



Northern Natural Gas Company

**Financial Statements as of and for the
Six-Month Period Ended June 30, 2012**

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

| | As of | |
|--|----------------------------|----------------------------|
| | June 30, 2012 | December 31, 2011 |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 44,852 | \$ 60,916 |
| Accounts receivable, net | 35,637 | 63,331 |
| Accounts receivable from affiliates | 3,299 | 7,430 |
| Notes receivable from MEHC | 230,000 | 230,000 |
| Transportation and exchange gas receivables | 2,822 | 8,899 |
| Income taxes receivable | 35,542 | 3,090 |
| Inventories | 23,831 | 24,402 |
| Other current assets | <u>15,723</u> | <u>18,372</u> |
| Total current assets | 391,706 | 416,440 |
| Property, plant and equipment, net | 2,211,362 | 2,205,962 |
| Regulatory assets | 165,529 | 152,618 |
| Other assets | <u>39,382</u> | <u>38,538</u> |
| Total assets | <u>\$ 2,807,979</u> | <u>\$ 2,813,558</u> |
| LIABILITIES AND SHAREHOLDER'S EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 10,171 | \$ 14,862 |
| Accounts payable to affiliates | 583 | 2,625 |
| Accrued interest | 12,783 | 12,783 |
| Accrued property and other taxes | 41,309 | 44,552 |
| Transportation and exchange gas payables | 1,904 | 7,670 |
| Derivative contracts | 9,101 | 10,516 |
| Current portion of long-term debt | 299,982 | 299,955 |
| Other current liabilities | <u>26,564</u> | <u>17,845</u> |
| Total current liabilities | 402,397 | 410,808 |
| Regulatory liabilities | 16,543 | 16,130 |
| Derivative contracts | 68,061 | 58,112 |
| Asset retirement obligations | 50,494 | 49,601 |
| Long-term debt | 649,786 | 649,774 |
| Deferred income taxes | 368,883 | 335,806 |
| Other long-term liabilities | <u>19,084</u> | <u>18,922</u> |
| Total liabilities | <u>1,575,248</u> | <u>1,539,153</u> |
| Commitments and contingencies (Notes 4 and 6) | | |
| Shareholder's equity: | | |
| Series A preferred stock - 1,000 shares authorized, \$0.01 par value, no shares issued and outstanding | - | - |
| Common stock - 10,000 shares authorized, \$1.00 par value, 1,002 shares issued and outstanding | 1 | 1 |
| Additional paid-in capital | 981,868 | 981,868 |
| Retained earnings | 250,865 | 294,132 |
| Accumulated other comprehensive loss, net | <u>(3)</u> | <u>(1,596)</u> |
| Total shareholder's equity | <u>1,232,731</u> | <u>1,274,405</u> |
| Total liabilities and shareholder's equity | <u>\$ 2,807,979</u> | <u>\$ 2,813,558</u> |

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

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

| | Six-Month Periods Ended June 30, | |
|---|---|------------------|
| | 2012 | 2011 |
| Operating revenue: | | |
| Transportation | \$ 263,788 | \$ 265,822 |
| Storage | 26,333 | 24,421 |
| Gas, liquids and other sales | <u>12,927</u> | <u>26,759</u> |
| Total operating revenue | <u>303,048</u> | <u>317,002</u> |
| Operating costs and expenses: | | |
| Operating and maintenance | 76,389 | 81,045 |
| Cost of gas and liquids sales | 14,121 | 26,212 |
| Depreciation and amortization | 31,947 | 33,934 |
| Amortization of regulatory assets | 1,108 | 4,102 |
| Taxes, other than income taxes | <u>27,110</u> | <u>25,885</u> |
| Total operating costs and expenses | <u>150,675</u> | <u>171,178</u> |
| Operating income | <u>152,373</u> | <u>145,824</u> |
| Other income (expense): | | |
| Interest expense, net | (25,303) | (29,974) |
| Interest income | 865 | 859 |
| Other, net | <u>1,398</u> | <u>669</u> |
| Total other income (expense) | <u>(23,040)</u> | <u>(28,446)</u> |
| Income before income tax expense | 129,333 | 117,378 |
| Income tax expense | <u>51,600</u> | <u>46,650</u> |
| Net income | <u>\$ 77,733</u> | <u>\$ 70,728</u> |

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

| | Six-Month Periods Ended June 30, | |
|---|---|------------------|
| | 2012 | 2011 |
| Net income | \$ 77,733 | \$ 70,728 |
| Other comprehensive income (loss) - | | |
| Unrealized gains (losses) on cash flow hedges, net of tax of \$1,053 and \$(77) | <u>1,593</u> | <u>(117)</u> |
| Comprehensive income | <u>\$ 79,326</u> | <u>\$ 70,611</u> |

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

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

| | <u>Common Stock</u> | <u>Additional Paid-In Capital</u> | <u>Retained Earnings</u> | <u>Accumulated Other Comprehensive Loss, net</u> | <u>Total</u> |
|--|-------------------------|---|------------------------------|--|---------------------|
| Balance, December 31, 2010 | \$ 1 | \$ 981,868 | \$ 232,978 | \$ (743) | \$ 1,214,104 |
| Net income | - | - | 70,728 | - | 70,728 |
| Other comprehensive loss – cash flow hedges | - | - | - | (117) | (117) |
| Balance, June 30, 2011 | <u>\$ 1</u> | <u>\$ 981,868</u> | <u>\$ 303,706</u> | <u>\$ (860)</u> | <u>\$ 1,284,715</u> |
| Balance, December 31, 2011 | \$ 1 | \$ 981,868 | \$ 294,132 | \$ (1,596) | \$ 1,274,405 |
| Net income | - | - | 77,733 | - | 77,733 |
| Other comprehensive income – cash flow hedges | - | - | - | 1,593 | 1,593 |
| Dividends on common stock | - | - | (121,000) | - | (121,000) |
| Balance, June 30, 2012 | <u>\$ 1</u> | <u>\$ 981,868</u> | <u>\$ 250,865</u> | <u>\$ (3)</u> | <u>\$ 1,232,731</u> |

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

| | Six-Month Periods | |
|--|--------------------------|------------------|
| | 2012 | 2011 |
| Cash flows from operating activities: | | |
| Net income | \$ 77,733 | \$ 70,728 |
| Adjustments to reconcile net income to net cash flows from operating activities: | | |
| Depreciation and amortization | 31,947 | 33,934 |
| Amortization of regulatory assets | 1,108 | 4,102 |
| Amortization of deferred financing costs | 401 | 431 |
| Deferred income taxes | 30,867 | 42,049 |
| Price risk management activities | (153) | (1,757) |
| Other, net | 3,833 | 2,923 |
| Changes in other operating assets and liabilities: | | |
| Accounts receivable and other assets | 26,692 | 36,139 |
| Inventories | 571 | 645 |
| Accounts payable and other accrued liabilities | (1,055) | (9,189) |
| Gas balancing activities | 6,155 | (26,756) |
| Accrued property, income and other taxes | <u>(35,695)</u> | <u>(26,081)</u> |
| Net cash flows from operating activities | <u>142,404</u> | <u>127,168</u> |
| Cash flows from investing activities: | | |
| Capital expenditures | (36,635) | (29,010) |
| Plant removal costs | (905) | (788) |
| Proceeds from sales of assets | <u>72</u> | <u>4,500</u> |
| Net cash flows from investing activities | <u>(37,468)</u> | <u>(25,298)</u> |
| Cash flows from financing activities: | | |
| Repayment of long-term debt | - | (250,000) |
| Proceeds from long-term debt | - | 199,956 |
| Dividends on common stock | (121,000) | - |
| Issuance of promissory notes by MEHC | - | (80,000) |
| Debt issuance costs | <u>-</u> | <u>(2,052)</u> |
| Net cash flows from financing activities | <u>(121,000)</u> | <u>(132,096)</u> |
| Net change in cash and cash equivalents | (16,064) | (30,226) |
| Cash and cash equivalents at beginning of period | <u>60,916</u> | <u>70,639</u> |
| Cash and cash equivalents at end of period | <u>\$ 44,852</u> | <u>\$ 40,413</u> |

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

Northern Natural Gas Company
Notes to Financial Statements
(Unaudited)

(1) General

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

The unaudited Financial Statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial information. Accordingly, they do not include all of the disclosures required by GAAP for annual financial statements. Management believes the unaudited Financial Statements contain all adjustments (consisting only of normal recurring adjustments) considered necessary for the fair presentation of the Financial Statements as of June 30, 2012 and for the six-month periods ended June 30, 2012 and 2011. The results of operations for the six-month period ended June 30, 2012 are not necessarily indicative of the results to be expected for the full year. The Company has evaluated subsequent events through August 17, 2012, which is the date the unaudited Financial Statements were available to be issued.

The preparation of the unaudited Financial Statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the Financial Statements and the reported amounts of revenue and expenses during the period. Actual results may differ from the estimates used in preparing the unaudited Financial Statements. Note 2 of Notes to Financial Statements included in the Company’s audited Financial Statements for the year ended December 31, 2011 describes the most significant accounting policies used in the preparation of the Financial Statements. There have been no significant changes in the Company’s assumptions regarding significant accounting estimates and policies during the six-month period ended June 30, 2012.

(2) New Accounting Pronouncements

In December 2011, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2011-11, which amends FASB Accounting Standards Codification (“ASC”) Topic 210, “Balance Sheet.” The amendments in this guidance require an entity to provide quantitative disclosures about offsetting financial instruments and derivative instruments. Additionally, this guidance requires qualitative and quantitative disclosures about master netting agreements or similar agreements when the financial instruments and derivative instruments are not offset. This guidance is effective for fiscal years beginning on or after January 1, 2013, and for interim periods within those fiscal years. The Company is currently evaluating the impact of adopting this guidance on its disclosures included within Notes to Financial Statements.

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

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

(3) Fair Value Measurements

The Company has various financial assets and liabilities that are measured at fair value on the Financial Statements using inputs from the three levels of the fair value hierarchy. A financial asset or liability classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement. The three levels are as follows:

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

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

| | Input Levels for Fair Value Measurements | | | Other⁽¹⁾ | Total |
|--|---|--------------------|----------------|----------------------------|--------------------|
| | Level 1 | Level 2 | Level 3 | | |
| <u>As of June 30, 2012</u> | | | | | |
| Assets: | | | | | |
| Commodity derivatives | \$ - | \$ 1,992 | \$ - | \$ (1,987) | \$ 5 |
| Money market mutual funds ⁽²⁾ | <u>53,804</u> | <u>-</u> | <u>-</u> | <u>-</u> | <u>53,804</u> |
| | <u>\$ 53,804</u> | <u>\$ 1,992</u> | <u>\$ -</u> | <u>\$ (1,987)</u> | <u>\$ 53,809</u> |
| Liabilities - commodity derivatives | <u>\$ -</u> | <u>\$ (79,149)</u> | <u>\$ -</u> | <u>\$ 1,987</u> | <u>\$ (77,162)</u> |
| <u>As of December 31, 2011</u> | | | | | |
| Assets: | | | | | |
| Commodity derivatives | \$ - | \$ 4,331 | \$ - | \$ (2,415) | \$ 1,916 |
| Money market mutual funds ⁽²⁾ | <u>65,013</u> | <u>-</u> | <u>-</u> | <u>-</u> | <u>65,013</u> |
| | <u>\$ 65,013</u> | <u>\$ 4,331</u> | <u>\$ -</u> | <u>\$ (2,415)</u> | <u>\$ 66,929</u> |
| Liabilities - commodity derivatives | <u>\$ -</u> | <u>\$ (71,043)</u> | <u>\$ -</u> | <u>\$ 2,415</u> | <u>\$ (68,628)</u> |

(1) Represents netting under master netting arrangements.

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

Derivative contracts are recorded on the Balance Sheets as either assets or liabilities and are stated at fair value unless they are designated as normal purchases or normal sales and qualify for the exception afforded by GAAP. When available, the fair value of derivative contracts is estimated using unadjusted quoted prices for identical contracts in the market in which the Company transacts. When quoted prices for identical contracts are not available, the Company uses forward price curves. Forward price curves represent the Company's estimates of the prices at which a buyer or seller could contract today for delivery or settlement at future dates. The Company bases its forward price curves upon market price quotations, when available, or internally developed and commercial models, with internal and external fundamental data inputs. Market price quotations are obtained from independent energy brokers, exchanges, direct communication with market participants and actual transactions executed by the Company. Market price quotations for certain major natural gas trading hubs are generally readily obtainable for the applicable term of the Company's outstanding derivative contracts; therefore, the Company's forward price curves for those locations and periods reflect observable market quotes. The estimated fair value of these derivative contracts is a function of underlying forward commodity prices, related volatility, counterparty creditworthiness and duration of contracts. Refer to Note 4 for further discussion regarding the Company's risk management and hedging activities.

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

(4) Risk Management and Hedging Activities

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

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

For certain designated markets, certain customers pay a fixed price of \$0.09 per decatherm (“dth”) of volumes delivered to purchase compressor fuel and system use gas from the Company. The Company estimates it will be required to purchase an annual average of 1.0 bcf of natural gas through October 2022 to meet these requirements based on a projected average system requirements factor of 1.2% of volumes delivered. The Company’s contracts with these customers provide service through October 2019, with annual renewal options for one customer to continue service through October 2022. As of June 30, 2012, the Company had purchased gas and entered into swap agreements covering more than the expected contractual requirements through October 2022.

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

There have been no significant changes in the Company’s accounting policies related to derivatives. Refer to Note 3 for additional information on derivative contracts.

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

| | <u>Derivative Assets</u> | | <u>Derivative Liabilities</u> | | <u>Total</u> |
|---|------------------------------|--------------------|-------------------------------|---------------------------|---------------------------|
| | <u>Current⁽¹⁾</u> | <u>Noncurrent</u> | <u>Current</u> | <u>Noncurrent</u> | |
| As of June 30, 2012 | | | | | |
| Not designated as hedging contracts⁽²⁾: | | | | | |
| Commodity assets | \$ 56 | \$ - | \$ 1,434 | \$ 1 | \$ 1,491 |
| Commodity liabilities | <u>(51)</u> | <u>-</u> | <u>(10,535)</u> | <u>(68,057)</u> | <u>(78,643)</u> |
| Total | <u>5</u> | <u>-</u> | <u>(9,101)</u> | <u>(68,056)</u> | <u>(77,152)</u> |
| Designated as cash flow hedging contracts: | | | | | |
| Commodity assets | - | - | - | 501 | 501 |
| Commodity liabilities | <u>-</u> | <u>-</u> | <u>-</u> | <u>(506)</u> | <u>(506)</u> |
| Total | <u>-</u> | <u>-</u> | <u>-</u> | <u>(5)</u> | <u>(5)</u> |
| Total derivatives - net basis⁽³⁾ | <u>\$ 5</u> | <u>\$ -</u> | <u>\$ (9,101)</u> | <u>\$ (68,061)</u> | <u>\$ (77,157)</u> |
| As of December 31, 2011 | | | | | |
| Not designated as hedging contracts⁽²⁾: | | | | | |
| Commodity assets | \$ 2,773 | \$ - | \$ 1,240 | \$ - | \$ 4,013 |
| Commodity liabilities | <u>(863)</u> | <u>-</u> | <u>(8,970)</u> | <u>(58,087)</u> | <u>(67,920)</u> |
| Total | <u>1,910</u> | <u>-</u> | <u>(7,730)</u> | <u>(58,087)</u> | <u>(63,907)</u> |
| Designated as cash flow hedging contracts: | | | | | |
| Commodity assets | 6 | - | - | 312 | 318 |
| Commodity liabilities | <u>-</u> | <u>-</u> | <u>(2,786)</u> | <u>(337)</u> | <u>(3,123)</u> |
| Total | <u>6</u> | <u>-</u> | <u>(2,786)</u> | <u>(25)</u> | <u>(2,805)</u> |
| Total derivatives - net basis⁽³⁾ | <u>\$ 1,916</u> | <u>\$ -</u> | <u>\$ (10,516)</u> | <u>\$ (58,112)</u> | <u>\$ (66,712)</u> |

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

(2) The Company's commodity derivatives not designated as hedging contracts are generally included in regulated rates, and as of June 30, 2012 and December 31, 2011, a regulatory asset of \$77.2 million and \$63.9 million, respectively, was recorded related to the net derivative liability of \$77.2 million and \$63.9 million, respectively.

(3) The net notional amounts of outstanding commodity derivative contracts with fixed price terms that comprise the mark-to-market values included above is 21 million dth of natural gas purchases as of June 30, 2012 and December 31, 2011.

Not Designated as Hedging Contracts

The following table reconciles the beginning and ending balances of the Company's net regulatory assets and summarizes the pre-tax gains and losses on commodity derivative contracts recognized in net regulatory assets, as well as amounts reclassified to earnings for the six-month periods ended June 30 (in thousands):

| | <u>2012</u> | <u>2011</u> |
|---|-------------------------|-------------------------|
| Beginning balance | \$ 63,907 | \$ 50,124 |
| Changes in fair value recognized in net regulatory assets | 14,125 | (5,528) |
| Net gains (losses) reclassified to operating revenue | 3,546 | (1,350) |
| Net losses reclassified to cost of gas and liquids sales | <u>(4,426)</u> | <u>(2,908)</u> |
| Ending balance | <u>\$ 77,152</u> | <u>\$ 40,338</u> |

The Company recognized pre-tax gains of \$0.2 million and pre-tax losses of \$0.2 million resulting from unrealized valuation changes on purchase contracts for the six-month periods ended June 30, 2012 and 2011, respectively, which are included in cost of gas and liquids sales on the Statements of Income.

Designated as Hedging Contracts

The following table reconciles the beginning and ending balances of the Company's accumulated other comprehensive loss (pre-tax) and summarizes pre-tax gains and losses on commodity derivative contracts designated and qualifying as cash flow hedges recognized in other comprehensive income ("OCI"), as well as amounts reclassified to earnings for the six-month periods ended June 30 (in thousands):

| | <u>2012</u> | <u>2011</u> |
|--|-------------|-----------------|
| Beginning balance ⁽¹⁾ | \$ 2,651 | \$ 2,475 |
| Changes in fair value recognized in OCI | (2,646) | (1,063) |
| Net gains reclassified to operating revenue | - | 1,518 |
| Net losses reclassified to cost of gas and liquids sales | - | (1,501) |
| Ending balance ⁽¹⁾ | <u>\$ 5</u> | <u>\$ 1,429</u> |

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

Realized gains and losses on hedges and hedge ineffectiveness are recognized on the Statements of Income as operating revenue or cost of gas and liquids sales depending upon the nature of the item being hedged. For each of the six-month periods ended June 30, 2012 and 2011, hedge ineffectiveness was insignificant. As of June 30, 2012, the Company had cash flow hedges with expiration dates extending through December 2013 and the pre-tax net unrealized losses forecasted to be reclassified from accumulated other comprehensive loss into earnings over the next twelve months are insignificant.

Credit Risk

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

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

Collateral and Contingent Features

In accordance with industry practice, certain derivative contracts contain provisions that require the Company to maintain specific credit ratings from one or more of the major credit rating agencies on its unsecured debt. These derivative contracts may either specifically provide bilateral rights to demand cash or other security if credit exposures on a net basis exceed specified rating-dependent threshold levels ("credit-risk-related contingent features"). These rights can vary by contract and by counterparty. As of June 30, 2012, the Company's credit ratings from the three recognized credit rating agencies were investment grade.

The aggregate fair value of the Company's derivative contracts in liability positions with specific credit-risk-related contingent features totaled \$79.1 million and \$71.0 million as of June 30, 2012 and December 31, 2011, respectively, for which the Company had not posted collateral. If all credit-risk-related contingent features for derivative contracts in liability positions had been triggered as of June 30, 2012 and December 31, 2011, the Company would have been required to post \$77.2 million and \$68.6 million, respectively, of collateral. The Company's collateral requirements could fluctuate considerably due to market price volatility, changes in credit ratings, changes in legislation or regulation, or other factors.

(5) Employee Benefit Plans

The Company participates in multi-employer benefit plans sponsored by MidAmerican Energy Company ("MEC"), an indirect wholly owned subsidiary of MEHC. The MidAmerican Energy Company Retirement Plan provides pension benefits for eligible employees ("pension plan") and the MidAmerican Energy Company Welfare Benefit Plan provides certain postretirement health care and life insurance benefits for eligible retirees ("other postretirement plan") on behalf of the Company. The Company's contributions to the pension and other postretirement plans were \$0.6 million for each of the six-month periods ended June 30, 2012 and 2011. As of June 30, 2012, the Company recorded an affiliate company payable included in other long-term liabilities relating to the pension plan and an affiliate company receivable included in other assets relating to the other postretirement plan of \$5.1 million and \$16.0 million, respectively. As of December 31, 2011, the Company recorded an affiliate company payable included in other long-term liabilities relating to the pension plan and an affiliate company receivable included in other assets relating to the other postretirement plan of \$5.1 million and \$15.4 million, respectively. Amounts attributable to the Company were allocated from MEC to the Company in accordance with the intercompany administrative service agreement. Offsetting regulatory assets and liabilities have been recorded related to the amounts not yet recognized as a component of net periodic benefit costs that will be included in regulated rates.

(6) Commitments and Contingencies

Legal Matters

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

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

- In September 2009, the Company filed an application with the FERC to extend the boundaries of the Cunningham natural gas storage facility. In June 2010, FERC issued an order granting the Company certificate authority to extend the boundaries of the Cunningham natural gas storage facility by 12,320 acres. The Company has either acquired leases or purchased the property on 3,580 acres, or 29% of the extension area. In July 2010, the Company filed a complaint in federal district court to acquire the remaining necessary interests by eminent domain. In June 2011, the Company filed a motion for preliminary injunction seeking access to the extension area to construct the facilities necessary to implement its containment plan to control the migrating storage gas. In March 2012, the federal district court judge issued an order granting the Company's motion for the preliminary injunction and required security in the form of a cash deposit of \$2.7 million and a bond of \$7.8 million, both of which were deposited with the court by the Company. In June 2012, the federal district court granted the Company's motion to establish a three-person compensation commission to determine the value of the interests to be taken. A discovery scheduling conference with the magistrate is scheduled for August 24, 2012.

- The Company filed a lawsuit in December 2008 against Nash, LD Drilling and Val Energy in the United States District Court for the District of Kansas (“District Court”) for conversion, nuisance and unjust enrichment. Shortly after the FERC order granting the Company authority to expand the boundaries of the Cunningham natural gas storage facility was issued in June 2010, the Company filed a motion to shut-in the production of the third-party wells producing the Company’s storage gas. In December 2010, the District Court granted the Company’s motion and ordered all of the wells in the extension area to be shut-in, which was completed in February 2011. The defendants appealed the injunction order to the Tenth Circuit Court of Appeals. Oral argument on the appeal was held in November 2011 and a decision is pending. Discovery has been stayed pending the outcome of the Kansas Supreme Court appeal discussed below.
- In December 2009, the Company filed a lawsuit in the 13th Judicial District, District Court, Pratt County, Kansas (“Pratt County State District Court”) against ONEOK Field Services Company and Lumen Energy Corporation alleging conversion based on their purchase of the storage gas from the producers. In April 2010, the Pratt County State District Court granted the defendants’ motion for summary judgment, finding that the Company does not have title to storage gas that has migrated beyond adjoining property. The Company appealed the decision to the Kansas Court of Appeals in April 2010, and the appeal was transferred to the Kansas Supreme Court at the Company’s request. Oral argument was held in March 2011. A decision on the merits is expected in the second half of 2012.

In December 2011, state court petitions were filed against the Company in three counties in Kansas, alleging trespass, nuisance and unjust enrichment, arising out of the migration of the Company’s storage gas. The cases were moved to federal district court in Wichita, Kansas on December 27, 2011, at the request of the Company. The Company filed responses to the petitions in January 2012, and the actions have been stayed pending the outcome of the Kansas Supreme Court appeal discussed above.

The Company has recorded Cunningham storage gas losses of 13.7 bcf from 2004 through 2011. The wells were shut-in in 2011. The replacement cost of storage gas losses is \$- million and \$4.0 million for the six-month periods ended June 30, 2012 and 2011, respectively, which are included in operating and maintenance and cost of gas and liquids sales on the Statements of Income.

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

(7) Other Related Party Transactions

The Company provided gas transportation, storage and other services to MEC totaling \$30.3 million and \$31.0 million for the six-month periods ended June 30, 2012 and 2011, respectively. MEC provides certain administrative and management services, including executive, financial, legal, human resources, payroll and tax, to the Company. Expenses incurred by MEC and billed to the Company are based on the individual services and expense items provided and were \$3.1 million and \$3.3 million for the six-month periods ended June 30, 2012 and 2011, respectively. MEC also provided electricity and other services to the Company of \$0.2 million for each of the six-month periods ended June 30, 2012 and 2011. The Company reimbursed MEC \$26.6 million for each of the six-month periods ended June 30, 2012 and 2011 for payroll, healthcare benefits and other benefit payments that MEC processed on behalf of the Company.

MEHC provides certain administrative and management services, including executive, financial, legal and tax, to the Company. Expenses incurred by MEHC and billed to the Company are based on the individual services and expense items provided and were \$0.9 million for each of the six-month periods ended June 30, 2012 and 2011. Income tax transactions with MEHC resulted in net payments of \$53.2 million and \$26.6 million for the six-month periods ended June 30, 2012 and 2011, respectively.

As of June 30, 2012 and December 31, 2011, the Company had net accounts payable to MEHC and certain subsidiaries for intercompany transactions totaling \$0.6 million and \$2.6 million, respectively.

The Company provides certain administrative and management services, including executive, financial, commercial, regulatory and legal, to Kern River Gas Transmission Company (“Kern River”), an indirect wholly owned subsidiary of MEHC. The Company billed Kern River \$0.6 million and \$0.5 million for the six-month periods ended June 30, 2012 and 2011, respectively, for these services.

The Company provides risk management services to Kern River, pursuant to a service agreement dated August 1, 2008. The Company relinquishes all risks, liabilities, losses and profits associated with these risk management services. For the six-month periods ended June 30, 2012 and 2011, the Company entered into insignificant risk management transactions that settled on behalf of Kern River.

BNSF Railway Company, an affiliate of the Company, provided contributions in aid of construction totaling \$3.9 million and \$- million for the six-month periods ended June 30, 2012 and 2011, respectively.

For the six-month periods ended June 30, 2012 and 2011, the Company received demand promissory notes bearing interest at a 30-day LIBOR plus a fixed per annum rate from MEHC in exchange for cash of \$- million and \$80.0 million, respectively. The balance of the demand promissory notes as of both June 30, 2012 and December 31, 2011 was \$230.0 million. Interest income of \$0.8 million and \$0.7 million was recorded for the six-month periods ended June 30, 2012 and 2011, respectively.