



**New Jersey  
Natural Gas**

2006 ANNUAL REPORT



## **NEW JERSEY NATURAL GAS**

### **2006 ANNUAL REPORT**

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## **INDEPENDENT AUDITORS' REPORT**

To the Board of Directors of  
New Jersey Natural Gas Company

We have audited the accompanying balance sheets and statements of capitalization of New Jersey Natural Gas Company (the "Company") as of September 30, 2006 and 2005, and the related statements of income, common stock equity and comprehensive income, and cash flows for the years then ended. 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 generally accepted auditing standards as established by the Auditing Standards Board (United States) and in accordance with the auditing 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. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also 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, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of the Company as of September 30, 2006 and 2005, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 6 to the financial statements, on September 30, 2006, the Company adopted Financial Accounting Standards Board Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*.

*Deloitte + Touche LLP*

December 20, 2006

# New Jersey Natural Gas

## STATEMENTS OF INCOME

(Thousands)

Fiscal years ended September 30,	2006	2005
<b>OPERATING REVENUES</b>	<b>\$1,138,774</b>	<b>\$1,138,280</b>
<b>OPERATING EXPENSES</b>		
Gas purchases	847,276	846,373
Operation and maintenance	84,907	76,626
Regulatory rider expenses	28,587	31,594
Depreciation and amortization	34,146	32,905
Energy and other taxes	55,829	53,374
Total operating expenses	1,050,745	1,040,872
<b>OPERATING INCOME</b>	<b>88,029</b>	<b>97,408</b>
Other income	3,448	3,144
Interest charges, net	16,456	14,293
<b>INCOME BEFORE INCOME TAXES</b>	<b>75,021</b>	<b>86,259</b>
Income tax provision	28,151	32,883
<b>NET INCOME</b>	<b>\$ 46,870</b>	<b>\$ 53,376</b>

The accompanying notes are an integral part of these statements.

# New Jersey Natural Gas

## STATEMENTS OF CASH FLOWS

(Thousands)

Fiscal years ended September 30,	2006	2005
<b>CASH FLOWS (USED IN) FROM OPERATING ACTIVITIES</b>		
Net income	\$ 46,870	\$ 53,376
Adjustments to reconcile net income to cash flows		
Depreciation and amortization	34,146	32,905
Amortization of deferred charges	301	301
Deferred income taxes	5,680	(3,267)
Manufactured gas plant remediation costs	(22,346)	(15,330)
Contributions to employee benefit plans	(11,317)	(9,008)
Changes in:		
Working capital	(155,175)	181,189
Other noncurrent assets	(19,517)	(42,711)
Other noncurrent liabilities	43,920	40,345
Cash flows (used in) from operating activities	(77,438)	237,800
<b>CASH FLOWS FROM (USED IN) FINANCING ACTIVITIES</b>		
Payments of common stock dividends to parent	(39,446)	(37,164)
Proceeds from long-term debt	35,800	-
Payments of long-term debt	(24,276)	(28,070)
Net proceeds from (payments related to) short-term debt	151,500	(107,600)
Proceeds from sale-leaseback transaction	4,090	4,904
Net cash flows from (used in) financing activities	127,668	(167,930)
<b>CASH FLOWS USED IN INVESTING ACTIVITIES</b>		
Expenditures for		
Utility plant	(53,060)	(52,801)
Cost of removal	(7,499)	(6,502)
(Investment in) withdrawal from restricted cash construction fund	(8,500)	7,800
Cash flows used in investing activities	(69,059)	(51,503)
Change in cash and temporary investments	(18,829)	18,367
Cash and temporary investments at beginning of year	23,194	4,827
Cash and temporary investments at end of year	\$ 4,365	\$ 23,194
<b>CHANGES IN COMPONENTS OF WORKING CAPITAL</b>		
Receivables	\$ 34,923	\$ (24,395)
Inventories	(27,487)	(34,277)
Underrecovered gas costs	38,759	32,456
Accounts payable and other	(9,646)	16,161
Gas purchases payable	(50,820)	47,325
Prepaid and accrued taxes, net	(17,333)	13,720
Customers' credit balances and deposits	39,064	3,359
Restricted broker margin accounts	(153,077)	115,865
Other current assets	(9,035)	11,312
Other current liabilities	(523)	(337)
Total	\$(155,175)	\$181,189
<b>SUPPLEMENTAL DISCLOSURES OF CASH FLOWS INFORMATION</b>		
Cash paid for		
Interest (net of amounts capitalized)	\$13,598	\$12,791
Income taxes	\$38,369	\$21,010

The accompanying notes are an integral part of these statements.

# New Jersey Natural Gas

## BALANCE SHEETS

### ASSETS

(Thousands)

September 30,	2006	2005
<b>PROPERTY, PLANT AND EQUIPMENT</b>		
Utility plant, at cost	\$1,214,456	\$1,169,819
Construction work in progress	29,160	27,634
	<b>1,243,616</b>	1,197,453
Accumulated depreciation and amortization	(326,298)	(307,100)
Property, plant and equipment, net	<b>917,318</b>	890,353
<b>CURRENT ASSETS</b>		
Cash and temporary investments	4,365	23,194
Customer accounts receivable	18,061	55,334
Unbilled revenues	12,543	10,207
Allowance for doubtful accounts	(2,679)	(2,693)
Gas in storage, at average cost	155,874	128,067
Materials and supplies, at average cost	2,788	3,108
Prepaid state taxes	26,343	24,020
Regulatory assets	8,105	34,904
Derivatives, at fair value	25,045	144,828
Broker margin account	30,833	-
Other	3,775	4,990
Total current assets	<b>285,053</b>	425,959
<b>NONCURRENT ASSETS</b>		
Regulatory assets	322,986	231,366
Derivatives, at fair value	10,431	14,094
Restricted cash construction fund	8,500	-
Prepaid pension asset	18,583	-
Other	24,063	19,986
Total noncurrent assets	<b>384,563</b>	265,446
Total assets	<b>\$1,586,934</b>	\$1,581,758

The accompanying notes are an integral part of these statements.

# New Jersey Natural Gas

## BALANCE SHEETS

### CAPITALIZATION AND LIABILITIES

(Thousands)

September 30,	2006	2005
<b>CAPITALIZATION</b>		
Common stock equity	\$ 464,742	\$ 448,286
Long-term debt	307,332	292,204
Total capitalization	772,074	740,490
<b>CURRENT LIABILITIES</b>		
Current maturities of long-term debt	3,739	3,253
Short-term debt	151,500	-
Regulatory liabilities	1,710	-
Gas purchases payable	39,244	90,064
Accounts payable and other	36,757	50,209
Accrued taxes	9,076	28,353
Broker margin account	-	122,244
Derivatives, at fair value	61,553	52,667
Customers' credit balances and deposits	60,945	21,881
Clean energy program	8,244	6,078
Total current liabilities	372,768	374,749
<b>NONCURRENT LIABILITIES</b>		
Deferred income taxes	166,744	150,083
Deferred investment tax credits	7,835	8,157
Derivatives, at fair value	56,290	71,094
Manufactured gas plant remediation	105,400	93,920
Regulatory liabilities	64,220	118,147
Clean energy and conservation incentive programs	13,138	18,612
Asset retirement obligation	23,293	-
Other	5,172	6,506
Total noncurrent liabilities	442,092	466,519
Total capitalization and liabilities	\$1,586,934	\$1,581,758

The accompanying notes are an integral part of these statements.

# New Jersey Natural Gas

## STATEMENTS OF CAPITALIZATION

(Thousands)

September 30,	2006	2005
<b>COMMON STOCK EQUITY</b>		
Common stock, \$5 par value; authorized 4,750,000 shares; outstanding 3,214,923 shares	<b>\$ 16,075</b>	\$ 16,075
Premium on common stock	<b>11,269</b>	11,269
Contribution from parent	<b>246,753</b>	246,753
Accumulated other comprehensive (loss), net of tax	<b>(73)</b>	(9,795)
Retained earnings	<b>190,718</b>	183,984
Total common stock equity	<b>464,742</b>	448,286
<b>LONG-TERM DEBT</b>		
<i>First mortgage bonds</i>	<i>Maturity date</i>	
5.38% Series W	August 1, 2023	-
6.27% Series X	November 1, 2008	<b>30,000</b>
6.25% Series Y	August 1, 2024	-
Variable Series AA	August 1, 2030	<b>25,000</b>
Variable Series BB	August 1, 2030	<b>16,000</b>
6.88% Series CC	October 1, 2010	<b>20,000</b>
Variable Series DD	September 1, 2027	<b>13,500</b>
Variable Series EE	January 1, 2028	<b>9,545</b>
Variable Series FF	January 1, 2028	<b>15,000</b>
Variable Series GG	April 1, 2033	<b>18,000</b>
5% Series HH	December 1, 2038	<b>12,000</b>
4.5% Series II	August 1, 2030	<b>10,300</b>
4.6% Series JJ	August 1, 2024	<b>10,500</b>
4.9% Series KK	October 1, 2040	<b>15,000</b>
4.77% Unsecured senior notes	March 15, 2014	<b>60,000</b>
Capital lease obligation Buildings	June 1, 2021	<b>27,701</b>
Capital lease obligation Meters	October 1, 2012	<b>28,525</b>
Less: Current maturities of long-term debt		<b>(3,739)</b>
Total Long-term debt	<b>307,332</b>	292,204
<b>Total Capitalization</b>	<b>\$772,074</b>	\$740,490

The accompanying notes are an integral part of these statements.

# New Jersey Natural Gas

## STATEMENTS OF COMMON STOCK EQUITY AND COMPREHENSIVE INCOME

<i>(Thousands)</i>	Number of Shares	Common Stock	Premium on Common Stock	Accum. Other Comprehensive Income	Contrib. from Parent	Retained Earnings	Total
Balance at September 30, 2004	3,215	\$16,075	\$11,269	\$(10,047)	\$246,753	\$168,109	\$432,159
Net income						53,376	53,376
Other comprehensive income (loss), net of tax:							
Change in fair value of derivatives, net of tax of \$(40)				58			58
Minimum pension liability adjustment, net of tax of \$(134)				194			194
Other comprehensive income							<u>252</u>
<i>Comprehensive income</i>							53,628
Cash dividend declared						(37,501)	(37,501)
Balance at September 30, 2005	3,215	16,075	11,269	(9,795)	246,753	183,984	448,286
Net income						<b>46,870</b>	<b>46,870</b>
Other comprehensive income (loss), net of tax:							
Change in fair value of derivatives, net of tax of \$(21)				31			31
Minimum pension liability adjustment, net of tax of \$(6,693)				9,691			9,691
Other comprehensive income							<u>9,722</u>
<i>Comprehensive income</i>							56,592
Cash dividend declared						(40,136)	(40,136)
<b>Balance at September 30, 2006</b>	<b>3,215</b>	<b>\$16,075</b>	<b>\$11,269</b>	<b>\$ (73)</b>	<b>\$246,753</b>	<b>\$190,718</b>	<b>\$464,742</b>

The accompanying notes are an integral part of these statements.

**NEW JERSEY NATURAL GAS**  
**NOTES TO FINANCIAL STATEMENTS**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

*Nature of the business*

New Jersey Natural Gas (the Company) is a local natural gas distribution company that provides regulated retail natural gas service to approximately 471,000 residential and commercial customers in central and northern New Jersey, and participates in the off-system sales and capacity release markets. The Company is the principal subsidiary of New Jersey Resources (NJR). The Company is subject to rate regulation by the New Jersey Board of Public Utilities (BPU).

*Regulatory Assets & Liabilities*

Under cost-based regulation, regulated utility enterprises generally are permitted to recover their operating expenses and earn a reasonable return on their utility investment.

The Company maintains its accounts in accordance with the Uniform System of Accounts as prescribed by the BPU. In accordance with the ratemaking process, the Company is required to follow Statement of Financial Accounting Standards (SFAS) No. 71, *Accounting for the Effects of Certain Types of Regulation* (SFAS 71), and as a result, the accounting principles applied by the Company differ in certain respects from those applied by unregulated businesses.

*Derivative Activities*

Derivative instruments associated with natural gas commodity contracts are recorded in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended (SFAS 133), under which the Company records the fair value of derivatives held as assets and liabilities. The Company's derivatives used to manage price risk on its natural gas purchasing activities are recoverable through its Basic Gas Supply Service (BGSS), a component of its tariff. Accordingly, the offset to the change in fair value of these derivatives is recorded as a Regulatory asset or liability on the Balance Sheets.

Fair values of exchange-traded instruments, principally futures, swaps and certain options, are based on actively quoted market prices. Fair values are subject to change in the near term and reflect management's best estimate based on various factors. In establishing the fair value of commodity contracts that do not have quoted prices, such as physical contracts, over-the-counter options and swaps, management uses available market data and pricing models to estimate fair values. Estimating fair values of instruments that do not have quoted market prices requires management's judgment in determining amounts which could reasonably be expected to be received from, or paid to, a third party in settlement of the instruments. These amounts could be materially different from amounts that might be realized in an actual sale transaction.

The Company has not designated any derivatives as fair value hedges as of September 30, 2006 and 2005.

*Revenues*

Revenues from the sale of natural gas to customers of the Company are recognized in the period that gas is delivered and consumed by customers, including an estimate for unbilled revenue.

Natural gas sales to individual customers are based on their meter readings, which are performed on a systematic basis throughout the month. At the end of each month, the amount of natural gas delivered to each customer after the last meter reading is estimated and the Company recognizes unbilled revenues related to these amounts. The unbilled revenue estimates are based on monthly send-out amounts, estimated customer usage by customer type, weather effects, unaccounted-for gas and the most recent rates.

Revenues from off-system sales and capacity releases are recorded in the period during which products or services are delivered and accepted by customers or over the related contractual term.

### *Gas Purchases*

The Company's tariff includes a component for BGSS, which is normally revised on an annual basis. Under the BGSS, the Company projects its cost of natural gas, net of supplier refunds, the impact of hedging activities and credits from nonfirm sales and transportation activities, and recovering or refunding the difference, if any, of such projected costs compared with those included in prices through levelized charges to customers. Any underrecoveries or overrecoveries are deferred and, subject to BPU approval, reflected in the BGSS in subsequent years.

### *Income Taxes*

The Company computes income taxes using the liability method, whereby deferred income taxes are generally determined based on the difference between the financial statement and tax basis of assets and liabilities using enacted tax rates in effect in the years in which the differences are expected to reverse. Net deferred tax assets are recorded when it is more likely than not such tax benefits will be realized. See *Note 7. Income Taxes*

Investment tax credits have been deferred and are being amortized as a reduction to the tax provision over the average lives of the related properties.

### *Capitalized and Deferred Interest*

The Company's capitalized interest totaled \$1.1 million in fiscal 2006 and \$594,000 in fiscal 2005, with average interest rates of 4.7 percent and 2.6 percent, respectively. These amounts are included in Utility plant on the Balance Sheets and are reflected on the Statements of Income as a reduction to Interest charges, net. The Company does not capitalize the cost of equity for its utility plant construction activities.

Pursuant to a BPU order, the Company is permitted to recover carrying costs on uncollected balances related to underrecovered natural gas costs incurred through October 31, 2001 and its manufactured gas plant (MGP) remediation expenditures (see *Note 4. Regulation*). Accordingly, Other income included \$2.3 million and \$1.8 million of interest related to underrecovered remediation and underrecovered gas costs in fiscal 2006 and 2005, respectively.

### *Sales Tax Accounting*

Sales tax and Transitional Energy Facilities Assessment (TEFA) are collected from customers and presented in both operating revenues and operating expenses on the Statements of Income as follows:

<i>Thousands</i>	September 30,	
	2006	2005
Sales Tax	<b>\$ 44,800</b>	\$41,600
TEFA	<b>8,100</b>	8,900
Total	<b>\$52,900</b>	\$50,500

### *Statements of Cash Flows*

For purposes of reporting cash flows, all temporary investments with maturities of three months or less are considered cash equivalents.

### *Utility Plant and Depreciation*

Regulated property, plant and equipment is stated at original cost. Costs include direct labor, materials and third-party construction contractor costs, allowance for capitalized interest and certain indirect costs related to equipment and employees engaged in construction. Upon retirement, the cost of depreciable regulated property, plus removal costs less salvage, is charged to accumulated depreciation with no gain or loss recorded.

Depreciation is computed on a straight-line basis for financial statement purposes, using rates based on the estimated average lives of the various classes of depreciable property. The composite rate of depreciation was 3.03 percent of average depreciable property in fiscal 2006, and 3.04 percent in fiscal 2005. Property classifications and estimated useful lives, as of September 30, 2006 and 2005, are as follows:

<u>Property Classifications</u>	<u>Estimated Useful Lives</u>
Distribution Facilities	31 to 63 years
Transmission Facilities	42 to 62 years
Storage Facilities	36 to 47 years
All other property	5 to 35 years

#### *Fair Value of Assets and Liabilities*

The fair value of cash and temporary investments, accounts receivable, accounts payable, commercial paper and borrowings under revolving credit facilities is estimated to equal their carrying amounts due to the short maturity of those instruments. The estimated fair value of long-term debt excluding current maturities and capital lease obligations is based on quoted market prices for similar issues and is as follows:

<u>(Thousands)</u>	<u>September 30,</u>	
	<u>2006</u>	<u>2005</u>
Carrying value	<b>\$ 254,800</b>	\$239,800
Fair market value	<b>\$ 257,600</b>	\$242,600

#### *Pension and Postemployment Plans*

The Company has two noncontributory defined pension plans covering substantially all employees, including officers. Benefits are based on each employee's years of service and compensation. The Company's funding policy is to contribute annually to these plans at least the minimum amount required under the Employee Retirement Income Security Act (ERISA) of 1974 and not more than can be deducted for federal income tax purposes. Plan assets consist of equity securities, fixed-income securities and short-term investments. The Company contributed \$7.9 million and \$8.4 million to the plans in fiscal 2006 and 2005, respectively.

The Company also provides two primarily noncontributory medical and life insurance plans for eligible retirees and dependents. Medical benefits, which make up the largest component of the plans, are based upon an age and years-of-service vesting schedule and other plan provisions. Funding of these benefits is made primarily into Voluntary Employee Beneficiary Association trust funds. The Company contributed \$3.4 million and \$638,000 to these plans in fiscal 2006 and 2005, respectively.

#### *New Accounting Standards*

In July 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48), which alters the framework for recognizing income tax contingencies. Previously, under SFAS No. 5, *Accounting for Contingencies*, the focus was on the subsequent liability recognition for estimated losses from tax contingencies where such losses were probable and the related amounts could be reasonably estimated. Under this new interpretation, a contingent tax asset (i.e., an uncertain tax position) may only be recognized if it is more likely than not that it will ultimately be sustained upon audit. The Company will adopt FIN 48 by the commencement of fiscal 2008. The Company is evaluating its tax positions for all jurisdictions and all years for which the statute of limitations remains open, as well as evaluating the impact that the adoption will have on its financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 defines fair value as the amount that would be exchanged to sell an asset or transfer a liability, in an orderly transaction between market participants, and establishes a fair value hierarchy of quotes and unobservable data that should be used to develop pricing assumptions. In addition, for assets and liabilities that are not actively traded, for example, certain kinds of derivatives, SFAS 157 requires that a fair value measurement include an adjustment for risks inherent in a valuation technique and/or inputs, such as those used in pricing models. SFAS 157 is effective for fiscal years

beginning after November 15, 2007, however, early adoption is permitted. The Company will adopt the provisions of the statement prospectively and is evaluating the adoption date and its effect on its financial condition.

In September 2006, the FASB issued SFAS No. 158, *Employers Accounting for Defined Benefit Pension and Other Postemployment Plans* (SFAS 158). The statement requires an employer to recognize the funded status, measured as the difference between the fair value of plan assets and the projected benefit obligation, of its benefit plans. SFAS 158 does not change how pensions and other postemployment benefits are accounted for and reported in the income statement. Certain economic events, which previously required disclosure only in the notes to the financial statements, will be recognized as assets and liabilities and offset in Accumulated other comprehensive income, net of tax, on the Statement of Common Stock Equity to the extent such amounts are not recognized in earnings as part of net periodic benefit costs. Amounts recognized in Accumulated other comprehensive income are adjusted as they are subsequently recognized in earnings. The Company will adopt SFAS 158 on September 30, 2007 and will apply the provisions of the statement prospectively. The Company is currently evaluating the effect of adoption on its financial condition.

#### *Use of Estimates*

The preparation of financial statements in conformity with generally accepted accounting principles (GAAP) used in the United States of America requires the Company to make estimates that affect the reported amounts of assets, liabilities, revenues, expenses and related disclosure of contingencies during the reporting period. On a continuous basis, the Company evaluates its estimates, including those related to the calculation of the fair value of natural gas commodity contracts and derivative instruments, unbilled revenues, provisions for depreciation and amortization, regulatory assets and liabilities, income taxes, pensions and other postemployment benefits and contingencies related to environmental matters and litigation. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. In the normal course of business estimated amounts are subsequently adjusted to actual results that may differ from estimates.

#### *Reclassifications*

Certain prior year amounts have been reclassified to conform to current year presentation.

## **2. LONG-TERM DEBT, DIVIDENDS AND RETAINED EARNINGS RESTRICTIONS**

Annual long-term debt, excluding capital leases, redemption requirements are as follows (in millions):

<u>September 30,</u>	<u>Redemption</u>
2007	\$
2008	
2009	30.0
2010	
2011	20.0
Thereafter	\$204.8

#### *First Mortgage Bonds*

The Company's mortgage secures its First Mortgage Bonds and represents a lien on substantially all of its property, including natural gas supply contracts. Certain indentures supplemental to the mortgage include restrictions as to cash dividends and other distributions on the Company's common stock that apply as long as certain series of First Mortgage Bonds are outstanding. Under the most restrictive provision, approximately \$176 million of the Company's retained earnings were available for such purposes at September 30, 2006.

On October 1, 2004, the Company's \$25 million, 8.25% Series Z First Mortgage Bonds matured.

The Company enters into loan agreements with the New Jersey Economic Development Authority (the EDA) under which the EDA issues tax-exempt bonds and the proceeds are loaned to the Company. To secure its loans from the EDA, the Company issues First Mortgage Bonds to the EDA with interest rates and maturity dates identical to those of the EDA Bonds.

In October 2005, the Company entered into a loan agreement under which the EDA loaned the Company the proceeds from \$35.8 million of tax-exempt EDA Bonds consisting of \$10.3 million, 4.5% (Series 2005A) and \$10.5 million, 4.6% (Series 2005B) Revenue Refunding Bonds; and \$15 million, 4.9% (Series 2005C) Natural Gas Facilities Revenue Bonds. The Series 2005 C bonds are supported by the Company's 4.9% Series KK bonds with a maturity date of October 1, 2040.

The Company used the proceeds from the Series A and B bonds to refinance the Company's \$10.3 million, 5.38% Series W First Mortgage Bonds and its \$10.5 million, 6.25% Series Y First Mortgage Bonds, respectively. The proceeds from the Series 2005C bonds were deposited into a construction fund. The Company drew down \$2.5 million from the construction fund in October 2005 and \$4 million in September 2006.

At September 30, 2006 and 2005, the Company had total long-term variable-rate debt outstanding of \$97.1 million. At September 30, 2006 and 2005, the weighted average interest rate on the Company's variable rate EDA Bonds was 3.3 percent and 2.2 percent, respectively.

In July 2006, the Company purchased interest rate caps with several banks to hedge the interest rate exposure on its \$97.1 million of tax-exempt, variable rate long-term debt with various maturity dates ranging from 2027 to 2040. The interest rate caps expire in July 2009 and limit the Company's variable rate debt exposure for the tax-exempt EDA Bonds at 4.5 percent. The interest rate caps are treated as cash flow hedges, with changes in fair value accounted for in Accumulated other comprehensive income.

#### *Sale-Leasebacks*

Under an agreement entered into with a financing company in 2002, the Company has received \$4.1 million and \$4.9 million in fiscal 2006 and 2005, respectively, related to the sale-leaseback of a portion of its meters. The Company plans to continue the sale-leaseback meter program on an annual basis.

In December 1995, the BPU approved the Company's petition to enter into a master lease agreement for its headquarters building for a 25.5-year term with two 5-year renewal options. The present value of the agreement's minimum lease payments is reflected as both a capital lease asset and a capital lease obligation, which are included in Utility plant and Long-term debt, respectively, on the Balance Sheets. In accordance with its ratemaking treatment, the Company records rent expense as if the lease was an operating lease.

Minimum annual lease payments, under both sale-leasebacks for the meters and the building, as of the fiscal year end are as follows (in millions):

Fiscal Year Ended September 30,	Minimum Lease Payment
2007	\$ 3.7
2008	4.0
2009	4.2
2010	4.6
2011	8.7
Thereafter	\$31.0

### 3. SHORT-TERM DEBT AND CREDIT FACILITIES

A summary of the Company's committed credit facilities, which require commitment fees on the unused amounts, is as follows:

<i>(Thousands)</i>	September 30,	
	2006	2005
Bank credit facilities	<b>\$250,000</b>	\$225,000
Amount outstanding at year-end		
Commercial paper	<b>\$151,500</b>	
Weighted average interest rate at year-end		
Commercial paper	<b>4.7%</b>	

In December 2004, the Company entered into a \$225 million committed facility with several banks, with a 5-year term expiring in December 2009, which replaced a \$225 million credit facility with a shorter term. In November 2005, the Company amended this facility to increase it to \$250 million. This facility is used to support the Company's commercial paper program.

As of September 30, 2006, the Company had a \$45 million letter of credit outstanding that will expire on December 31, 2006, in conjunction with a long-term swap agreement. The long-term swap agreement was entered into as a hedge related to an offsetting physical purchase of natural gas for the same time period and volume. This letter of credit reduces the amount available under the Company's committed credit facility by the same amount. The Company does not anticipate that this letter of credit will be drawn upon by the counterparty and it will be renewed as necessary, upon its expiration.

#### **4. REGULATION**

##### *Energy Deregulation Legislation*

In February 1999, the Electric Discount and Energy Competition Act (EDECA), which provided the framework for the restructuring of New Jersey's energy market, became law. In March 2001, the BPU issued a written order that approved a stipulation among various parties to fully open the Company's residential markets to competition, restructure its prices and expand an incentive for residential and small commercial customers to switch to transportation service. As required by EDECA, the Company restructured its prices to segregate its BGSS, the component of prices whereby the Company provides the commodity and interstate pipeline capacity to the customer, and delivery (i.e., transportation) prices. The Company earns no gross margin on the commodity portion of its natural gas sales. The Company earns gross margin through the delivery of natural gas to its customers. Customers can choose the supplier of their natural gas commodity.

Under EDECA, the BPU is required to audit the state's energy utilities every two years. The primary purpose of the audit is to ensure that utilities and their affiliates offering unregulated retail services do not have any unfair competitive advantage over nonaffiliated providers of similar retail services. A combined competitive services and management audit of the Company began in November 2006.

##### *Weather and Usage*

For the reporting periods through September 30, 2006, the impact of weather on the Company's utility gross margin had been significantly mitigated due to its Weather Normalization Clause (WNC), however, lower customer usage per degree-day was not captured by the WNC. The Company has experienced lower customer usage per degree-day, which it believes is due primarily to customer conservation resulting from an increase in wholesale natural gas commodity costs. In order to reduce the impact of the reduction in customer usage, the Company filed a Conservation and Usage Adjustment (CUA) proposal with the BPU in December 2005. On October 12, 2006, the BPU approved a stipulation reached with the staff of the BPU and the Division of Rate Counsel (on September 30, 2006) that modified the CUA proposal into the Conservation Incentive Program (CIP).

The CIP is a three-year pilot program, designed to decouple the link between customer usage and the Company's gross margin to allow the Company to encourage its customers to conserve energy. For the term of the pilot the existing WNC will be suspended and replaced with the CIP tracking mechanism, which addresses gross margin variations related to both weather and customer usage in comparison to established benchmarks. Recovery of such gross margin variations is subject to additional conditions including an earnings test and an evaluation of BGSS-related savings under the CIP agreement. If the Company does not file for a rate review with the BPU within two years, the return on equity for the earnings test will decline from 10.5 percent to 10.25 percent. To encourage energy efficiency, the Company is obligated to initiate and fund programs to further customer conservation efforts over the term of the pilot. In September 2006, the Company accrued the estimated present value of this obligation, which was approximately \$1.8 million. An annual filing for the clause shall be made in June of each year coincident with the Company's annual BGSS filing.

### *Basic Gas Supply Service*

On January 6, 2003, the BPU approved a statewide BGSS agreement requiring all New Jersey natural gas utilities to make an annual filing by each subsequent June 1 for review of BGSS and to request a potential rate change to be effective the following October 1. The agreement also allows natural gas utilities to provisionally increase residential and small commercial customer BGSS rates up to 5 percent on December 1 and February 1 on a self-implementing basis, after proper notice and BPU action on the June filing. Such increases are subject to subsequent BPU review and final approval.

On June 1, 2005, the Company filed for a 4.2 percent price increase to an average residential customer, to be effective on October 1, 2005. On July 21, 2005, the Company amended its filing, requesting an effective date of September 1, 2005. The BPU approved this increase on a provisional basis on August 19, 2005, and it became effective on September 1, 2005. This requested increase was necessary due to higher wholesale commodity costs and was subject to refund with interest.

On November 10, 2005, the Company filed for a 23.2 percent price increase to an average residential customer, which was provisionally approved and became effective on December 14, 2005. This increase was necessary due to higher wholesale commodity costs and was subject to refund with interest.

In January and March 2006, the Company filed supporting documentation with the BPU for a bill credit to its customers for the period February 1, 2006 through April 30, 2006. The bill credits, which temporarily reduced the BGSS tariff component, provided a benefit of approximately \$28.6 million to the Company's residential and small commercial customers during that period.

On June 1, 2006, the Company filed for a reduction to the BGSS rate that would decrease an average residential customer's bill by approximately 6.6 percent. The BPU approved this decrease on a provisional basis on September 27, 2006. The Company also refunded approximately \$22.5 million to residential and small commercial customers in September 2006.

On October 25, 2006, the Company filed supporting documentation with the BPU for a self-implementing BGSS price reduction to be effective November 1, 2006, which will lower residential and small commercial customers' bills by approximately an additional 4 percent.

On December 1, 2006, the Company provided notification to the BPU and Rate Counsel of its intention to issue BGSS refunds of \$51.5 million to residential and small commercial customers. The typical residential heating customer is expected to receive a refund of approximately \$120 in their December bill. No additional BPU action is required prior to implementation.

All of the above credits and refunds were possible due primarily to a decline in wholesale natural gas prices that occurred subsequent to the Company's November 10, 2005 BGSS filing. These refunds and credits apply only to the Company's residential and small commercial sales customers, as transportation customers are not subject to the BGSS clause.

### *Incentive Programs*

The Company is eligible to receive incentives for reducing BGSS costs through a series of gross margin-sharing programs that include off-system sales, capacity release, storage incentive and financial risk management programs. On April 12, 2006, the BPU approved an agreement whereby the existing gross margin-sharing programs between customers and shareowners were extended through October 31, 2007.

### *Societal Benefits Clause (SBC)*

The SBC is comprised of three primary components, a Universal Service Fund rider (USF), a Manufactured Gas Plant Remediation Adjustment Clause (RAC), and the New Jersey Clean Energy Program (NJCEP). The USF is a permanent statewide program that was approved by the BPU in March 2003 for all natural gas and electric utilities for the benefit of limited-income customers; the RAC is a rider approved by the BPU in June 1992 that provides for recovery of expenditures incurred to remediate former gas manufacturing facilities; and the NJCEP is a program approved by the BPU in March 2001 designed to promote energy efficiency and renewable energy. Recovery of SBC program costs is subject to BPU approval of annual filings that include an updated report of expenditures incurred each year.

### Universal Service Fund

Through the USF, eligible customers receive a credit toward their utility bill. The credits applied to eligible customers are recovered through the USF rider in the SBC. The Company recovers carrying costs on deferred USF balances. On July 1, 2006, the natural gas utilities filed to increase the statewide USF recovery rate as a result of higher USF benefits effective October 1, 2006. In October 2006, the BPU approved the requested recovery rate to be effective November 1, 2006, which resulted in an approximate .9 percent increase to the total bill of a residential sales customer.

### Clean Energy Program

On December 23, 2004, the BPU issued a decision establishing the statewide NJCEP funding amount for the period from January 1, 2005 to December 31, 2008. The Company's obligation to the state of New Jersey, which is recoverable from customers through the SBC, gradually increases from \$4.2 million in fiscal 2005 to \$9.5 million in fiscal 2008. As a result, the Company has a remaining discounted liability and a corresponding Regulatory asset included in SBC of \$19.6 million at September 30, 2006. Additionally, this decision reaffirmed the right and basis for utilities to collect lost revenue related to the implementation of Clean Energy programs for measures installed prior to December 31, 2003. As of September 30, 2005, the Company recorded \$1 million of revenue related to this program and has sought recovery of such revenue in its September 30, 2005 SBC filing. The Company also filed the results of the fiscal 2005 WNC on September 30, 2005, which seeks to apply a \$2.1 million refund to other clauses that are currently underrecovered.

### Remediation Adjustment Clause

On April 12, 2006, the BPU approved the Company's 2004 annual filing and signed a stipulation agreement that maintained the existing recovery rate of approximately \$19.2 million annually, which recognizes remediation expenditures through June 30, 2004.

### October 2006 Filings

On October 25, 2006, the Company made its annual SBC filing, which updates RAC expenditures through June 30, 2006, and provides current clean energy funding projections. In addition, the Company proposed to reduce the RAC recovery from \$19.2 million to \$15.9 million, annually, and increase the recovery for NJCEP from \$7.1 million to \$13.6 million, for the calendar year 2007, to address current funding obligations and a prior year underrecovery. At the same time, the Company filed supporting documentation for the WNC surcharge of approximately \$10.3 million for the period from October 1, 2005 through May 31, 2006. The combined effect of these two filings is an increase of approximately 1.7 percent for the average residential customer, with a requested effective date of January 1, 2007.

### *Other Proceedings*

The Company is also involved in various proceedings associated with several other adjustment clauses and an audit of its BGSS, the outcome of which, in management's opinion, will not have a material adverse impact on its financial condition, results of operations or cash flows.

## Regulatory Assets & Liabilities

At September 30, 2006 and 2005, respectively, the Company had the following regulatory assets on the Balance Sheets:

<i>(Thousands)</i>	2006	2005	Recovery Period
Regulatory assets current			
Underrecovered gas costs	\$	\$ 37,049	Less than one year (1)
WNC	<b>8,105</b>	(2,145)	Less than one year (4)
<b>Total-current</b>	<b>\$ 8,105</b>	\$ 34,904	
Regulatory assets noncurrent			
Remediation costs (Note 9)			
Expended, net	<b>\$ 83,746</b>	\$ 86,912	(2)
Liability for future expenditures	<b>105,400</b>	93,920	(3)
Deferred income and other taxes	<b>13,476</b>	12,901	Various
Derivatives (Note 1)	<b>82,451</b>		Through Oct. 2011 (5)
Postemployment benefit costs (Note 8)	<b>2,117</b>	2,418	Through Sept. 2014 (4)
SBC	<b>35,796</b>	35,215	Various (6)
<b>Total-noncurrent</b>	<b>\$ 322,986</b>	\$ 231,366	

- (1) Recoverable, subject to BPU annual approval, without interest, except for \$6.4 million that was recoverable with interest through November 30, 2005.
- (2) Recoverable, subject to BPU approval, with interest over rolling seven-year periods. Also net of estimated future insurance proceeds of \$10 million at September 30, 2006.
- (3) Estimated future expenditures. Recovery will be requested when actual expenditures are incurred. (See Note 9. Commitments and Contingent Liabilities.)
- (4) Recoverable/refundable, subject to BPU approval, without interest.
- (5) Recoverable, subject to BPU approval, through BGSS, without interest.
- (6) Recoverable with interest, subject to BPU approval.

If there are any changes in regulatory positions that indicate the recovery of regulatory assets is not probable, the related cost would be charged to income in the period of such determination.

At September 30, 2006 and 2005, the Company had the following regulatory liabilities on the Balance Sheets:

<i>(Thousands)</i>	2006	2005
Regulatory liability current		
Overrecovered gas costs	<b>\$ 1,710</b>	\$
Regulatory liabilities noncurrent		
Cost of removal obligation (1)	<b>\$ 58,161</b>	\$ 77,067
Market development fund (MDF) (2)	<b>6,059</b>	5,945
Derivatives		35,135
<b>Total-noncurrent</b>	<b>\$ 64,220</b>	\$ 118,147

- (1) The Company accrues and collects for cost of removal in rates. This liability represents collections in excess of actual expenditures. Approximately \$18.2 million of regulatory assets relating to asset retirement obligation have been netted against the cost of removal obligation as of September 30, 2006. See Note 6. Asset Retirement Obligations.
- (2) The MDF, created with funds available as a result of the implementation of the Energy Tax Reform Act of 1997, currently provides financial incentives to encourage customers to switch to third party suppliers and has supported other unbundling related initiatives. Balance earns interest at prevailing SBC rate. The MDF funding obligations terminated as of October 31, 2006. \$4.9 million of this fund was credited to the New Jersey Clean Energy Program, as a result of a filing with the BPU on October 25, 2006. The remaining balance is being held until final resolution of the Company's fiscal 2005 SBC filing.

## 5. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

The Company is subject to market risk due to fluctuations in the price of natural gas. To hedge against such fluctuations, the Company enters into futures contracts, option agreements and swap agreements to hedge purchases and sales of natural gas.

Generally, exchange-traded futures contracts require a deposit of margin cash, the amount of which is subject to change based on market movements and in accordance with exchange rules. The Company maintains a margin account. The balances as of September 30, 2006 and 2005 are as follows:

<i>(Thousands)</i>	2006	2005
Broker margin deposit (liability)	<b>\$ 30,833</b>	\$(122,244)

## 6. ASSET RETIREMENT OBLIGATIONS (ARO)

In March 2005, the FASB issued Financial Interpretation Number 47, *Accounting for Conditional Asset Retirement Obligations* (FIN 47), to clarify the term conditional asset retirement obligation (CARO) as used in SFAS No. 143, *Accounting for Asset Retirement Obligations*. A CARO refers to a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the company. FIN 47 removes the conditionality surrounding an ARO, such that the obligation to perform the asset retirement activity is unconditional even though uncertainty exists about the timing and/or method of settlement. The Company adopted FIN 47 effective as of September 30, 2006.

FIN 47 requires the Company to recognize a reasonably estimated liability for the fair value of a CARO. The fair value of a liability for a CARO should be recognized when incurred, which is generally upon acquisition, construction, development and/or through the normal operation of the asset. An asset retirement cost will be capitalized concurrently by increasing the carrying amount of the related asset by the same amount as the liability. In periods subsequent to the initial measurement, The Company is required to recognize changes in the liability resulting from the passage of time (accretion) or due to revisions to either timing or the amount of the originally estimated cash flows to settle the CARO.

As of September 30, 2006, the Company identified a CARO related to the costs associated with cutting and capping its main and service gas distribution pipelines, which is required by New Jersey law when taking such gas distribution pipeline out of service.

The Company recorded liabilities of approximately \$5.1 million related to the present value of CARO and \$18.2 million related to accumulated accretion. The Company believes that CARO-related amounts represent timing differences in the recognition of legal retirement costs that are currently being recovered in the Company's rates and, therefore, is deferring such differences as a regulatory asset under SFAS 71. The \$18.2 million related to accumulated accretion, which represents a regulatory asset, has been netted against the Company's cost of removal regulatory liability on the Balance Sheet.

The pro forma amounts of the liabilities for asset retirement obligations for the periods ended September 30, 2006, and 2005, respectively, are presented in the following table. These amounts were calculated using current information, assumptions and interest rates:

(Thousands)	Pro-Forma September 30,	
	2006	2005
Beginning of period ARO liability	<b>\$22,029</b>	\$20,841
Accretion <sup>(1)</sup>	<b>1,264</b>	1,188
End of period ARO liability	<b>\$23,293</b>	\$22,029

(1) Accretion is not reflected on the Company's Statements of Operations as it is deferred and recovered in rate base

Accretion for the next five years, is estimated to be as follows:

(Thousands) Fiscal Year Ended September 30,	Estimated Accretion
2007	\$1,312
2008	\$1,384
2009	\$1,459
2010	\$1,538
2011	\$1,618

Accretion amounts will not be reflected as expense on the Company's Statements of Operations, but rather deferred as a regulatory asset and netted against the Company's regulatory liabilities, for presentation purposes, on the Balance Sheet.

## 7. INCOME TAXES

A reconciliation of the U.S. federal statutory rate of 35 percent to the Company's effective rate from operations for the fiscal years ended September 30, 2006 and 2005 is as follows:

<i>(Thousands)</i>	2006	2005
Statutory income tax expense	<b>\$26,257</b>	\$30,191
Change resulting from		
State income taxes	<b>4,485</b>	5,184
Depreciation and cost of removal	<b>(1,674)</b>	(1,641)
Investment tax credits	<b>(322)</b>	(322)
Other	<b>(595)</b>	(529)
Income tax provision	<b>\$28,151</b>	\$32,883
Effective income tax rate	<b>37.5%</b>	38.1%

The Income tax provision (benefit) from operations consists of the following:

<i>(Thousands)</i>	2006	2005
Current		
Federal	<b>\$26,048</b>	\$31,917
State	<b>8,220</b>	10,584
Deferred		
Federal	<b>(4,475)</b>	(6,687)
State	<b>(1,320)</b>	(2,609)
Investment tax credits	<b>(322)</b>	(322)
Income tax provision	<b>\$28,151</b>	\$32,883

The temporary differences, which give rise to deferred tax assets and liabilities, consist of the following:

<i>(Thousands)</i>	September 30, 2006	2005
Current		
Underrecovered gas costs	<b>\$ (702)</b>	\$15,135
WNC	<b>3,330</b>	(876)
Conservation program	<b>4,112</b>	(3,338)
Other	<b>(1,772)</b>	(1,937)
Current deferred tax liability, net	<b>\$4,968</b>	\$ 8,984
Non-current		
Property-related items	<b>\$128,536</b>	\$131,101
Customer contributions	<b>(1,421)</b>	(2,304)
Capitalized overhead and interest	<b>(2,677)</b>	936
Unamortized investment tax credits	<b>(4,219)</b>	(4,392)
Remediation costs	<b>30,919</b>	32,434
Other	<b>15,606</b>	(7,692)
Total noncurrent deferred tax liability, net	<b>\$166,744</b>	\$150,083
Total deferred tax liabilities, net	<b>\$171,712</b>	\$159,067

## **8. EMPLOYEE BENEFIT PLANS**

### *Pension and Other Postemployment Benefit Plans (OPEB)*

The Company has two trustee, non-contributory defined benefit retirement plans covering regular represented and non-represented employees with more than one year of service.

Defined Benefit Plan benefits are based on years of service and average compensation during the highest 60 consecutive months of employment.

The Company provides postemployment medical and life insurance benefits to employees who meet the eligibility requirements.

The Company's funding policy for its pension plans is to contribute at least the minimum amount required by the Employment Retirement Income Security Act of 1974, as amended. In fiscal 2006 and 2005, the Company had no minimum funding requirements; however, the Company made discretionary contributions of \$7.9 million and \$8.4 million in fiscal 2006 and 2005, respectively, to the pension plans. The Company elected to make these discretionary tax-deductible contributions to improve the funded status of the pension plans. The Company currently has no plans to fund the pension plans over the next five years.

The Company made tax-deductible contributions of \$3.4 million in fiscal 2006 and \$638 thousand in fiscal 2005 to the OPEB plans. It is anticipated that the Company's funding level to the OPEB plans will be approximately \$600,000 annually over the next five years.



A reconciliation of the funded status of the plans to the amounts recognized on the Balance Sheets is presented below, using a measurement date of September 30 is as follows:

(Thousands)	Pension		OPEB	
	2006	2005	2006	2005
<b>Change in Benefit Obligation</b>				
Benefit Obligation at beginning of year	\$78,475	\$ 70,681	\$ 34,002	\$ 28,812
Service cost	2,030	1,783	1,036	885
Interest cost	4,413	4,155	1,915	1,695
Plan participants contributions	46	50		
Actuarial (gain) loss	(1,451)	5,304	3,257	3,887
Special termination benefits				18
Benefits paid	(3,538)	(3,498)	(1,293)	(1,295)
<b>Benefit obligation at end of year</b>	<b>\$79,975</b>	<b>\$ 78,475</b>	<b>\$ 38,917</b>	<b>\$ 34,002</b>
<b>Change in plan assets</b>				
Fair value of plan assets at beginning of year	\$63,851	\$ 51,949	\$ 20,707	\$ 19,106
Actual return on plan assets	5,626	6,980	1,965	2,258
Employer contributions	7,862	8,370	3,455	638
Plan participants contributions	46	50		
Benefits paid	(3,538)	(3,498)	(1,293)	(1,295)
Other			997	
<b>Fair value of plan assets at end of year</b>	<b>\$73,847</b>	<b>\$ 63,851</b>	<b>\$ 25,831</b>	<b>\$ 20,707</b>
<b>Funded status</b>	<b>\$ (6,128)</b>	<b>\$ (14,624)</b>	<b>\$ (13,086)</b>	<b>\$ (13,295)</b>
Unrecognized actuarial loss	24,338	27,496	16,300	14,761
Unrecognized transition obligation			2,014	2,300
Unrecognized prior service cost	373	429	380	449
Unrecognized net initial obligation		(9)		
<b>Net amount recognized</b>	<b>\$18,583</b>	<b>\$ 13,292</b>	<b>\$ 5,608</b>	<b>\$ 4,215</b>
<b>Amounts recognized on Balance Sheets</b>				
<b>Accrued benefit liability included in:</b>				
Prepaid pension asset	\$18,583	\$	\$	\$
Accounts payable and other	—		(90)	(613)
Postemployment employee benefit liability	—	(3,633)	5,698	4,828
Intangible asset	—	542		
Accumulated other comprehensive income	—	16,383		
<b>Net amount recognized</b>	<b>\$18,583</b>	<b>\$ 13,292</b>	<b>\$ 5,608</b>	<b>\$ 4,215</b>

The accumulated benefit obligation (ABO) of the pension plans at September 30, 2006 and 2005 was \$71.1 million and \$68.8 million, respectively.

Pursuant to SFAS No. 87, Employers Accounting for Pension (SFAS 87), the Company was required to record a \$328,000 reduction to its minimum pension liability in fiscal 2005, which is included in Postemployment employee benefit liability on the Balance Sheets.

The expected long-term rate of return is based on the asset categories in which the Company invests and the current expectations and historical performance for these categories.

The mix and targeted allocation of the pension and OPEB plans assets are as follows:

Asset Allocation	2007 Target Allocation	Assets at Sept. 30,	
		2006	2005
U.S. equity securities	53%	53%	53%
International equity securities	18	18	19
Fixed income	29	29	28
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid during the following fiscal years:

<i>(Thousands)</i>	<b>Pension</b>	<b>OPEB</b>
2007	\$ 3,983	\$ 1,694
2008	\$ 4,186	\$ 1,834
2009	\$ 4,286	\$ 1,902
2010	\$ 4,538	\$ 1,972
2011-2015	\$25,510	\$11,308

In fiscal 2004, the Company adopted FASB Staff Position *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003* (the Act) (FSP 106-2). The estimated subsidy payments from the Act are:

<b>Fiscal Year</b>	<b>Estimated Subsidy Payment (thousands)</b>
2007	\$ 100
2008	100
2009	100
2010	200
2011	200
2012-2016	\$1,100

#### *Pension Equalization Plan*

The Company is included in NJR's unfunded nonqualified pension equalization plan (PEP) that was established to provide employees with the full level of benefits as stated in the qualified plan without reductions due to various limitations imposed by the provisions of federal income tax laws and regulations. There were no plan assets in the nonqualified plan due to the nature of the plan. The Company recorded a \$0 and \$928,000 net periodic PEP cost in fiscal 2006 and 2005, respectively. The PEP's weighted averaged assumptions are identical to the qualified pension plan assumptions.

The PBO and ABO for the Company's nonfunded PEP were \$2.0 million and \$1.9 million respectively, as of September 30, 2006, and \$2.1 million and \$1.9 million, respectively, as of September 30, 2005.

#### *Voluntary Early Retirement Program*

In September 2004, the Company offered a voluntary early retirement program to officers of the Company. The early retirement program resulted in \$1.5 million being charged to Operations and maintenance expense in fiscal 2005.

#### *Defined Contribution Plan*

The Company participates in NJR's Employees' Retirement Savings Plan (Savings Plan) to eligible employees. The Company matches 50 percent of participants' contributions up to 6 percent of base compensation.

The amount expensed and contributed for the matching provision of the Savings Plan was \$697,000 and \$702,000 in fiscal 2006 and fiscal 2005, respectively.

## **9. COMMITMENTS AND CONTINGENT LIABILITIES**

#### *Cash Commitments*

The Company has entered into long-term contracts, expiring at various dates through 2022, for the supply, storage and delivery of natural gas. These contracts include current annual fixed charges of approximately \$102.5 million at current contract rates and volumes, which are recovered through the BGSS.

The Company's capital expenditures are estimated at \$66 million and \$63 million in fiscal 2007 and 2008, respectively, and consist primarily of its construction program to support customer growth, maintenance of its distribution system and replacement needed under proposed pipeline safety rulemaking.

The Company's future minimum lease payments under various operating leases are less than \$3.7 million annually for the next five years and \$680,000 in the aggregate for all years thereafter.

#### *Manufactured Gas Plant Remediation*

The Company has identified 11 former MGP sites, dating back to the late 1800s and early 1900s, which contain contaminated residues from the former gas manufacturing operations. Ten of the 11 sites in question were acquired by the Company in 1952. Gas manufacturing operations ceased at these sites at least by the mid-1950s and, in some cases, had been discontinued many years earlier. All of the former gas manufacturing facilities were subsequently dismantled by the Company or the previous owners. Since October 1989, the Company has been operating under Administrative Consent Orders or Memoranda of Agreement with the New Jersey Department of Environmental Protection (NJDEP) covering all 11 sites. These orders and agreements establish the procedures to be followed in developing a final remedial cleanup plan for each site. The Company is currently involved in administrative proceedings with the NJDEP with respect to the MGP sites in question, as well as participating in various studies and investigations by outside consultants to determine the nature and extent of any such contaminated residues and to develop appropriate programs of remedial action, where warranted. Until September 2000, most of the cost of such studies and investigations had been shared under an agreement with the former owner and operator of 10 of the MGP sites, Jersey Central Power & Light Company (JCP&L), a subsidiary of FirstEnergy Corporation (FirstEnergy).

In September 2000, a revised agreement was executed pursuant to which the Company is responsible for two of the sites, while JCP&L is responsible for the remaining eight sites. Also in September 2000, the Company purchased a 20-year cost-containment insurance policy and an Environmental Response Compensation and Liability Insurance Policy (ERCLIP) for the two sites (see *Kemper Insurance Company Litigation* below). On September 14, 2004, the BPU approved a simultaneous transfer of properties whereby the Company would take ownership of two sites. The Company continues to participate in the investigation and remedial action and bears the cost related to the one MGP site that was not subject to the original cost-sharing agreement.

In June 1992, the BPU approved a remediation rider through which the Company may, subject to BPU approval, recover its remediation expenditures, including carrying costs, over rolling 7-year periods. The BPU reviews the remediation recovery each year when the Company files its annual report of expenditures. On April 12, 2006, the BPU approved a stipulation related to the Company's 2004 filing, that maintained the existing recovery rate of approximately \$19.2 million annually that recognizes remediation expenditures through June 2004. Currently, two SBC annual filings are pending BPU approval. On September 30, 2005, the Company filed updated information regarding expenditures to SBC programs and activities, including MGP expenditures through June 30, 2005. While the SBC filing maintained the same overall rate, the filing proposed to reduce the portion related to the remediation rider recovery to \$11.6 million of annual expenditures to reflect actual spending levels. In the subsequent annual filing in October 2006, the Company filed to supersede its prior request, seeking a decrease to the existing remediation rider recovery from \$19.2 million, annually, to \$15.9 million, annually. As of September 30, 2006, \$83.7 million of previously incurred remediation costs, net of recoveries from customers as well as received and anticipated insurance proceeds, are included in Regulatory assets on the Balance Sheet. See *Note 4. Regulatory Assets and Liabilities*.

In March 1995, the Company instituted an action for declaratory relief against 24 separate insurance companies in the Superior Court of New Jersey. These insurance carriers provided comprehensive general liability coverage to the Company from 1951 through 1985. In July 1996, the complaint was amended to name Kaiser-Nelson Steel and Salvage Company (Kaiser-Nelson) and its successors for environmental damages caused by Kaiser-Nelson's decommissioning of structures at several MGP sites. In September 2001, the Company reached a favorable settlement with the insurance carrier that provided the majority of the Company's coverage. This settlement involved a significant cash payment to the Company, which was credited to the remediation rider, and was received in four installments ending October 2004. In January 2006, the Company reached a settlement of all claims with Kaiser-Nelson, which included a cash payment that was received by the Company and credited to the remediation rider. Consequently, the Company has now dismissed or reached a settlement with all of its insurance carriers who provided comprehensive general liability coverage to the Company in connection with the MGP sites.

The Company is presently investigating the potential settlement of alleged Natural Resource Damage (NRD) claims that might be brought by the NJDEP concerning three MGP sites. NJDEP has not made any specific demands for compensation for alleged injury to groundwater or other natural resources. The Company's evaluation of these potential claims is in the early stages, and it is not yet possible to quantify the amount of compensation that NJDEP might seek to recover. The Company anticipates any costs associated with this matter would be recoverable through the remediation rider.

The Company is involved with environmental investigations and remedial actions at certain MGP sites. In September 2006, with the assistance of an outside consulting firm, the Company updated an environmental review of the MGP sites, including a review of potential liability for investigation and remedial action. Based on this review, the Company estimated at the time of the review that, exclusive of any insurance recoveries, total future expenditures to remediate and monitor the three MGP sites for which it is responsible, will range from \$105.4 million to \$174.6 million. The Company's estimate of these liabilities is based upon known facts, existing technology and enacted laws and regulations in place when the review was completed. However, actual costs are expected to differ from these estimates. Where available information is sufficient to estimate the amount of the liability, it is the Company's policy to accrue the full amount of such estimate. Where the information is sufficient only to establish a range of probable liability, and no point within the range is more likely than any other, it is the Company's policy to accrue the lower end of the range. Accordingly, the Company has recorded an MGP remediation liability and a corresponding Regulatory asset of \$105.4 million on the Balance Sheet. The actual costs to be incurred by the Company are dependent upon several factors, including final determination of remedial action, changing technologies and governmental regulations, the ultimate ability of other responsible parties to pay and any insurance recoveries. The Company will continue to seek recovery of such costs through its remediation rider. If any future regulatory position indicates that the recovery of such costs is not probable, the related cost would be charged to income in the period of such determination.

#### *Long Branch MGP Site Litigation*

Since July 2003, a series of complaints were filed in the New Jersey Superior Court against the Company, NJR, JCP&L and FirstEnergy. The complaints were originally filed in Monmouth County and, as of February 2004, were designated as a Mass Tort Litigation (the Mass Tort Litigation) for centralized case management purposes and transferred to the Bergen County Law Division. There were originally 528 complaints filed. All 528 complaints have been dismissed or settled.

Among other things, the complaints alleged personal injuries, wrongful death, survivorship actions, property damage and claims for medical monitoring stemming from the operation and remediation of the former MGP site in Long Branch, New Jersey. The relief sought included compensatory damages, the establishment of a medical monitoring fund, disgorgement of alleged profits, cost of cleanup and remediation, natural resource damages and punitive damages.

In December 2005, a confidential settlement between the Company and the plaintiffs was finalized and approved by the New Jersey Superior Court in Bergen County.

JCP&L and FirstEnergy made a demand upon the Company and NJR for indemnification pursuant to the September 2000 agreement between these entities and the Company, whereby the Company assumed responsibility for the Long Branch site. The Company has agreed to honor the indemnification terms of the agreement.

The Company's insurance carriers were initially notified of the claims, and Kemper Insurance Company (Kemper), under the ERCLIP, initially agreed to provide a defense and certain coverage, subject to a reservation of rights regarding various allegations in the complaints, typically not covered by insurance. However, as Kemper's defense and insurance obligations were not met, the Company initiated litigation against Kemper (see *Kemper Insurance Company Litigation* below).

Management believes that litigation costs and the settlement amount are recoverable through insurance (subject to the outcome of the Kemper Insurance Company Litigation). Additionally, management believes that any liabilities not recoverable through insurance, except for punitive and personal injury damages, would be recoverable, with BPU approval, through the remediation rider. However, there can be no assurance as to the ultimate resolution of the recovery of these amounts or the impact on the Company's financial condition, results of operations or cash flows.

Twelve *pro se* matters have been filed against the Company and NJR since February 26, 2005. These complaints were filed in the Superior Court of New Jersey Law Division, Bergen County and allege the same claims made in the Mass Tort Litigation. Five of these actions have since been dismissed by the court. The Company and NJR believe that the allegations in the complaints have no merit and are vigorously defending against them.

The amount of total liability, resulting from the *pro se* matters described in the preceding paragraph if any, and any related insurance recovery cannot be determined at this time; however, based on information and relevant circumstances known at this time, management does not believe these suits will have a material adverse effect on the Company's financial condition, results of operations or cash flows.

#### *Kemper Insurance Company Litigation*

In October 2004, the Company instituted suit for declaratory relief against Kemper in the Superior Court of New Jersey, Law Division, Ocean County. The case is under active case management. Kemper provided insurance under an ERCLIP together with a cost containment coverage policy effective July 21, 2000. Prior to the institution of this suit, the Company requested that Kemper defend and indemnify claims involving the Mass Tort Long Branch litigation (see *Long Branch Litigation*, above) and reimburse the Company for remediation costs for the Long Branch site that exceed the self-insured retention. Kemper reserved its rights regarding various allegations in the Mass Tort Litigation and agreed to participate in the defense of that matter. Although Kemper has not denied coverage, it has not yet reimbursed the Company for any costs incurred to date. In fiscal 2003, Kemper ceased its underwriting operations and voluntarily commenced a runoff of its business. The Illinois Department of Insurance has approved Kemper's runoff plan. Management believes that, with the exception of any liability for punitive and personal injury damages, any costs associated with Kemper's failure to meet its future obligations will be recoverable, with BPU approval, through the remediation rider.

There can be no assurance as to the ultimate resolution of this matter or the impact on the Company's financial condition, results of operations or cash flows.

#### *Various*

The Company is a party to various other claims, legal actions, complaints and investigations arising in the ordinary course of business. In the Company's opinion, the ultimate disposition of these matters will not have a material adverse effect on its financial condition, results of operations or cash flows.

## **10. RELATED PARTY TRANSACTIONS**

The Company participates in various transactions with NJR and other subsidiaries of NJR in the ordinary course of business. These transactions result in either charges or credits to Operation and maintenance expense in the Statements of Income.

The following table summarizes charges from NJR and NJR Service Corporation (NJRSC) during fiscal 2006 and 2005. Charges from NJR were for various services, including executive management and corporate governance. Charges from NJRSC were primarily related to financial and administrative, legal, human resources, corporate communications, taxation, internal audit and technology services.

<i>(Thousands)</i>	<b>2006</b>	2005
NJRSC	<b>\$15,700</b>	\$14,100
NJR	<b>6,700</b>	5,700
Total	<b>\$22,400</b>	\$19,800

The following table summarizes charges from the Company to NJR Home Services (NJRHS), NJR Energy Services (NJRES) and Commercial Realty and Resources (CR&R) during fiscal 2006 and 2005. Charges to NJRHS were for services related to billing, customer inquiry, payment processing and vehicle fleet maintenance. Charges to NJRES were for administrative services. Charges to CR&R were for base rent and operating expenses.

<i>(Thousands)</i>	<b>2006</b>	2005
NJRHS	<b>\$1,600</b>	\$1,500
NJRES	<b>798</b>	1,300
CR&R	<b>948</b>	983
Total	<b>\$3,346</b>	\$3,783

The following table reflects the receivable (payable) the Company had with NJR and other subsidiaries of NJR at September 30, 2006 and 2005, which are included on the balance sheets:

<i>(Thousands)</i>	<b>2006</b>	2005
NJR	<b>\$1,339</b>	(630)
NJRES	<b>(44)</b>	257
NJRHS	<b>(657)</b>	408
CR&R	<b>23</b>	(7)
NJRSC	<b>(1,732)</b>	(1,143)
Total	<b>\$(1,071)</b>	\$(1,115)