to the Securities Exchange Act of 1934.

Date: January 24, 2007

/s/ GEORGIA R. NELSON
Georgia R. Nelson

POWER OF ATTORNEY

The undersigned, a Director, Officer, or Director and Officer of Nicor Inc. and Northern Illinois Gas Company (doing business as Nicor Gas Company), Illinois corporations, hereby authorizes any officer of Nicor Inc. and each of them, to execute in the name and on behalf of the undersigned as such Director, Officer, or Director and Officer, the 2006 Annual Report on Form 10–K of Nicor Inc. and Nicor Gas Company (and any amendments thereto) to be filed pursuant to the Securities Exchange Act of 1934.

Date: January 24, 2007

/s/ JOHN RAU
John Rau

POWER OF ATTORNEY

The undersigned, a Director, Officer, or Director and Officer of Nicor Inc. and Northern Illinois Gas Company (doing business as Nicor Gas Company), Illinois corporations, hereby authorizes any officer of Nicor Inc. and each of them, to execute in the name and on behalf of the undersigned as such Director, Officer, or Director and Officer, the 2006 Annual Report on Form 10–K of Nicor Inc. and Nicor Gas Company (and any amendments thereto) to be filed pursuant to the Securities Exchange Act of 1934.

Date: January 24, 2007

/s/ JOHN F. RIORDAN
John F. Riordan

CERTIFICATION

I, Russ M. Strobel, certify that:

1) I have reviewed this annual report on Form 10–K of Nicor Gas Company;

2) Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3) Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4) The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a–15(e) and 15d–15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a–15(f) and 15d–15(f)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5) The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date February 23, 2007

/s/ RUSS M. STROBEL
Russ M. Strobel
Chairman, President and Chief Executive Officer

Source: NORTHERN ILLINOIS GA, 10–K, February 23, 2007

CERTIFICATION

I, Richard L. Hawley, certify that:

1) I have reviewed this annual report on Form 10-K of Nicor Gas Company;

2) Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3) Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4) The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5) The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date February 23, 2007

/s/ RICHARD L. HAWLEY
Richard L. Hawley
Executive Vice President and
Chief Financial Officer

Source: NORTHERN ILLINOIS GA, 10-K, February 23, 2007

CERTIFICATION

Pursuant to 18 U.S.C. Section 1350, as created by Section 906 of the Sarbanes−Oxley Act of 2002, the undersigned officer of Nicor Gas Company (the "Company") hereby certifies, to such officer's knowledge, that:

(i) the accompanying Annual Report on Form 10−K of the Company for the twelve month period ended December 31, 2006 (the "Report") fully complies with the requirements of Section 13(a) or Section 15(d), as applicable, of the Securities Exchange Act of 1934, as amended; and

(ii) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: February 23, 2007

/s/ RUSS M. STROBEL
Russ M. Strobel
Chairman, President and Chief
Executive Officer

Nicor Gas Company
Form 10-K
Exhibit 32.02

CERTIFICATION

Pursuant to 18 U.S.C. Section 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002, the undersigned officer of Nicor Gas Company (the "Company") hereby certifies, to such officer's knowledge, that:

(i) the accompanying Annual Report on Form 10-K of the Company for the twelve month period ended December 31, 2006 (the "Report") fully complies with the requirements of Section 13(a) or Section 15(d), as applicable, of the Securities Exchange Act of 1934, as amended; and

(ii) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: February 23, 2007

/s/ RICHARD L. HAWLEY
Richard L. Hawley
Executive Vice President and
Chief Financial Officer

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

FORM 10-K

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

For the fiscal year ended December 31, 2006

Commission File Number 1-7850

SOUTHWEST GAS CORPORATION

(Exact name of registrant as specified in its charter)

California (State or other jurisdiction of incorporation or organization)	**88-0085720** (I.R.S. Employer Identification No.)
5241 Spring Mountain Road **Post Office Box 98510** **Las Vegas, Nevada** (Address of principal executive offices)	**89193-8510** (Zip Code)

Registrant's telephone number, including area code: (702) 876-7237

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, $1 par value	New York Stock Exchange, Inc.
7.70% Preferred Trust Securities	New York Stock Exchange, Inc.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. **Yes** ☑ **No** ☐

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. **Yes** ☐ **No** ☑

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☑

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☑ Accelerated filer ☐ Non-accelerated filer ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ☐ **No** ☑

Aggregate market value of the voting and non-voting common stock held by nonaffiliates of the registrant:
$1,275,488,075 as of June 30, 2006

The number of shares outstanding of common stock:
Common Stock, $1 Par Value, 41,997,015 shares as of February 15, 2007

DOCUMENTS INCORPORATED BY REFERENCE

Description	Part Into Which Incorporated
Annual Report to Shareholders for the Year Ended December 31, 2006	Parts I, II, and IV
2007 Proxy Statement	Part III

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PART I

Item 1. BUSINESS

Southwest Gas Corporation (the "Company") was incorporated in March 1931 under the laws of the state of California. The Company is composed of two business segments: natural gas operations ("Southwest" or the "natural gas operations" segment) and construction services.

Southwest is engaged in the business of purchasing, transporting, and distributing natural gas in portions of Arizona, Nevada, and California. Southwest is the largest distributor of natural gas in Arizona, selling and transporting natural gas in most of central and southern Arizona, including the Phoenix and Tucson metropolitan areas. Southwest is also the largest distributor of natural gas in Nevada, serving the Las Vegas metropolitan area and northern Nevada. In addition, Southwest distributes and transports natural gas in portions of California, including the Lake Tahoe area and the high desert and mountain areas in San Bernardino County.

Northern Pipeline Construction Co. ("NPL" or the "construction services" segment), a wholly owned subsidiary, is a full-service underground piping contractor that provides utility companies with trenching and installation, replacement, and maintenance services for energy distribution systems.

Financial information concerning the Company's business segments is included in Note 12 of the Notes to Consolidated Financial Statements, which is included in the 2006 Annual Report to Shareholders and is incorporated herein by reference.

The Company maintains a website (www.swgas.com) for the benefit of shareholders, investors, customers, and other interested parties. The Company makes its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports available, free of charge, through its website as soon as reasonably practicable after such material is electronically filed with, or furnished to, the Securities and Exchange Commission ("SEC"). The Company's Corporate Governance Guidelines, Code of Business Conduct and Ethics, and charters of the nominating and corporate governance, audit, and compensation committees of the board of directors are also available on the website and are available in print by request.

NATURAL GAS OPERATIONS

General Description

Southwest is subject to regulation by the Arizona Corporation Commission ("ACC"), the Public Utilities Commission of Nevada ("PUCN"), and the California Public Utilities Commission ("CPUC"). These commissions regulate public utility rates, practices, facilities, and service territories in their respective states. The CPUC also regulates the issuance of all securities by the Company, with the exception of short-term borrowings. Certain accounting practices, transmission facilities, and rates are subject to regulation by the Federal Energy Regulatory Commission ("FERC"). NPL is not regulated by the state utilities commissions in any of its operating areas.

As of December 31, 2006, Southwest purchased and distributed or transported natural gas to 1,784,000 residential, commercial, and industrial customers in geographically diverse portions of Arizona, Nevada, and California. There were 71,000 customers added to the system during 2006.

The table below lists the percentage of operating margin (operating revenues less net cost of gas) by major customer class for the years indicated:

	Distribution		
For the Year Ended	Residential and Small Commercial	Other Sales Customers	Transportation
December 31, 2006	85%	6%	9%
December 31, 2005	86%	5%	9%
December 31, 2004	86%	5%	9%

Southwest is not dependent on any one or a few customers such that the loss of any one or several would have a significant adverse impact on earnings or cash flows.

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Transportation of customer-secured gas to end-users accounted for 48 percent of total system throughput in 2006. Customers who utilized this service transported 118 million dekatherms in 2006, 127 million dekatherms in 2005, and 126 million dekatherms in 2004. Although these volumes were significant, these customers provide a much smaller proportionate share of operating margin.

The demand for natural gas is seasonal. Variability in weather from normal temperatures can materially impact results of operations. It is the opinion of management that comparisons of earnings for interim periods do not reliably reflect overall trends and changes in operations. Also, earnings for interim periods can be significantly affected by the timing of general rate relief.

Rates and Regulation

Rates that Southwest is authorized to charge its distribution system customers are determined by the ACC, PUCN, and CPUC in general rate cases and are derived using rate base, cost of service, and cost of capital experienced in an historical test year, as adjusted in Arizona and Nevada, and projected for a future test year in California. The FERC regulates the northern Nevada transmission and liquefied natural gas ("LNG") storage facilities of Paiute Pipeline Company ("Paiute"), a wholly owned subsidiary, and the rates it charges for transportation of gas directly to certain end-users and to various local distribution companies ("LDCs"). The LDCs transporting on the Paiute system are: Sierra Pacific Power Company (serving Reno and Sparks, Nevada) and Southwest Gas Corporation (serving Truckee, South Lake Tahoe and North Lake Tahoe, California and various locations throughout northern Nevada).

Rates charged to customers vary according to customer class and rate jurisdiction and are set at levels that are intended to allow for the recovery of all prudently incurred costs, including a return on rate base sufficient to pay interest on debt and subordinated debentures, and a reasonable return on common equity. Rate base consists generally of the original cost of utility plant in service, plus certain other assets such as working capital and inventories, less accumulated depreciation on utility plant in service, net deferred income tax liabilities, and certain other deductions. Rate schedules in Southwest's service territories, with the exception of Nevada, contain purchased gas adjustment clauses, which allow Southwest to file for rate adjustments as the cost of purchased gas changes. In Nevada, effective November 2005, Southwest began operating under the deferred energy regulations as established by the Nevada Administrative Code, which governs the recovery of energy costs in the state. These provisions result in little difference from purchased gas adjustment clauses in the method used to account for or report purchased gas costs, including the ability of the Company to defer over or under-collections of gas costs to balancing accounts. Effective October 2005, the Company began filing for quarterly gas cost adjustments in Nevada, calculated on a twelve-month rolling average. These adjustments are made effective immediately upon filing each quarter, but are subject to an annual prudence review and audit of the natural gas costs incurred. The Company filed its first quarterly adjustment in April 2006. Deferred energy and purchased gas adjustment (collectively "PGA") rate changes affect cash flows but have no direct impact on profit margin. Filings to change rates in accordance with PGA clauses are subject to audit by the appropriate state regulatory commission staff. Information with respect to recent general rate cases and PGA filings is included in the Rates and Regulatory Proceedings section of Management's Discussion and Analysis ("MD&A") in the 2006 Annual Report to Shareholders.

The table below lists the docketed general rate filings last initiated and the status of such filing within each ratemaking area:

Ratemaking Area	Type of Filing	Month Filed	Month Final Rates Effective
Arizona	General rate case	December 2004	March 2006
California:			
Northern and Southern	General rate case	February 2002	May 2003
Northern and Southern	Annual attrition	October 2006	January 2007
Nevada:			
Northern and Southern	General rate case	March 2004	September 2004
FERC:			
Paiute	General rate case	January 2005	August 2005

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Demand for Natural Gas

Deliveries of natural gas by Southwest are made under a priority system established by state regulatory commissions. The priority system is intended to ensure that the gas requirements of higher-priority customers, primarily residential customers and other customers who use 500 therms or less of gas per day, are fully satisfied on a daily basis before lower-priority customers, primarily electric utility and large industrial customers able to use alternative fuels, are provided any quantity of gas or capacity.

Demand for natural gas is greatly affected by temperature. On cold days, use of gas by residential and commercial customers may be as much as six times greater than on warm days because of increased use of gas for space heating. To fully satisfy this increased high-priority demand, gas is withdrawn from storage in certain service areas, or peaking supplies are purchased from suppliers. If necessary, service to interruptible lower-priority customers may be curtailed to provide the needed delivery system capacity. No weather-related curtailments occurred during the latest peak heating season. Southwest maintains no significant backlog on its orders for gas service.

Natural Gas Supply

Southwest is responsible for acquiring (purchasing) and arranging delivery of (transporting via interstate pipelines) natural gas to its system for all sales customers.

The primary objective of Southwest in acquiring gas supply is to ensure that adequate supplies of natural gas are available from reliable sources at the best cost. Gas is acquired from a wide variety of sources and a mix of purchase provisions, including spot market purchases and firm supplies with a variety of terms. During 2006, Southwest acquired gas supplies from 56 suppliers. Southwest regularly monitors the number of suppliers, their quality and their relative contribution to the overall customer supply portfolio. New suppliers are contracted whenever possible, and solicitations for supplies are extended to the largest possible list of suppliers. Competitive pricing, flexibility in meeting Southwest requirements, and aggressive participation by suppliers who have demonstrated reliability of service are key to their inclusion in the annual portfolio mix. The goal of this practice is to mitigate the risk of nonperformance by any one supplier and ensure competitive prices for customer supplies.

Balancing reliable supply assurances with the associated costs results in a continually changing mix of purchase provisions within the supply portfolios. To address the unique requirements of its various market areas, Southwest assembles and administers a separate natural gas supply portfolio for each of its jurisdictional areas. Firm and spot market natural gas purchases are made in a competitive bid environment. Southwest has experienced price volatility over the past five years, as the weighted average delivered cost of natural gas has ranged from a low of 38 cents per therm in 2002 to a high of 79 cents per therm in 2006. Price volatility is expected to continue throughout 2007.

To mitigate customer exposure to market price volatility, Southwest continues to purchase a significant percentage of its forecasted annual normal weather requirements under firm, fixed-price arrangements that are secured periodically throughout the year. About half of Southwest's annual normal weather supply needs are secured using short duration contracts (one year or less). For the 2006/2007 heating season, fixed-price contracts ranged in price from $6 to $11 per dekatherm. Natural gas purchases not covered by fixed-price contracts are made under variable-price contracts with firm quantities and on the spot market. Prices for these contracts are not known until the month of purchase.

The firm, fixed-price arrangements are structured such that a stated volume of gas is required to be scheduled by Southwest and delivered by the supplier. If the gas is not needed by Southwest or cannot be procured by the supplier, the contract provides for fixed or market-based penalties to be paid by the non-performing party.

In managing its gas supply portfolios, Southwest uses the fixed-price and variable-price arrangements noted above, but does not currently utilize other stand-alone derivative financial instruments for speculative purposes or for hedging. During 2007, Southwest intends to supplement its current volatility mitigation program with stand-alone financial derivative instruments. The combination of fixed-price contracts and derivative instruments should increase flexibility for Southwest and increase supplier diversification. The costs of such derivative financial instruments are expected to be recovered from customers. None of the Company's current long-term financial instruments or other contracts are derivatives that are marked to market or contain embedded derivatives with significant mark-to-market value.

Storage availability can influence the average annual price of gas, as storage allows a company to purchase natural gas in larger quantities during the off-peak season and store it for use in high demand periods when prices may be greater or supplies/capacity tighter. Southwest currently has no storage availability in its Arizona or southern Nevada rate jurisdictions.

Limited storage availability exists in southern and northern California and northern Nevada. A contract with

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Southern California Gas Company is intended for delivery only within Southwest's southern California rate jurisdiction. In addition, a contract with Paiute for its LNG facility allows for peaking capability only in northern Nevada and northern California. Gas is purchased for injection during the off-peak period for use in the high demand months, but is limited in its impact on the overall price.

Gas supplies for the southern system of Southwest (Arizona, southern Nevada, and southern California properties) are primarily obtained from producing regions in Colorado and New Mexico (San Juan basin), Texas (Permian basin), and Rocky Mountain areas. For its northern system (northern Nevada and northern California properties), Southwest primarily obtains gas from Rocky Mountain producing areas and from Canada.

Southwest arranges for transportation of gas to its Arizona, Nevada, and California service territories through the pipeline systems of El Paso Natural Gas Company ("El Paso"), Kern River Gas Transmission Company ("Kern River"), Transwestern Pipeline Company ("Transwestern"), Northwest Pipeline Corporation, Tuscarora Gas Pipeline Company ("Tuscarora"), Southern California Gas Company, and Paiute. Supply and pipeline capacity availability on both short- and long-term bases is regularly monitored by Southwest to ensure the reliability of service to its customers. Southwest currently receives firm transportation service, both on a short- and long-term basis, for all of its service territories on the pipeline systems noted above and also has interruptible contracts in place that allow additional capacity to be acquired should an unforeseen need arise.

Southwest is dependent upon the El Paso pipeline system for the transportation of gas to virtually all of its Arizona service territories and, for part of 2006, to a portion of its southern Nevada service territory. During 2005, Southwest entered into negotiations with alternative transportation service providers to evaluate capacity options for its southern Nevada service territory. After evaluating several proposals, Transwestern was chosen to replace the capacity previously provided by El Paso for southern Nevada, effective September 2006. The new five-year contract with Transwestern extends capacity during winter months and provides greater flexibility in meeting monthly requirements. Rates under the new contract do not differ significantly from those previously paid. El Paso service is available in Southern Nevada on an interruptible basis.

The Company believes that the current level of contracted firm interstate capacity is sufficient to serve each of its service territories. As the need arises to acquire additional capacity on one of the interstate pipeline transmission systems, primarily due to customer growth, Southwest will continue to consider available options to obtain that capacity, either through the use of firm contracts with a pipeline company or by purchasing capacity on the open market.

Competition

Electric utilities are the principal competitors of Southwest for the residential and small commercial markets throughout its service areas. Competition for space heating, general household, and small commercial energy needs generally occurs at the initial installation phase when the customer/builder typically makes the decision as to which type of equipment to install and operate. The customer will generally continue to use the chosen energy source for the life of the equipment. As a result of its success in these markets, Southwest has experienced consistent growth among the residential and small commercial customer classes.

Unlike residential and small commercial customers, certain large commercial, industrial, and electric generation customers have the capability to switch to alternative energy sources. To date, Southwest has been successful in retaining most of these customers by setting rates at levels competitive with alternative energy sources such as electricity, fuel oils, and coal. However, high natural gas prices may impact Southwest's ability to retain some of these customers. Overall, management does not anticipate any material adverse impact on operating margin from fuel switching.

Southwest competes with interstate transmission pipeline companies, such as El Paso, Kern River, Transwestern and Tuscarora, to provide service to certain large end-users. End-use customers located in proximity to these interstate pipelines pose a potential bypass threat. Southwest attempts to closely monitor each customer situation and provide competitive service in order to retain the customer. Southwest has remained competitive through the use of negotiated transportation contract rates, special long-term contracts with electric generation and cogeneration customers, and other tariff programs. These competitive response initiatives have mitigated the loss of margin earned from large customers.

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Environmental Matters

Federal, state, and local laws and regulations governing the discharge of materials into the environment have had little direct impact upon Southwest. Environmental efforts, with respect to matters such as protection of endangered species and archeological finds, have increased the complexity and time required to obtain pipeline rights-of-way and construction permits. However, increased environmental legislation and regulation are also beneficial to the natural gas industry. Because natural gas is one of the most environmentally safe fossil fuels currently available, its use can help energy users to comply with stricter environmental standards.

Employees

At December 31, 2006, the natural gas operations segment had 2,525 regular full-time equivalent employees. Southwest believes it has a good relationship with its employees and that compensation, benefits, and working conditions afforded its employees are comparable to those generally found in the utility industry. No employees are represented by a union.

CONSTRUCTION SERVICES

NPL is a full-service underground piping contractor that provides utility companies with trenching and installation, replacement, and maintenance services for energy distribution systems. NPL contracts primarily with LDCs to install, repair, and maintain energy distribution systems from the town border station to the end-user. The primary focus of business operations is main and service replacement as well as new business installations. Construction work varies from relatively small projects to the piping of entire communities. Construction activity is seasonal in most areas. Peak construction periods are the summer and fall months in colder climate areas, such as the Midwest. In the warmer climate areas, such as the southwestern United States, construction continues year round. Construction activity is also cyclical and can be significantly impacted by changes in general and local economic conditions, including interest rates, employment levels, job growth, equipment resale market, and local and federal tax rates.

NPL business activities are often concentrated in utility service territories where existing energy lines are scheduled for replacement. An LDC will typically contract with NPL to provide pipe replacement services and new line installations. Contract terms generally specify unit-price or fixed-price arrangements. Unit-price contracts establish prices for all of the various services to be performed during the contract period. These contracts often have annual pricing reviews. During 2006, approximately 91 percent of revenue was earned under unit-price contracts. As of December 31, 2006, no significant backlog existed with respect to outstanding construction contracts.

Materials used by NPL in its pipeline construction activities are typically specified, purchased, and supplied by NPL's customers. Construction contracts also contain provisions which make customers generally liable for remediating environmental hazards encountered during the construction process. Such hazards might include digging in an area that was contaminated prior to construction, finding endangered animals, digging in historically significant sites, etc. Otherwise, NPL's operations have minimal environmental impact (dust control, normal waste disposal, handling harmful materials, etc.).

Competition within the industry has traditionally been limited to several regional competitors in what has been a largely fragmented industry. Several national competitors also exist within the industry. NPL currently operates in approximately 16 major markets nationwide. Its customers are the primary LDCs in those markets. During 2006, NPL served 59 major customers, with Southwest accounting for approximately 27 percent of NPL revenues. With the exception of three other customers that in total accounted for approximately 31 percent of revenue, no other customer had a relatively significant contribution to NPL revenues.

Employment fluctuates between seasonal construction periods, which are normally heaviest in the summer and fall months. At December 31, 2006, NPL had 2,377 regular full-time equivalent employees. Employment peaked in September 2006 when there were 2,526 employees. Most employees are represented by unions and are covered by collective bargaining agreements, which is typical of the utility construction industry.

Operations are conducted from 17 field locations with corporate headquarters located in Phoenix, Arizona. Buildings are normally leased from third parties. The lease terms are typically five years or less. Field location facilities consist of a small building for repairs and land to store equipment.

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NPL is not directly affected by regulations promulgated by the ACC, PUCN, CPUC, or FERC in its construction services. NPL is an unregulated construction subsidiary of Southwest Gas Corporation. However, because NPL performs work for the regulated natural gas segment of the Company, its construction costs are subject indirectly to "prudency reviews" just as any other capital work that is performed by third parties or directly by Southwest. However, such "prudency reviews" would not bring NPL under the regulatory jurisdiction of any of the commissions noted above.

Item 1A. RISK FACTORS

*Although the Company is not able to predict all factors that may affect future results, described below (and in **Item 7A. Quantitative and Qualitative Disclosures about Market Risk** of this report) are some of the risk factors identified by the Company that may have a negative impact on our future financial performance or affect whether we achieve the goals or expectations expressed or implied in any forward-looking statements contained herein. Unless indicated otherwise, references below to "we," "us" and "our" should be read to refer to Southwest Gas Corporation and its subsidiaries.*

Our liquidity, and in certain circumstances our earnings, may be reduced during periods in which natural gas prices are rising significantly or are more volatile.

Increases in the cost of natural gas may arise from a variety of factors, including weather, changes in demand, the level of production and availability of natural gas, transportation constraints, transportation capacity cost increases, federal and state energy and environmental regulation and legislation, the degree of market liquidity, natural disasters, wars and other catastrophic events, national and worldwide economic and political conditions, the price and availability of alternative fuels, and the success of our strategies in managing price risk.

Rate schedules in each of our service territories contain PGA clauses which permit us to file for rate adjustments to recover increases in the cost of purchased gas. Increases in the cost of purchased gas have no direct impact on our profit margins, but do affect cash flows and can therefore impact the amount of our capital resources. We have used short-term borrowings in the past to temporarily finance increases in purchased gas costs, and we expect to do so during 2007, if the need again arises.

We may file requests for rate increases to cover the rise in the costs of purchased gas. Due to the nature of the regulatory process, there is a risk of a disallowance of full recovery of these costs during any period in which there has been a substantial run-up of these costs or our costs are more volatile. Any disallowance of purchased gas costs would reduce cash flow and earnings.

Governmental policies and regulatory actions can reduce our earnings.

Regulatory commissions set our rates and determine what we can charge for our rate-regulated services. Our ability to obtain timely future rate increases depends on regulatory discretion. Governmental policies and regulatory actions, including those of the ACC, the CPUC, the FERC, and the PUCN relating to allowed rates of return, rate structure, purchased gas and investment recovery, operation and construction of facilities, present or prospective wholesale and retail competition, changes in tax laws and policies, and changes in and compliance with environmental and safety laws and policies, can reduce our earnings. Risks and uncertainties relating to delays in obtaining regulatory approvals, conditions imposed in regulatory approvals, or determinations in regulatory investigations can also impact financial performance. In particular, the timing and amount of rate relief can materially impact results of operation.

We are unable to predict what types of conditions might be imposed on Southwest or what types of determinations might be made in pending or future regulatory proceedings or investigations. We nevertheless believe that it is not uncommon for conditions to be imposed in regulatory proceedings, for Southwest to agree to conditions as part of a settlement of a regulatory proceeding, or for determinations to be made in regulatory investigations that reduce our earnings and liquidity. For example, we may request recovery of a particular operating expense in a general rate case filing that a regulator disallows, negatively impacting our earnings.

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Significant customer growth in Arizona and Nevada could strain our capital resources.

We continue to experience significant population and customer growth throughout our service territories. During 2006, we added 71,000 customers, a four percent growth rate. This growth has required large amounts of capital to finance the investment in new transmission and distribution plant. In 2006, our natural gas construction expenditures totaled $306 million. Approximately 76 percent of these current-period expenditures represented new construction, and the balance represented costs associated with routine replacement of existing transmission, distribution, and general plant.

Cash flows from operating activities (net of dividends) have been insufficient, and are expected to continue to be insufficient, to fund all necessary capital expenditures. We have funded this shortfall through the issuance of additional debt and equity securities, and expect to continue to do so. However, our ability to issue additional securities is dependent upon, among other things, conditions in the capital markets, regulatory authorizations, our credit rating, and our level of earnings.

Significant customer growth in Arizona and Nevada could also impact earnings.

Our ability to earn the rates of return authorized by the ACC and the PUCN is also more difficult because of significant customer growth. The rates we charge our distribution customers in Arizona and Nevada are derived using rate base, cost of service, and cost of capital experienced in a historical test year, as adjusted. This results in "regulatory lag" which delays our recovery of some of the costs of capital improvements and operating costs from customers in Arizona and Nevada.

Our earnings are greatly affected by variations in temperature during the winter heating season.

The demand for natural gas is seasonal and is greatly affected by temperature. Variability in weather from normal temperatures can materially impact results of operations, particularly in our Arizona service territories where rates are highly leveraged. On cold days, use of gas by residential and commercial customers may be as much as six times greater than on warm days because of the increased use of gas for space heating. Weather has been and will continue to be one of the dominant factors in our financial performance.

Uncertain economic conditions may affect our ability to finance capital expenditures.

Our ability to finance capital expenditures and other matters will depend upon general economic conditions in the capital markets. Declining interest rates are generally believed to be favorable to utilities while rising interest rates are believed to be unfavorable because of the high capital costs of utilities. In addition, our authorized rate of return is based upon certain assumptions regarding interest rates. If interest rates are lower than assumed rates, our authorized rate of return in the future could be reduced. If interest rates are higher than assumed rates, it will be more difficult for us to earn our currently authorized rate of return.

The nature of our operations presents inherent risks of loss that could adversely affect our results of operations.

Our operations are subject to inherent hazards and risks such as gas leaks, fires, natural disasters, explosions, pipeline ruptures, and other hazards and risks that may cause unforeseen interruptions, personal injury, or property damage. Additionally, our facilities, machinery, and equipment, including our pipelines, are subject to third party damage from construction activities and vandalism. Any of these events could cause environmental pollution, personal injury or death claims, damage to our properties or the properties of others, or loss of revenue by us or others.

We maintain liability insurance for some, but not all, risks associated with the operation of our natural gas pipelines and facilities. In connection with these liability insurance policies, we have been responsible for an initial deductible or self-insured retention amount per incident, after which the insurance carriers would be responsible for amounts up to the policy limits. The Company's current insurance contracts limit the self-insured retention to $1 million per incident plus payment of the first $5 million in aggregate claims above $1 million. We cannot predict the likelihood that any future event will occur which will result in a claim exceeding $1 million; however, a large claim for which we were deemed liable would reduce our earnings.

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We rely on having access to interstate pipelines' transportation capacity. If these pipelines were not available, it could impact our ability to meet our customers' full requirements.

We must acquire both sufficient natural gas supplies and interstate pipeline capacity to meet customer requirements. We must contract for reliable and adequate delivery capacity for our distribution system, while considering the dynamics of the interstate pipeline capacity market, our own in-system resources, as well as the characteristics of our customer base. Interruptions to or reductions of interstate pipeline service caused by physical constraints, excessive customer usage or other force majeure could reduce our normal supply of gas, particularly in our Arizona service territories where we are wholly dependent upon the El Paso pipeline system. A prolonged interruption or reduction of service, particularly during the winter heating season, would reduce cash flow and earnings.

A significant reduction in our credit ratings could materially and adversely affect our business, financial condition, and results of operations.

We cannot be certain that any of our current ratings will remain in effect for any given period of time or that a rating will not be lowered or withdrawn entirely by a rating agency if, in its judgment, circumstances in the future so warrant. For example, in May 2006, Moody's Investors Service, Inc. ("Moody's") lowered its rating on the Company's unsecured long-term debt to Baa3 from Baa2 and changed the outlook for the rating to stable from negative. The change in credit rating will result in an estimated annualized increase of $375,000 in interest expense on existing long-term debt. No debt covenants were affected by the downgrade.

Any future downgrade could further increase our borrowing costs, which would diminish our financial results. We would likely be required to pay a higher interest rate in future financings, and our potential pool of investors and funding sources could decrease. A downgrade could require additional support in the form of letters of credit or cash or other collateral and otherwise adversely affect our business, financial condition and results of operations.

Item 1B. UNRESOLVED STAFF COMMENTS

None.

Item 2. PROPERTIES

The plant investment of Southwest consists primarily of transmission and distribution mains, compressor stations, peak shaving/storage plants, service lines, meters, and regulators, which comprise the pipeline systems and facilities located in and around the communities served. Southwest also includes other properties such as land, buildings, furnishings, work equipment, vehicles, and software systems in plant investment. The northern Nevada and northern California properties of Southwest are referred to as the northern system; the Arizona, southern Nevada, and southern California properties are referred to as the southern system. Several properties are leased by Southwest, including a portion of the corporate headquarters office complex located in Las Vegas, Nevada and the administrative offices in Phoenix, Arizona. Total gas plant, exclusive of leased property, at December 31, 2006 was $3.8 billion, including construction work in progress. It is the opinion of management that the properties of Southwest are suitable and adequate for its purposes.

Substantially all gas main and service lines are constructed across property owned by others under right-of-way grants obtained from the record owners thereof, on the streets and grounds of municipalities under authority conferred by franchises or otherwise, or on public highways or public lands under authority of various federal and state statutes. None of the numerous county and municipal franchises are exclusive, and some are of limited duration. These franchises are renewed regularly as they expire, and Southwest anticipates no serious difficulties in obtaining future renewals.

With respect to the right-of-way grants, Southwest has had continuous and uninterrupted possession and use of all such rights-of-way, and the associated gas mains and service lines, commencing with the initial stages of the construction of such facilities. Permits have been obtained from public authorities and other governmental entities in certain instances to cross or to lay facilities along roads and highways. These permits typically are revocable at the election of the grantor and Southwest occasionally must relocate its facilities when requested to do so by the grantor. Permits have also been obtained from railroad companies to cross over or under railroad lands or rights-of-way, which in some instances require annual or other periodic payments and are revocable at the election of the grantors.

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Southwest operates two primary pipeline transmission systems:

- a system (including an LNG storage facility) owned by Paiute extending from the Idaho-Nevada border to the Reno, Sparks, and Carson City areas and communities in the Lake Tahoe area in both California and Nevada and other communities in northern and western Nevada; and
- a system extending from the Colorado River at the southern tip of Nevada to the Las Vegas distribution area.

Southwest provides natural gas service in parts of Arizona, Nevada, and California. Service areas in Arizona include most of the central and southern areas of the state including Phoenix, Tucson, Yuma, and surrounding communities. Service areas in northern Nevada include Carson City, Yerington, Fallon, Lovelock, Winnemucca, and Elko. Service areas in southern Nevada include the Las Vegas valley (including Henderson and Boulder City) and Laughlin. Service areas in southern California include Barstow, Big Bear, Needles, and Victorville. Service areas in northern California include the Lake Tahoe area and Truckee.

Information on properties of NPL can be found on page 5 of this Form 10-K under Construction Services.

Item 3. LEGAL PROCEEDINGS

The Company maintains liability insurance for various risks associated with the operation of its natural gas pipelines and facilities. In May 2005, a leaking natural gas line was involved in a fire that severely injured an individual. By December 2005, the Company had recorded a total liability related to this incident equal to the Company's maximum self-insured retention level for the policy year August 2004 to July 2005 of $11 million. In the fourth quarter of 2006, the case was settled. The amount of the settlement that exceeded $11 million was covered by insurance. The Company's current insurance contracts limit the self-insured retention to $1 million per incident plus payment of the first $5 million in aggregate claims above $1 million.

The Company is named as a defendant in various legal proceedings. The ultimate dispositions of these proceedings are not presently determinable; however, it is the opinion of management that none of this litigation individually or in the aggregate will have a material adverse impact on the Company's financial position or results of operations.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

Item 4A. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The listing of the executive officers of the Company is set forth under **Part III Item 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**, which by this reference is incorporated herein.

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PART II

Item 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The principal market on which the common stock of the Company is traded is the New York Stock Exchange. At February 15, 2007, there were 23,306 holders of record of common stock, and the market price of the common stock was $38.80. The quarterly market price of, and dividends on, Company common stock required by this item are included in the 2006 Annual Report to Shareholders filed as an exhibit hereto and incorporated herein by reference.

The Company's common stock dividend policy states that common stock dividends will be paid at a prudent level within the normal dividend payout range for its respective businesses, and that dividends will be established at a level considered sustainable in order to minimize business risk and maintain a strong capital structure throughout all economic cycles. The quarterly common stock dividend was 20.5 cents per share throughout 2005 and 2006. The dividend of 20.5 cents per share has been paid quarterly since September 1994. In February 2007, the Board of Directors increased the quarterly dividend payout to 21.5 cents per share, effective with the June 2007 payment.

Item 6. SELECTED FINANCIAL DATA

Information required by this item is included in the 2006 Annual Report to Shareholders and is incorporated herein by reference.

Item 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Information required by this item is included in the 2006 Annual Report to Shareholders and is incorporated herein by reference.

Item 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company is exposed to various forms of market risk, including commodity price risk, weather risk, and interest rate risk. The following describes the Company's exposure to these risks.

Commodity Price Risk

About half of Southwest's annual normal weather gas supply needs are secured using short duration contracts (one year or less). For the 2006/2007 heating season, fixed-price contracts ranged in price from $6 to $11 per dekatherm. Natural gas purchases not covered by fixed-price contracts are made under variable-price contracts with firm quantities and on the spot market. Prices for these contracts are not known until the month of purchase. The PGA mechanism allows Southwest to file to change the gas cost component of the rates charged to its customers to reflect increases or decreases in the price expected to be paid to its suppliers and companies providing interstate pipeline transportation service. Filings to change rates in accordance with PGA clauses are subject to audit by state regulatory commission staffs.

The Company does not currently utilize stand-alone derivative financial instruments, other than fixed-price term and variable-rate contracts, for speculative purposes or for hedging. During 2007, Southwest intends to supplement its current volatility mitigation program with stand-alone derivative instruments. The combination of fixed-price contracts and derivative instruments should increase flexibility for Southwest and increase supplier diversification. The Company intends to pursue the recovery of such costs as part of the PGA mechanisms upon approval by Southwest's regulatory commissions in each jurisdiction.

Weather Risk

A significant portion of the Company's operating margin is volume driven with current rates based on an assumption of normal weather. Demand for natural gas is greatly affected by temperature. On cold days, use of gas by residential and commercial customers may be as much as six times greater than on warm days because of increased use of gas for

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space heating. Space heating-related volumes are the primary component of billings for these customer classes and are concentrated in the months of November to April. Variances in temperatures from normal levels, especially during these months, have a significant impact on the margin and associated net income of the Company. This impact is most pronounced in Arizona, where 54 percent of Southwest's customers are located and where rates are highly leveraged.

The Company continues to pursue mechanisms in each of its service territories intended to stabilize the recovery of the Company's fixed costs and reduce fluctuations in customers' bills due to colder or warmer-than-normal weather. In California, the CPUC authorized a margin tracker balancing account in April 2004 that mitigates margin volatility due to weather and other usage variations. In Nevada, the PUCN approved certain rate design improvements in September 2004 to mitigate weather variations, including an increase in the monthly basic service charge and the use of declining block rates. In Arizona, most of Southwest's requests for weather mitigation measures in its recent general rate case were rejected in the ACC's final order approved in February 2006. The ACC did however encourage Southwest to work with the ACC Staff and other interested parties prospectively to seek rate design alternatives that will provide benefits to all affected stakeholders.

Interest Rate Risk

Interest rate risk is the risk that changes in interest rates could adversely affect earnings or cash flows. Specific interest rate risks for the Company include the risk of increasing interest rates on variable-rate obligations. Interest rate risk sensitivity analysis is used to measure interest rate risk by computing estimated changes in cash flows as a result of assumed changes in market interest rates. In Nevada, fluctuations in interest rates on variable-rate Industrial Development Revenue Bonds ("IDRBs") are tracked and recovered from ratepayers through an interest balancing account. As of December 31, 2006 and 2005, the Company had $197 million and $224 million, respectively, in variable-rate debt outstanding, excluding Nevada variable-rate IDRBs. Assuming a constant outstanding balance in variable-rate debt for the next twelve months, a hypothetical one percent change in interest rates would increase or decrease interest expense for the next twelve months by approximately $2 million.

Other risk information is included in **Item 1A. Risk Factors** of this report.

Item 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The Consolidated Financial Statements of Southwest Gas Corporation and Notes thereto, together with the report of PricewaterhouseCoopers LLP, are included in the 2006 Annual Report to Shareholders and are incorporated herein by reference.

Item 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

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Item 9A. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

The Company has established disclosure controls and procedures that are designed to provide reasonable assurance that information required to be disclosed in reports filed or submitted under the Securities Exchange Act of 1934 is recorded, processed, summarized, communicated to management, and reported within the time periods specified in the SEC's rules and forms. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and benefits of controls must be considered relative to their costs. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or management override of the control. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and may not be detected.

Based on the most recent evaluation, as of December 31, 2006, management of the Company, including the Chief Executive Officer and Chief Financial Officer, believe the Company's disclosure controls and procedures are effective at attaining the level of reasonable assurance noted above.

Internal Control Over Financial Reporting

The report of management of the Company required to be reported herein is incorporated by reference to the information reported in the 2006 Annual Report to Shareholders under the caption "Management's Report on Internal Control Over Financial Reporting" on page 61.

The Attestation Report of the Registered Public Accounting Firm required to be reported herein is incorporated by reference to the information reported in the 2006 Annual Report to Shareholders under the caption "Report of Independent Registered Public Accounting Firm" on page 62.

There has been no change in our internal control over financial reporting that occurred during our most recent fiscal quarter that has materially affected or is reasonably likely to materially affect our internal control over financial reporting.

Item 9B. OTHER INFORMATION

None.

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PART III

Item 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

(a) *Identification of Directors.* Information with respect to Directors is set forth under the heading "Election of Directors" in the definitive 2007 Proxy Statement, which by this reference is incorporated herein.

(b) *Identification of Executive Officers.* The name, age, position, and period position held during the last five years for each of the Executive Officers of the Company as of December 31, 2006 are as follows:

Name	Age	Position	Period Position Held
Jeffrey W. Shaw	48	Chief Executive Officer	2004-Present
		President	2003-2004
		Senior Vice President/Gas Resources and Pricing	2002-2003
		Senior Vice President/Finance and Treasurer	2002
James P. Kane	60	President	2004-Present
		Executive Vice President/Operations	2002-2004
George C. Biehl	59	Executive Vice President/Chief Financial Officer and Corporate Secretary	2002-Present
John P. Hester	44	Senior Vice President/Regulatory Affairs & Energy Resources	2006-Present
		Vice President/Regulatory Affairs and Systems Planning	2003-2006
		Director/State Regulatory Affairs and Systems Planning	2002-2003
Edward A. Janov	52	Senior Vice President/Finance	2004-Present
		Vice President/Finance	2003-2004
		Vice President/Finance and Treasurer	2002-2003
		Vice President/Chief Accounting Officer	2002
Christina A. Palacios	61	Senior Vice President/Central Arizona Division	2005-Present
		Senior Vice President/Southern Arizona Division	2004-2005
		Vice President/Southern Arizona Division	2002-2004
Thomas R. Sheets	56	Senior Vice President/Legal Affairs and General Counsel	2002-Present
Dudley J. Sondeno	54	Senior Vice President/Chief Knowledge and Technology Officer	2002-Present
Roy R. Centrella	49	Vice President/Controller and Chief Accounting Officer	2002-Present
		Controller	2002
Kenneth J. Kenny	44	Vice President/Treasurer	2005-Present
		Treasurer	2003-2005
		Assistant Treasurer/Director Financial Services	2002-2003

(c) *Identification of Certain Significant Employees.* None.

(d) *Family Relationships.* No Directors or Executive Officers are related either by blood, marriage, or adoption.

(e) *Business Experience.* Information with respect to Directors is set forth under the heading "Election of Directors" in the definitive 2007 Proxy Statement, which by this reference is incorporated herein. All Executive Officers have held responsible positions with the Company for at least five years as described in (b) above.

(f) *Involvement in Certain Legal Proceedings.* None.

(g) *Promoters and Control Persons.* None.

(h) *Audit Committee Financial Expert.* Information with respect to the financial expert of the Board of Directors' audit committee is set forth under the heading "Committees of the Board" in the definitive 2007 Proxy Statement, which by this reference is incorporated herein.

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(i) *Identification of the Audit Committee.* Information with respect to the composition of the Board of Directors' audit committee is set forth under the heading "Committees of the Board" in the definitive 2007 Proxy Statement, which by this reference is incorporated herein.

(j) *Material Changes in Director Nomination Procedures for Security Holders.* None.

Section 16(a) Beneficial Ownership Reporting Compliance. The Company has adopted procedures to assist its directors and executive officers in complying with Section 16(a) of the Exchange Act, as amended, which includes assisting in the preparation of forms for filing. For 2006, all reports were timely filed.

Code of Business Conduct and Ethics. The Company has adopted a code of business conduct and ethics for its employees, including its chief executive officer, chief financial officer, chief accounting officer, and non-employee directors. A code of ethics is defined as written standards that are reasonably designed to deter wrongdoing and to promote: 1) honest and ethical conduct; 2) full, fair, accurate, timely, and understandable disclosure in reports and documents that a registrant files; 3) compliance with applicable governmental laws, rules, and regulations; 4) the prompt internal reporting of violations of the code to an appropriate person or persons identified in the code; and 5) accountability for adherence to the code. The Company's Code of Business Conduct & Ethics can be viewed on the Company's website (www.swgas.com). If any substantive amendments to the Code of Business Conduct & Ethics are made or any waivers are granted, including any implicit waiver, from a provision of the Code of Business Conduct & Ethics, to the Company's chief executive officer, chief financial officer and chief accounting officer, the Company will disclose the nature of such amendment or waiver on the Company's website, www.swgas.com.

Item 11. EXECUTIVE COMPENSATION

Information with respect to executive compensation is set forth under the heading "Executive Compensation" in the definitive 2007 Proxy Statement, which by this reference is incorporated herein.

Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

(a) *Security Ownership of Certain Beneficial Owners.* Information with respect to security ownership of certain beneficial owners is set forth under the heading "Securities Ownership by Directors, Director Nominees, Executive Officers, and Certain Beneficial Owners" in the definitive 2007 Proxy Statement, which by this reference is incorporated herein.

(b) *Security Ownership of Management.* Information with respect to security ownership of management is set forth under the heading "Securities Ownership by Directors, Director Nominees, Executive Officers, and Certain Beneficial Owners" in the definitive 2007 Proxy Statement, which by this reference is incorporated herein.

(c) *Changes in Control.* None.

(d) *Securities Authorized for Issuance Under Equity Compensation Plans.*

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At December 31, 2006, the Company had two stock-based compensation plans. With respect to the first plan, the Company may grant options to purchase shares of common stock to key employees and outside directors.

Equity Compensation Plan Information

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance
(Thousands of shares)			
Equity compensation plans approved by security holders	957	$ 26.26	—
Equity compensation plans not approved by security holders	—	—	—
Total	957	$ 26.26	—

Pursuant to the terms of the management incentive plan, the Company may issue performance shares to encourage key employees to remain in its employment to achieve short-term and long-term performance goals.

Plan category	Number of securities to be issued upon vesting of performance shares	Weighted-average grant date fair value of award	Number of securities remaining available for future issuance
(Thousands of shares)			
Equity compensation plans approved by security holders	319	$ 24.61	— (a)
Equity compensation plans not approved by security holders	—	—	—
Total	319	$ 24.61	—

(a) No common shares are registered for this plan, but performance shares are authorized for future grant under the terms of the plan.

Additional information regarding the two equity compensation plans is included in Note 10 of the Notes to Consolidated Financial Statements in the 2006 Annual Report to Shareholders.

Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

Information with respect to certain relationships and related transactions, and director independence is set forth under the heading "Governance of the Company" in the definitive 2007 Proxy Statement, which by this reference is incorporated herein.

Item 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

Information with respect to accounting fees and services associated with PricewaterhouseCoopers LLP is set forth under the heading "Selection of Independent Accountants" in the definitive 2007 Proxy Statement, which by this reference is incorporated herein.

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PART IV

Item 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a) The following documents are filed as part of this report on Form 10-K:

(1) The Consolidated Financial Statements of the Company (including the Reports of Independent Accountants) required to be reported herein are incorporated by reference to the information reported in the 2006 Annual Report to Shareholders under the following captions:

Consolidated Balance Sheets	38
Consolidated Statements of Income	39
Consolidated Statements of Cash Flows	40
Consolidated Statements of Stockholders' Equity and Comprehensive Income	41
Notes to Consolidated Financial Statements	42
Management's Report on Internal Control Over Financial Reporting	61
Report of Independent Registered Public Accounting Firm	62

(2) All schedules have been omitted because the required information is either inapplicable or included in the Notes to Consolidated Financial Statements.

(3) See **LIST OF EXHIBITS.**

(b) See **LIST OF EXHIBITS.**

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LIST OF EXHIBITS

Exhibit Number	Description of Document
1.01	Sales Agency Financing Agreement, dated as of March 16, 2006, between Southwest Gas Corporation and BNY Capital Markets, Inc. Incorporated herein by reference to the report on Form 8-K dated March 16, 2006.
3(i)	Restated Articles of Incorporation, as amended. Incorporated herein by reference to the report on Form 10-Q for the quarter ended March 31, 1997.
3(ii)	Amended Bylaws of Southwest Gas Corporation. Incorporated herein by reference to the report on Form 8-K dated March 16, 2006.
4.01	Indenture between City of Big Bear Lake, California, and Harris Trust and Savings Bank as Trustee, dated December 1, 1993, with respect to the issuance of $50,000,000 Industrial Development Revenue Bonds (Southwest Gas Corporation Project), 1993 Series A, due 2028. Incorporated herein by reference to the report on Form 10-K for the year ended December 31, 1993.
4.02	Form of Deposit Agreement. Incorporated herein by reference to the Registration Statement on Form S-3, No. 33-55621.
4.03	Form of Depositary Receipt (attached as Exhibit A to Form of Deposit Agreement included as Exhibit 4.02 hereto). Incorporated herein by reference to the Registration Statement on Form S-3, No. 33-55621.
4.04	Indenture between the Company and Harris Trust and Savings Bank dated July 15, 1996, with respect to Debt Securities. Incorporated herein by reference to the report on Form 8-K dated July 26, 1996.
4.05	First Supplemental Indenture of the Company to Harris Trust and Savings Bank dated August 1, 1996, supplementing and amending the Indenture dated as of July 15, 1996, with respect to 7 1/2% and 8% Debentures, due 2006 and 2026, respectively. Incorporated herein by reference to the report on Form 8-K dated July 31, 1996.
4.06	Second Supplemental Indenture of the Company to Harris Trust and Savings Bank dated December 30, 1996, supplementing and amending the Indenture dated as of July 15, 1996, with respect to Medium-Term Notes. Incorporated herein by reference to the report on Form 8-K dated December 30, 1996.
4.07	Indenture between Clark County, Nevada, and Harris Trust and Savings Bank as Trustee, dated as of October 1, 1999, with respect to the issuance of $35,000,000 Industrial Development Revenue Bonds (Southwest Gas Corporation), Series 1999A and Taxable Series 1999B or convertibles of Series B (Series C and D), due 2038. Incorporated herein by reference to the report on Form 10-K for the year ended December 31, 1999.
4.08	Third Supplemental Indenture between the Company and The Bank of New York, as successor to Harris Trust and Savings Bank, dated as of February 13, 2001, supplementing and amending the Indenture dated as of July 15, 1996, with respect to the $200,000,000, 8.375% Notes, due 2011. Incorporated herein by reference to the report on Form 8-K dated February 8, 2001.
4.09	Fourth Supplemental Indenture of the Company to The Bank of New York, as successor to Harris Trust and Savings Bank, dated as of May 6, 2002, supplementing and amending the Indenture dated as of

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July 15, 1996, with respect to the 7.625% Senior Unsecured Notes due 2012. Incorporated herein by reference to the report on Form 8-K dated May 1, 2002.

4.10 Certificate of Trust of Southwest Gas Capital II. Incorporated herein by reference to the Registration Statement on Form S-3, No. 333-106419.

4.11 Certificate of Trust of Southwest Gas Capital III. Incorporated herein by reference to the Registration Statement on Form S-3, No. 333-106419.

4.12 Certificate of Trust of Southwest Gas Capital IV. Incorporated herein by reference to the Registration Statement on Form S-3, No. 333-106419.

4.13 Trust Agreement of Southwest Gas Capital III. Incorporated herein by reference to the Registration Statement on Form S-3, No. 333-106419.

4.14 Trust Agreement of Southwest Gas Capital IV. Incorporated herein by reference to the Registration Statement on Form S-3, No. 333-106419.

4.15 Form of Common Stock Certificate. Incorporated herein by reference to the report on Form 8-K dated July 22, 2003.

4.16 Form of Preferred Trust Security. Incorporated herein by reference to the report on Form 8-K dated August 20, 2003.

4.17 Form of Indenture with respect to the 7.70% Junior Subordinated Debentures. Incorporated herein by reference to the report on Form 8-K dated August 20, 2003.

4.18 Form of 7.70% Junior Subordinated Debenture. Incorporated herein by reference to the report on Form 8-K dated August 20, 2003.

4.19 Form of Amended and Restated Trust Agreement of Southwest Gas Capital II. Incorporated herein by reference to the report on Form 8-K dated August 20, 2003.

4.20 Form of Guarantee Agreement with respect to the Preferred Trust Securities. Incorporated herein by reference to the report on Form 8-K dated August 20, 2003.

4.21 Indenture between Clark County, Nevada, and BNY Midwest Trust Company as Trustee, dated as of July 1, 2004, with respect to the issuance of $65,000,000 Industrial Development Revenue Bonds (Southwest Gas Corporation), Series 2004A, due 2034. Incorporated herein by reference to the report on Form 10-Q for the quarter ended September 30, 2004.

4.22 Indenture between Clark County, Nevada, and BNY Midwest Trust Company as Trustee, dated as of October 1, 2004, with respect to the issuance of $75,000,000 Industrial Development Refunding Revenue Bonds (Southwest Gas Corporation), Series 2004B, due 2033. Incorporated herein by reference to the report on Form 10-K for the year ended December 31, 2004.

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4.23 Indenture of Trust between Clark County, Nevada and the Bank of New York Trust Company, N.A. as Trustee, dated as of October 1, 2005, relating to Clark County, Nevada Industrial Development Revenue Bonds Series 2005A. Incorporated herein by reference to the report on Form 10-Q for the quarter ended September 30, 2005.

4.24 Indenture of Trust between Clark County, Nevada and the Bank of New York Trust Company, N.A. as Trustee, dated as of September 1, 2006, relating to Clark County, Nevada Industrial Development Revenue Bonds Series 2006A. Incorporated herein by reference to the report on Form 10-Q for the quarter ended September 30, 2006.

4.25 The Company hereby agrees to furnish to the SEC, upon request, a copy of any instruments defining the rights of holders of long-term debt issued by Southwest Gas Corporation or its subsidiaries; the total amount of securities authorized thereunder does not exceed 10 percent of the consolidated total assets of Southwest Gas Corporation and its subsidiaries.

10.01 Project Agreement between the Company and City of Big Bear Lake, California, dated as of December 1, 1993. Incorporated herein by reference to the report on Form 10-K for the year ended December 31, 1993.

10.02 Amended and Restated Lease Agreement between the Company and Spring Mountain Road Associates, dated as of July 1, 1996. Incorporated herein by reference to the report on Form 10-Q for the quarter ended September 30, 1996.

10.03* Southwest Gas Corporation Supplemental Retirement Plan, amended and restated as of March 1, 1999. Incorporated herein by reference to the report on Form 10-K for the year ended December 31, 1999.

10.04* Southwest Gas Corporation Board of Directors Retirement Plan, amended and restated as of March 1, 1999. Incorporated herein by reference to the report on Form 10-K for the year ended December 31, 1999.

10.05 Financing Agreement between the Company and Clark County, Nevada, dated as of October 1, 1999. Incorporated herein by reference to the report on Form 10-K for the year ended December 31, 1999.

10.06* Amended Form of Employment Agreement with Company Officers. Incorporated herein by reference to the reports on Form 10-Q for the quarters ended September 30, 1998, September 30, 2000, and September 30, 2001, and the reports on Form 8-K dated September 21, 2004 and August 1, 2006.

10.07* Amended Form of Change in Control Agreement with Company Officers. Incorporated herein by reference to the reports on Form 10-Q for the quarters ended September 30, 1998, September 30, 2000, and September 30, 2001, and the reports on Form 8-K dated September 21, 2004 and August 1, 2006.

10.08* Southwest Gas Corporation Management Incentive Plan, amended and restated January 1, 2002. Incorporated herein by reference to the Proxy Statement dated April 2, 2002.

10.09* Southwest Gas Corporation 2002 Stock Incentive Plan. Incorporated herein by reference to the Proxy Statement dated April 2, 2002.

10.10* Southwest Gas Corporation Executive Deferral Plan, amended and restated as of November 19, 2002. Incorporated herein by reference to the Report on Form 10-K for the year ended December 31, 2002.

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10.11* Southwest Gas Corporation Directors Deferral Plan, amended and restated as of November 19, 2002. Incorporated herein by reference to the Report on Form 10-K for the year ended December 31, 2002.

10.12 Financing agreement dated as of March 1, 2003 by and between Clark County, Nevada and Southwest Gas Corporation relating to Clark County, Nevada Industrial Development Revenue Bonds Series 2003A, Series 2003B, Series 2003C, Series 2003D and Series 2003E. Incorporated herein by reference to the report on Form 10-Q for the quarter ended September 30, 2003.

10.13* Form of Executive Option Grant under 2002 Stock Incentive Plan. Incorporated herein by reference to the report on Form 10-Q for the quarter ended September 30, 2004.

10.14 Financing Agreement dated as of October 1, 2004 by and between the Company and Clark County, Nevada relating to Clark County Nevada Industrial Development Revenue Bonds Series 2004B. Incorporated herein by reference to the report on Form 10-K for the year ended December 31, 2004.

10.15 $300 million Five-Year Credit Facility. Incorporated herein by reference to the report on Form 10-Q for the quarter ended June 30, 2005. First Amendment to $300 million Five-Year Credit Facility. Incorporated herein by reference to the report on Form 10-Q for the quarter ended June 30, 2006.

10.16 First Amendment to Financing Agreement by and between Clark County, Nevada, and Southwest Gas Corporation dated as of July 1, 2005, amending the Financing Agreement dated as of March 1, 2003, with respect to Clark County, Nevada Industrial Development Revenue Bonds Series 2003A, Series 2003B, Series 2003C, Series 2003D and Series 2003E. Incorporated herein by reference to the report on Form 10-Q for the quarter ended June 30, 2005.

10.17 Financing Agreement dated as of October 1, 2005 by and between Clark County, Nevada and Southwest Gas Corporation relating to Clark County, Nevada Industrial Development Revenue Bonds Series 2005A. Incorporated herein by reference to the report on Form 10-Q for the quarter ended September 30, 2005.

10.18 Financing Agreement dated as of September 1, 2006 by and between Clark County, Nevada and Southwest Gas Corporation relating to Clark County, Nevada Industrial Development Revenue Bonds Series 2006A. Incorporated herein by reference to the report on Form 10-Q for the quarter ended September 30, 2006.

10.19* Amendment to Employment and Change in Control Agreements.

12.01 Computation of Ratios of Earnings to Fixed Charges of Southwest Gas Corporation.

13.01 Portions of 2006 Annual Report incorporated by reference to the Form 10-K.

21.01 List of subsidiaries of Southwest Gas Corporation.

23.01 Consent of PricewaterhouseCoopers LLP, an independent registered public accounting firm.

31.01 Section 302 Certifications.

32.01 Section 906 Certifications.

* Management Contracts or Compensation Plans

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

SOUTHWEST GAS CORPORATION

Date: February 28, 2007

By /s/ JEFFREY W. SHAW
Jeffrey W. Shaw
Chief Executive Officer

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ GEORGE C. BIEHL (George C. Biehl)	Director, Executive Vice President, Chief Financial Officer, and Corporate Secretary	February 28, 2007
/s/ THOMAS E. CHESTNUT (Thomas E. Chestnut)	Director	February 28, 2007
/s/ STEPHEN C. COMER (Stephen C. Comer)	Director	February 28, 2007
/s/ RICHARD M. GARDNER (Richard M. Gardner)	Director	February 28, 2007
/s/ LEROY C. HANNEMAN, JR. (LeRoy C. Hanneman, Jr.)	Chairman of the Board of Directors	February 28, 2007
/s/ JAMES J. KROPID (James J. Kropid)	Director	February 28, 2007
/s/ MICHAEL O. MAFFIE (Michael O. Maffie)	Director	February 28, 2007
/s/ ANNE L. MARIUCCI (Anne L. Mariucci)	Director	February 28, 2007
/s/ MICHAEL J. MELARKEY (Michael J. Melarkey)	Director	February 28, 2007
/s/ JEFFREY W. SHAW (Jeffrey W. Shaw)	Director and Chief Executive Officer	February 28, 2007
/s/ CAROLYN M. SPARKS (Carolyn M. Sparks)	Director	February 28, 2007
/s/ TERRENCE L. WRIGHT (Terrence L. Wright)	Director	February 28, 2007
/s/ ROY R. CENTRELLA (Roy R. Centrella)	Vice President, Controller, and Chief Accounting Officer	February 28, 2007

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23.01	Consent of PricewaterhouseCoopers LLP, an independent registered public accounting firm.
31.01	Section 302 Certifications.
32.01	Section 906 Certifications.