

**Connecticut Natural Gas Corporation**  
**Financial Statements**  
**For the Years Ended December 31, 2006 and 2005**

**Connecticut Natural Gas Corporation**

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**Report of Independent Auditors**

To the Shareholder and Board of Directors  
of Connecticut Natural Gas Corporation:

In our opinion, the accompanying balance sheets and the related statements of income, of cash flows and of changes in common stock equity present fairly, in all material respects, the financial position of Connecticut Natural Gas Corporation at December 31, 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. 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 of these statements in accordance with 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. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 1 to the financial statements, effective December 31, 2006, the Company adopted Statement of Financial Accounting Standards No. 158 *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*.



PricewaterhouseCoopers LLP  
February 28, 2007

**Connecticut Natural Gas Corporation  
Statements of Income**

<b>Year Ended December 31,</b>	<b>2006</b>	<b>2005</b>
<b>(Thousands, except per share amounts)</b>		
<b>Operating Revenues</b>		
Sales and services	<b>\$400,709</b>	\$418,142
<b>Operating Expenses</b>		
Natural gas purchased	<b>268,510</b>	275,913
Other operating expenses	<b>52,684</b>	51,264
Maintenance	<b>4,742</b>	5,065
Depreciation and amortization	<b>22,994</b>	23,788
Other taxes	<b>23,736</b>	24,238
<b>Total Operating Expenses</b>	<b>372,666</b>	380,268
<b>Operating Income</b>	<b>28,043</b>	37,874
<b>Other (Income)</b>	<b>(4,720)</b>	(1,575)
<b>Other Deductions</b>	<b>648</b>	934
<b>Interest Charges, Net</b>	<b>12,034</b>	10,727
<b>Income Before Income Taxes</b>	<b>20,081</b>	27,788
<b>Income Taxes</b>	<b>7,481</b>	10,716
<b>Net Income</b>	<b>12,600</b>	17,072
<b>Preferred Stock Dividends</b>	<b>52</b>	52
<b>Earnings Available for Common Stock</b>	<b>\$12,548</b>	\$17,020

The [notes](#) on pages 7 through 23 are an integral part of our financial statements.

**Connecticut Natural Gas Corporation  
Balance Sheets**

<b>December 31,</b>	<b>2006</b>	<b>2005</b>
(Thousands)		
<b>Assets</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$8,328	\$1,719
Accounts receivable and unbilled revenues, net	68,807	92,882
Affiliated account receivable	3,552	3,276
Natural gas in storage, at average cost	74,031	69,073
Materials and supplies, at average cost	675	705
Deferred income taxes	7,825	11,933
Prepayments and other current assets	6,237	3,899
<b>Total Current Assets</b>	<b>169,455</b>	<b>183,487</b>
<b>Utility Plant, at Original Cost</b>		
Natural gas	588,233	569,339
Less accumulated depreciation	184,057	190,685
<b>Net Utility Plant in Service</b>	<b>404,176</b>	<b>378,654</b>
Construction work in progress	122	104
<b>Total Utility Plant</b>	<b>404,298</b>	<b>378,758</b>
<b>Other Property and Investments, Net</b>	<b>15,146</b>	<b>14,794</b>
<b>Regulatory and Other Assets</b>		
Regulatory assets		
Deferred income taxes	13,508	11,210
Deferred purchase gas costs	10,396	33,469
Pension and other postretirement benefits	51,460	-
Other	26,895	23,222
Total regulatory assets	102,259	67,901
Other assets		
Goodwill, net	218,630	218,630
Prepaid pension benefits	-	36,917
Other	11,756	11,706
Total other assets	230,386	267,253
<b>Total Regulatory and Other Assets</b>	<b>332,645</b>	<b>335,154</b>
<b>Total Assets</b>	<b>\$921,544</b>	<b>\$912,193</b>

The [notes](#) on pages 7 through 23 are an integral part of our financial statements

**Connecticut Natural Gas Corporation  
Balance Sheets**

December 31,	2006	2005
(Thousands)		
<b>Liabilities</b>		
<b>Current Liabilities</b>		
Current portion of long-term debt	\$19,000	-
Notes payable	20,000	\$41,000
Accounts payable and accrued liabilities	7,397	7,198
Account payable, purchased gas	44,039	65,471
Accounts payable to affiliates	3,505	2,856
Interest accrued	3,458	3,293
Taxes accrued	10,129	4,788
Other	7,797	3,090
<b>Total Current Liabilities</b>	<b>115,325</b>	<b>127,696</b>
<b>Regulatory and Other Liabilities</b>		
Regulatory liabilities		
Pension and other postretirement benefits	18,685	-
Accrued removal obligation	95,919	70,866
Unfunded future income taxes	-	2,342
Other	15,028	15,185
Total regulatory liabilities	129,632	88,393
Other liabilities		
Deferred income taxes	83,052	69,517
Pension and other postretirement benefits	41,835	75,081
Asset retirement obligation	7,083	6,855
Other	16,727	21,697
Total other liabilities	148,697	173,150
<b>Total Regulatory and Other Liabilities</b>	<b>278,329</b>	<b>261,543</b>
Other long-term debt	130,000	149,000
<b>Total Liabilities</b>	<b>523,654</b>	<b>538,239</b>
<b>Commitments and Contingencies</b>		
<b>Preferred Stock</b>		
Preferred stock	750	750
<b>Common Stock Equity</b>		
Common stock (\$3.125 par value, 20,000,000 shares, authorized, 10,634,436 shares outstanding for 2005 and 2006)	33,233	33,233
Capital in excess of par value	335,286	335,101
Retained earnings	29,387	25,839
Accumulated other comprehensive (loss)	(766)	(20,969)
<b>Total Common Stock Equity</b>	<b>397,140</b>	<b>373,204</b>
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$921,544</b>	<b>\$912,193</b>

The notes on pages 7 through 23 are an integral part of our financial statements.

**Connecticut Natural Gas Corporation**  
**Statements of Cash Flows**

Year Ended December 31,	2006	2005
<b>(Thousands)</b>		
<b>Operating Activities</b>		
Net income	\$12,600	\$17,072
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	19,550	20,467
Deferred income taxes and investment tax credits, net	(1,150)	5,475
Pension expense	4,443	4,104
Changes in current operating assets and liabilities		
Accounts receivable and unbilled revenues, net	23,799	(19,339)
Inventory	(4,928)	(17,302)
Prepayments and other current assets	(1,713)	(33)
Accounts payable and accrued liabilities	(21,805)	11,845
Interest accrued	165	553
Taxes accrued	5,341	(746)
Other current liabilities	4,603	(882)
Pension contributions	-	(15,000)
Other assets	15,354	(16,211)
Other liabilities	1,992	1,503
<b>Net Cash Provided by (Used in) Operating Activities</b>	<b>58,251</b>	<b>(8,494)</b>
<b>Investing Activities</b>		
Utility plant additions	(23,105)	(20,684)
Investments	294	668
<b>Net Cash Used in Investing Activities</b>	<b>(22,811)</b>	<b>(20,016)</b>
<b>Financing Activities</b>		
Equity contribution	-	10,000
Long-term note issuances	-	45,000
Notes payable	(21,000)	(18,000)
Book overdraft	1,221	-
Dividends on common and preferred stock	(9,052)	(12,052)
<b>Net Cash (Used in) Provided by Financing Activities</b>	<b>(28,831)</b>	<b>24,948</b>
<b>Net Increase (Decrease) in Cash and Cash Equivalents</b>	<b>6,609</b>	<b>(3,562)</b>
<b>Cash and Cash Equivalents, Beginning of Year</b>	<b>1,719</b>	<b>5,281</b>
<b>Cash and Cash Equivalents, End of Year</b>	<b>\$8,328</b>	<b>\$1,719</b>

The [notes](#) on pages 7 through 23 are an integral part of our financial statements.

**Connecticut Natural Gas Corporation**  
**Statements of Changes in Common Stock Equity**

(Thousands, except per share amounts)	Common Stock Outstanding \$3.125 Par Value		Capital in Excess of Par Value	Retained Earnings	Accumulated Other Comprehensive (Loss)	Total
	Shares	Amount				
<b>Balance, January 1, 2005</b>	10,634,436	\$33,233	\$324,928	\$20,819	\$(15,893)	\$363,087
Net income				17,072		17,072
Other comprehensive (loss), net of tax					(5,076)	(5,076)
Comprehensive income						11,996
Dividends - common stock				(12,000)		(12,000)
Dividends - preferred stock				(52)		(52)
Equity contributions from parent			10,173			10,173
<b>Balance, December 31, 2005</b>	10,634,436	33,233	335,101	25,839	(20,969)	373,204
Net income				12,600		12,600
Other comprehensive income, net of tax					11,755	11,755
Comprehensive income						24,355
Adjustment to initially apply Statement 158					8,448	8,448
Dividends - common stock				(9,000)		(9,000)
Dividends - preferred stock				(52)		(52)
Equity contributions from parent			185			185
<b>Balance, December 31, 2006</b>	10,634,436	\$33,233	\$335,286	\$29,387	\$(766)	\$397,140

The [notes](#) on pages 7 through 23 are an integral part of our financial statements.

## Notes to Financial Statements

### Connecticut Natural Gas Corporation

#### Note 1. Significant Accounting Policies

**Background:** Connecticut Natural Gas Corporation (CNG) is primarily engaged in the transportation and distribution of natural gas in Connecticut. CNG is the principal operating utility of CTG Resources, Inc., which is a wholly-owned subsidiary of Energy East Corporation (Energy East).

**Accounts receivable:** Accounts receivable include unbilled revenues of \$23 million at December 31, 2006, and \$34 million at December 31, 2005, and are shown net of an allowance for doubtful accounts of \$9 million at December 31, 2006, and \$10 million at December 31, 2005. Accounts receivable do not bear interest, although late fees may be assessed. Bad debt expense was \$13 million in 2006 and \$14 million in 2005.

Unbilled revenues represent estimates of receivables for energy provided but not yet billed. The estimates are determined based on various assumptions, such as current month energy load requirements, billing rates by customer classification and delivery loss factors. Changes in those assumptions could significantly affect the estimates of unbilled revenues.

The allowance for doubtful accounts is our best estimate of the amount of probable credit losses in our existing accounts receivable, determined based on experience for each service region and operating segment and other economic data. Each month we review our allowance for doubtful accounts and past due accounts over 90 days and/or above a specified amount, and review all other balances on a pooled basis by age and type of receivable. When we believe that a receivable will not be recovered, we charge off the account balance against the allowance. Changes in assumptions about input factors such as economic conditions and customer receivables, which are inherently uncertain and susceptible to change from period to period, could significantly affect the allowance for doubtful accounts estimates.

**Asset retirement obligation and FIN 47:** In accordance with Financial Accounting Standards Board (FASB) Statement 143, Accounting for Asset Retirement Obligations, and FASB Interpretation Number (FIN) 47, Accounting for Conditional Asset Retirement Obligations, we record the fair value of the liability for an asset retirement obligation and/or a conditional asset retirement obligation in the period in which it is incurred and capitalize the cost by increasing the carrying amount of the related long-lived asset. We adjust the liability to its present value periodically over time, and depreciate the capitalized cost over the useful life of the related asset. Upon settlement we will either settle the obligation at its recorded amount or incur a gain or a loss. We defer any timing differences between rate recovery and depreciation expense as either a regulatory asset or a regulatory liability.

FIN 47 clarifies that the term "conditional asset retirement obligation" as used in Statement 143 refers to an entity's "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 entity." FIN 47 requires that if an entity has sufficient information to reasonably estimate the fair value of the liability for a conditional asset retirement obligation, it must recognize that liability at the time the liability is incurred. We began applying FIN 47 effective December 31, 2005. Our application of FIN 47 did not have a material effect on our financial position, and there was no effect on our results of operations or cash flows.

## Notes to Financial Statements

### Connecticut Natural Gas Corporation

Our asset retirement obligation (ARO) including our estimated conditional asset retirement obligation at December 31 was \$7 million for 2006 and 2005. The ARO primarily consists of obligations related to removal or retirement of: asbestos, polychlorinated biphenyl (PCB) contaminated equipment, gas pipeline and cast iron gas mains.

**Statements of cash flows:** We consider all highly liquid investments with a maturity date of three months or less when acquired to be cash equivalents and those investments are included in cash and cash equivalents.

<b>Supplemental Disclosure of Cash Flows Information</b>	<b>2006</b>	<b>2005</b>
(Thousands)		
Cash paid during the year ended December 31:		
Interest, net of amounts capitalized	\$11,086	\$9,943
Income taxes, net of benefits received	\$ 1,224	\$7,862

The Company's book overdrafts are treated as a current liability by including them in accounts payable on the balance sheet.

**Depreciation and amortization:** We determine depreciation expense substantially using the straight-line method, based on the average service lives of groups of depreciable property, which include estimated cost of removal, in service at the company. The weighted-average service lives of certain classifications of property are: production - 29 years, storage - 32 years, distribution property - 49 years, and other property - 9 years. Our depreciation accruals were equivalent to 4.1% of average depreciable property for 2006 and 2005.

We charge repairs and minor replacements to operating expense, and capitalize renewals and betterments, including certain indirect costs. We charge the original cost of utility plant retired or otherwise disposed of to accumulated depreciation.

**Estimates:** Preparation of the financial statements in conformity with accounting principles generally accepted in the United States of America 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 revenues and expenses during the reporting period. Actual results could differ from those estimates.

## Notes to Financial Statements

### Connecticut Natural Gas Corporation

**FIN 48:** In July 2006 the FASB released FIN 48, Accounting for Uncertainty in Income Taxes, which clarifies uncertainty in income taxes recognized in financial statements in accordance with Statement 109, Accounting for Income Taxes, by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or to be taken in a tax return. The evaluation of a tax position is a two-step process. The first step is for an entity to determine if it is more likely than not that a tax position will be sustained upon examination. The second step involves measuring the amount of tax benefit to be recognized in the financial statements based on the largest amount of benefit that meets the prescribed recognition threshold. The difference between the amounts based on that position and the position taken in a tax return is generally recorded as a liability. FIN 48 is effective for fiscal years beginning after December 15, 2006. Upon adoption of FIN 48, the cumulative effect of applying the provisions of FIN 48 must be reported as an adjustment to the opening balance of retained earnings for that fiscal year. We are required to adopt FIN 48 on January 1, 2007. While we are still in the process of measuring the effect of the adoption, we estimate that the adoption will not have a material effect on our results of operations or financial position.

**Goodwill:** We recorded the excess of the cost over fair value of net assets of purchased businesses as goodwill. We evaluate the carrying value of goodwill for impairment at least annually and on an interim basis if there are indications that goodwill might be impaired. We recognize impairment if the fair value of goodwill is less than its carrying value. (See Note 2.)

#### **Other (Income) and Other Deductions:**

<b>Year Ended December 31,</b>	<b>2006</b>	<b>2005</b>
<b>(Thousands)</b>		
Interest and dividend income	<b>\$(353)</b>	\$(247)
BP Optimization	<b>(253)</b>	(903)
Gains from settlement of derivative contracts	<b>(3,483)</b>	-
Allowance for funds used during construction	-	(24)
Miscellaneous	<b>(631)</b>	(401)
<b>Total other (income)</b>	<b>\$(4,720)</b>	\$(1,575)
Donations, civic and political	<b>\$147</b>	\$160
BP Optimization	<b>82</b>	142
Miscellaneous	<b>419</b>	632
<b>Total other deductions</b>	<b>\$648</b>	\$934

## Notes to Financial Statements

### Connecticut Natural Gas Corporation

**Regulatory assets and liabilities:** Pursuant to Statement 71, Accounting for the Effects of Certain Types of Regulation, we capitalize, as regulatory assets, incurred and accrued costs that are probable of recovery in natural gas rates. Substantially all regulatory assets for which funds have been expended are either included in rate base or are accruing carrying costs. We also record, as regulatory liabilities, obligations to refund previously collected revenue or to spend revenue collected from customers on future costs.

Unfunded future income taxes and deferred income taxes are amortized as the related temporary differences reverse. Unamortized loss on debt reacquisitions is amortized over the lives of the related debt issues. Other regulatory assets and other regulatory liabilities are amortized over various periods in accordance with each operating utility's current rate plans.

At December 31, 2006 and 2005, our other regulatory assets and liabilities consisted of:

<b>(thousands)</b>	<b>2006</b>	<b>2005</b>
<b>Other regulatory assets</b>		
Postretirement cost	\$11,752	\$12,724
Low-income program	10,277	7,397
Other	4,866	3,101
<b>Total other regulatory assets</b>	<b>\$26,895</b>	<b>\$23,222</b>
<b>Other regulatory liabilities</b>		
Deferred natural gas cost	\$7,975	\$8,851
Optimization sharing	2,510	2,598
Asset retirement obligation	4,197	2,578
Other	346	1,158
<b>Total other regulatory liabilities</b>	<b>\$15,028</b>	<b>\$15,185</b>

**Related party transactions:** Utility Shared Services Corporation and Energy East Management Corporation provide various administrative and management services to Energy East's operating utilities, including CNG, pursuant to service agreements. The cost of those services is allocated in accordance with methodologies set forth in the service agreements. The cost allocation methodologies vary depending on the type of service provided. The cost for services provided to CNG by Utility Shared Services Corporation and Energy East Management Corporation was approximately \$9 million in 2006 and \$8 million in 2005.

**Revenue recognition:** We recognize revenues upon delivery of gas and gas-related products and services to our customers. Regulated gas operations revenues are based on rates authorized by the DPUC. We are required to provide natural gas service to residential customers within our defined service territory and are precluded by Connecticut state law from discontinued service to hardship residential customers during a winter moratorium period (November – April).

## Notes to Financial Statements

### Connecticut Natural Gas Corporation

**Risk management:** The financial instruments we hold or issue are not for trading or speculative purposes.

We have a purchased gas adjustment clause that allows us to recover through rates any changes in the market price of purchased natural gas, substantially eliminating our exposure to natural gas price risk.

To provide financial protection from declining natural gas sales revenues due to warmer than normal winter temperatures, CNG entered into a weather derivative contract for the winter period November 1, 2006 through April 30, 2007. The structure of the derivative contract allows for CNG to receive and /or make payments in May 2007 based on the actual Heating Degree Day variance from the purchased put option strike level and/or the written call option strike level. If the actual Heating Degree Days for the November 1, 2006 through April 30, 2007 time period are less than the put option strike level (i.e. warmer than normal temperatures), CNG will receive payment. If the actual Heating Degree Days for the November 1, 2006 through April 30, 2007 time period are more than the call option strike level (i.e. colder than normal temperatures), CNG will make payment. CNG received a payment of \$820 thousand in April 2006 pertaining to the settlement of a weather derivative contract for the November 2005 through March 2006 period. The cost of the weather derivative contract (option premium) is \$335 thousand and is recorded as a derivative asset and amortized as Other Deductions over the November 2006 through April 2007 period. The value of the derivative is carried as a derivative asset on the financial books of record with changes in the value of the derivative asset recorded to the income statement as Other Income/Other Deductions. As of December 31, 2006 the total value of the derivative asset was \$2.8 million.

**Statement 157:** In September 2006 the FASB issued Statement 157, Fair Value Measurements. Changes from current practice that will result from the application of Statement 157 relate to the definition of fair value, the methods used to measure fair value, and expanded disclosures about fair value measurements. FAS 157 applies under other accounting pronouncements that require or permit fair value measurements in which the FASB previously concluded that fair value is the relevant measurement attribute. It does not require any new fair value measurements, but may change current practice for some entities. Statement 157 will be effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years, with earlier application encouraged. The provisions are to be applied prospectively, with certain exceptions. A cumulative-effect adjustment to retained earnings is required for application to certain financial instruments. CNG will adopt Statement 157 effective January 1, 2008. CNG is currently assessing the effect Statement 157 would have on its results of operations, financial position and cash flows.

**Statement 158:** In September 2006 the FASB issued Statement 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, which amends FASB Statements No. 87, 88, 106 and 132(R), and requires an employer to:

- recognize the overfunded or underfunded status of defined benefit pension and/or other postretirement plans as an asset or liability in its balance sheet;
- recognize changes in the funded status of such plans in the year in which the changes occur through comprehensive income;
- measure the funded status of a plan as of the date of its year-end balance sheet, and

## **Notes to Financial Statements**

### **Connecticut Natural Gas Corporation**

- disclose in the notes to the annual financial statements certain effects that the delayed recognition of the gains or losses, prior service costs or credits and transition asset or obligation are expected to have on net periodic benefit cost for the next fiscal year.

The funded status of a benefit plan is measured as the difference between plan assets at fair value and the benefit obligation, which is the projected benefit obligation for a pension plan and the accumulated postretirement benefit obligation for any other postretirement plan. As required by Statement 158, gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost pursuant to Statement 87, Employers' Accounting for Pensions, or Statement 106, Employers' Accounting for Postretirement Benefits Other Than Pensions, are recognized as a component of other comprehensive income, net of tax. Gains or losses, prior service costs or credits and the transition asset or obligation remaining from the initial application of Statements 87 and 106 that are recognized in accumulated other comprehensive income are adjusted as they are subsequently recognized as components of net periodic benefit cost pursuant to the recognition and amortization provisions of those Statements. However, CNG is a rate-regulated entity that meets the criteria to apply Statement 71. Based on its assessments of the facts and circumstances applicable to CNG's jurisdiction and regulatory environment, CNG has determined that it is allowed to defer as regulatory assets or regulatory liabilities the above indicated items. Other entities that are not rate-regulated would recognize those items as a component of other comprehensive income and/or include them in accumulated other comprehensive income.

CNG initially applied the recognition and disclosure provisions of Statement 158 as of December 31, 2006, with no material effect on its financial position and no effect on its results of operation or cash flows. Retrospective application of the recognition provisions and measurement provisions is not permitted. CNG measures its pension and other postretirement plan assets and benefit obligations as of the date of its fiscal year-end balance sheet and therefore has no need to change its measurement date.

## Notes to Financial Statements

### Connecticut Natural Gas Corporation

The incremental effect of applying Statement 158 for our qualified plans on individual line items in CNG's balance sheet as of December 31, 2006, is:

	Before Application of Statement 158	Adjustments	After Application of Statement 158
<b>(Thousands)</b>			
Other Assets			
Regulatory asset – Pension and other postretirement	-	\$51,460	\$51,460
All other regulatory assets	\$50,799	-	50,799
Prepaid pension benefits	32,473	(32,473)	-
Other assets	11,807	(51)	11,756
Total other assets	807,529	-	807,529
<b>Total Assets</b>	<b>\$902,608</b>	<b>\$18,936</b>	<b>\$921,544</b>
<b>Liabilities</b>			
Regulatory liabilities			
Deferred income taxes	(17,768)	17,768	-
Pension benefit	11,836	6,849	18,685
Other liabilities			
Deferred income taxes	95,930	(12,878)	83,052
Other pension and postretirement benefits	23,413	18,422	41,835
Total other liabilities	42,408	(18,598)	23,810
Long-term debt and other liabilities	356,272	-	356,272
<b>Total Liabilities</b>	<b>512,091</b>	<b>11,563</b>	<b>523,654</b>
Preferred stock	750	-	750
Retained earnings	29,387	-	29,387
Accumulated OCI	(8,139)	7,373	(766)
Other common equity accounts	368,519	-	368,519
<b>Total Common Stock Equity</b>	<b>389,767</b>	<b>7,373</b>	<b>397,140</b>
<b>Total Liabilities and Stockholder's Equity</b>	<b>\$902,608</b>	<b>\$18,936</b>	<b>\$921,544</b>

**Statement 159:** In February 2007 the FASB issued Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (Statement 159), which will allow an entity to measure eligible financial instruments and certain other items at fair value at specified election dates on an instrument-by-instrument basis (the fair value option). The fair value option is irrevocable unless a new election date occurs. The fair value option will significantly expand an entity's ability to select the measurement attribute for certain key assets and liabilities, and allow it to mitigate potential mismatches that arise under the current mixed measurement attribute model. Statement 159 will be effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007, with early adoption permitted when specified conditions are met. Retrospective application to fiscal years preceding the effective date is not permitted unless the entity chooses early adoption. Application to eligible items existing at the effective date (or early adoption date) is permitted. We plan to adopt Statement 159 as of January 1, 2008. We are currently assessing the effect Statement 159 would have on our results of operations, financial position and cash flows.

**Taxes:** CNG computes its income tax provision on a separate return method. The determination and allocation of CNG's income tax provision and its components are outlined and agreed to in its tax sharing agreement with Energy East.

Deferred income taxes reflect the effect of temporary differences between the amount of assets and liabilities recognized for financial reporting purposes and the amount recognized for tax

## Notes to Financial Statements

### Connecticut Natural Gas Corporation

purposes. CNG amortizes Investment Tax Credits (ITCs) over the estimated lives of the related assets.

CNG accounts for sales tax collected from customers and remitted to taxing authorities on a net basis.

Energy East revised its Income Tax Allocation Agreement (Agreement) in 2006. The revised Agreement, which applies to income tax returns after 2004, and is accounted for at the time of the filing of the income tax returns in the subsequent year, eliminates the push-down requirements of PUHCA and better aligns the allocation of income taxes with the Cost of Service "stand alone" approach used in each of our regulated entities' rate structures.

If the revised agreement had been in place in 2005, CNG's income taxes would have been \$0.3 million higher for 2005.

#### **Note 2. Goodwill and Other Intangible Assets**

We do not amortize goodwill or intangible assets with indefinite lives (unamortized intangible assets). We test goodwill and unamortized intangible assets for impairment at least annually. We amortize intangible assets with finite lives (amortized intangible assets) and review them for impairment. We completed our annual impairment testing in the third quarter of 2006 and determined that we had no impairment of goodwill or unamortized intangible assets.

The carrying amount of goodwill was \$219 million at December 31, 2006 and 2005.

**Other Intangible Assets:** Our unamortized intangible assets had a carrying amount of less than \$1 million at December 31, 2006, and primarily consisted of franchise cost and \$2 million at December 31, 2005, and primarily consisted of pension assets.

#### **Note 3. Income Taxes**

<b>Year Ended December 31,</b>	<b>2006</b>	<b>2005</b>
(Thousands)		
Current		
Federal	<b>\$7,917</b>	\$4,748
State	<b>714</b>	493
Current taxes charged to expense	<b>8,631</b>	5,241
Deferred		
Federal	<b>(1,576)</b>	5,067
State	<b>647</b>	629
Deferred taxes charged to expense	<b>(929)</b>	5,696
ITC adjustments	<b>(221)</b>	(221)
<b>Total</b>	<b>\$7,481</b>	\$10,716

Our tax expense differed from the expense at the statutory rate of 35% due to the following:

## Notes to Financial Statements

### Connecticut Natural Gas Corporation

Year Ended December 31,	2006	2005
(Thousands)		
Tax expense at statutory rate	\$7,028	\$9,726
Depreciation and amortization not normalized	1,395	1,385
ITC amortization	(221)	(221)
State taxes, net of federal benefit	885	729
Other, net	(1,606)	(903)
<b>Total</b>	<b>\$7,481</b>	<b>\$10,716</b>

The effective tax rate was 37% in 2006 and 39% in 2005.

At December 31, 2006 and 2005, our deferred tax assets and liabilities consisted of:

	2006	2005
(Thousands)		
<b>Current Deferred Income Tax Assets (Liabilities)</b>		
Derivative assets	\$(1,087)	\$(144)
Other	8,912	12,077
<b>Total Current Deferred Income Tax Assets (Liabilities)</b>	<b>\$7,825</b>	<b>\$11,933</b>
<b>Noncurrent Deferred Income Tax Liabilities</b>		
Depreciation	\$61,900	\$61,724
Unfunded future income taxes	300	(934)
Accumulated deferred ITC	760	1,162
Pension	1,746	(9,927)
Postretirement benefits	(2,493)	(4,145)
Other	7,331	10,427
<b>Total Noncurrent Deferred Income Tax Liabilities</b>	<b>69,544</b>	<b>58,307</b>
Less amounts classified as regulatory liabilities		
Deferred income taxes	(13,508)	(11,210)
<b>Total Noncurrent Deferred Income Tax Liabilities</b>	<b>83,052</b>	<b>69,517</b>
Deferred Tax Assets	11,405	27,083
Deferred Tax Liabilities	73,124	73,457
<b>Net Accumulated Deferred Income Taxes</b>	<b>\$61,719</b>	<b>\$46,374</b>

We have no federal tax credit or loss carry forwards and no valuation allowances.

#### Note 4. Long-term Debt

At December 31, 2006 and 2005, our other long-term debt was:

Company	Interest Rates	Maturity	Amount (Thousands)		
			2006	2005	
	<b>Medium Term Note</b>				
CNG	Medium Term Note Series A	6.85% - 9.10%	2012 - 2017	\$55,000	\$55,000
CNG	Medium Term Note Series B	6.04% - 8.49%	2007 - 2024	49,000	49,000
CNG	Medium Term Note Series C	5.63% - 5.84%	2035	45,000	45,000
Total medium-term note				149,000	149,000
Less debt due within one year, included in current liabilities				19,000	-
<b>Total</b>				<b>\$130,000</b>	<b>\$149,000</b>

## Notes to Financial Statements

### Connecticut Natural Gas Corporation

We have no intercompany collateralizations and have no guarantees to affiliates or subsidiaries. Our debt has no guarantees from its parent or affiliates or any additional credit supports.

At December 31, 2006, other long-term debt, including sinking fund obligations (in thousands) that will become due during the next five years is:

<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>
\$19,000	\$20,000	\$ -	\$ -	\$ -

#### **Note 5. Bank Loans and Other Borrowings**

CNG participates in a joint borrowing with the other operating utilities under Energy East in a revolving credit facility providing individual maximum borrowings of up to \$75 million. We pay a facility fee of 6 basis points annually on its current revolver sub limit.

We use drawings on its credit facility to finance working capital needs, to temporarily finance certain refunding and for other corporate purposes. We have \$20 million of short term debt outstanding at December 31, 2006 and \$41 million at December 31, 2005. The weighted-average interest rate on short-term debt was 5.5% at December 31, 2006, and 4.6% at December 31, 2005.

In our revolving credit facility, we covenant not to permit, without the consent of the lender, our ratio of total indebtedness to total capitalization to exceed 0.65 to 1.00 at any time. The facility contains various other covenants, including a restriction on the amount of secured indebtedness each borrower may maintain. Continued unremedied failure to comply with those covenants for 5 days after written notice of such failure from the lender constitutes an event of default and would result in acceleration of maturity. At December 31, 2006, our ratio of total indebtedness to total capitalization was 0.30 to 1.00. We are not in default, and no condition exists that is likely to create a default, under the facility.

#### **Note 6. Preferred Stock:**

At December 31, 2006 and 2005, our cumulative preferred stock was:

<b>Series</b>	<b>Par Value Per Share</b>	<b>Redemption Price Per Share</b>	<b>Shares Authorized And Outstanding</b>	<b>Amount 2006</b>	<b>Amount 2005</b>
6.00%	\$100	\$110.00	4,104	\$411	\$411
8.00% Noncallable	3.125	-	108,706	339	339
<b>Total</b>				<b>\$750</b>	<b>\$750</b>

At December 31, 2006 we had 775,609 shares of \$3.125 par value preferred stock and 9,994,989 shares of \$100 par value preferred stock authorized but unissued.

## Notes to Financial Statements

### Connecticut Natural Gas Corporation

#### Note 7. Commitments and Contingencies

**Capital spending:** We have commitments in connection with our capital spending program. Capital spending in 2007 is expected to be paid for principally with internally generated funds. The program is subject to periodic review and revision. Our capital spending will be primarily for the extension of energy delivery service, necessary improvements to existing facilities, compliance with environmental requirements and governmental mandates.

#### Note 8. Environmental Liability

In the ordinary course of business, the Company may incur costs to clean up environmental contaminants related to natural gas activities. The Company is currently in the process of remediating a regulator station site in Wethersfield, Connecticut that has been contaminated from the historical operations of the site. The remediation is being conducted under a voluntary program which is approved by the CDEP and the EPA. The Company has recorded an estimated liability of \$272,000 related to the remediation of this site. In the settlement of the Company's last rate case, the Company will recover the remediation cost in rates over a six year period.

#### Note 9. Fair Value of Financial Instruments

The carrying amounts and estimated fair values of our financial instruments are shown in the following table. The fair values are based on the quoted market prices for the same or similar issues of the same remaining maturities.

December 31,	2006		2005	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
(Thousands)				
Noncurrent investments - classified as available-for-sale	\$15,000	\$15,000	\$14,794	\$14,794
Various medium-term notes	\$149,000	\$159,457	\$149,000	\$167,919

The carrying amounts for cash and cash equivalents, notes payable, and interest accrued approximate their estimated fair values.

## Notes to Financial Statements

### Connecticut Natural Gas Corporation

#### Note 10. Accumulated Other Comprehensive Income (Loss)

	Balance December 31, 2004	Other Comprehensive Income (Loss) 2005	Balance December 31, 2005	Other Comprehensive Income (Loss) 2006	Adjustment to Initially Apply Statement 158	Balance December 31, 2006
<b>(Thousands)</b>						
Unrealized gains (losses) on investments:						
Unrealized holding gains during period, net of income tax (expense) of, \$(142) for 2005 and \$(344) for 2006		\$214		\$519		
Net unrealized (losses) gains on investments	\$(387)	214	\$(173)	519	-	\$346
Pension liability net of income tax benefit (expense) of, \$3,515 for 2005 and \$(13,079) for 2006 <sup>(1)</sup>	(15,496)	(5,300)	(20,796)	11,273	8,448	(1,075)
Unrealized gains (losses) on derivatives qualified as hedges:						
Unrealized gains (losses) during period on derivatives qualified as hedges, net of income tax (expense) of, \$(35) for 2005 and \$32 for 2006		54		(48)		
Reclassification adjustment for (gains) losses included in net income, net of income tax expense of \$29 for 2005 and \$(8) for 2006		(44)		11		
Net unrealized (losses) gains on derivatives qualified as hedges	(10)	10	-	(37)	-	(37)
<b>Accumulated Other Comprehensive (Loss) Income</b>	<b>\$(15,893)</b>	<b>\$(5,076)</b>	<b>\$(20,969)</b>	<b>\$11,755</b>	<b>8,448</b>	<b>(766)</b>

<sup>(1)</sup>2006 Balance represents liability for nonqualified plans not included in regulatory assets.

## Notes to Financial Statements

### Connecticut Natural Gas Corporation

#### Note 11. Retirement Benefits

CNG sponsors defined benefit pension plans and postretirement benefit plans that cover substantially all of our employees. We use a December 31 measurement date for our pension and postretirement benefit plans.

Obligations and funded status:	Pension Benefits		Postretirement Benefits	
	2006	2005	2006	2005
<b>(Thousands)</b>				
<b>Change in benefit obligation</b>				
Benefit obligation at January 1	\$180,901	\$164,759	\$31,675	\$31,953
Service cost	3,352	3,149	375	317
Interest cost	9,725	9,589	1,797	1,806
Plan participants' contributions	-	-	25	366
Plan amendments	-	419	247	-
Actuarial loss (gain)	(9,856)	10,443	998	240
Benefits paid	(7,545)	(7,458)	(2,659)	(3,007)
Federal Subsidy on benefits paid	-	-	158	-
Benefit obligation at December 31	\$176,577	\$180,901	\$32,616	\$31,675
<b>Change in plan assets</b>				
Fair value of plan assets at January 1	\$144,059	\$126,248	\$11,454	\$11,984
Actual return on plan assets	21,075	10,269	766	808
Employer contributions	-	15,000	158	1,300
Plan participants contributions	-	-	25	366
Benefits paid	(7,545)	(7,458)	(2,634)	(3,004)
Fair value of plan assets at December 31	\$157,589	\$144,059	\$9,769	\$11,454
Funded status <sup>(1)</sup>	\$(18,988)	\$(36,842)	\$(22,847)	\$(20,221)
Unrecognized net actuarial loss <sup>(1)</sup>		72,455		(1,088)
Unrecognized prior service cost (benefit) <sup>(1)</sup>		1,304		(547)
Total unrecognized amounts		\$73,759		\$(1,635)
Prepaid (accrued) benefit cost		\$36,917		\$(21,856)

<sup>(1)</sup>December 31, 2006, these amounts for pension benefits and postretirement benefits are included in regulatory assets or regulatory liabilities, as appropriate, due to the application of Statement 158 and in accordance with Statement 71. See statement 158 disclosure in Note 1.

Amounts recognized on the balance sheet	Pension Benefits		Postretirement Benefits	
	2006	2005	2006	2005
Noncurrent Liabilities	\$(18,988)		\$(22,847)	
Prepaid benefit cost		\$36,917		-
Accrued benefit cost		-		\$(21,856)
Additional minimum liability		(53,225)		-
Intangible asset		1,852		-
Regulatory liability		18,120		-
Accumulated other comprehensive income		33,253		-
Net amount recognized		\$36,917		\$(21,856)

## Notes to Financial Statements

### Connecticut Natural Gas Corporation

The minimum liability for pension benefits included in other comprehensive income increased \$7 million in 2005. We recorded a minimum pension liability of \$53 million at December 31, 2005, as required by Statement 87. We recognized the effect of the minimum pension liability in other long-term liabilities, intangible assets, regulatory liabilities and other comprehensive income, as appropriate. That treatment was prescribed when the accumulated benefit obligation in the plan exceeded the fair value of the underlying pension plan assets and accrued pension liabilities. The increase in the unfunded accumulated benefit obligation in 2005 was primarily due to a decrease in the assumed discount rate. The minimum pension liability was eliminated and related amounts reversed based on their balances at December 31, 2006, due to the application of Statement 158. See Statement 158 disclosure in Note 1.

Amounts recognized in regulatory assets and regulatory liabilities at December 31, 2006, consist of:

	Pension Benefits	Postretirement Benefits
<b>(Thousands)</b>		
Net loss (gain)	\$50,264	\$(564)
Prior service cost (benefit)	\$ 1,196	\$(1)

Our accumulated benefit obligation for all defined benefit pension plans at December 31 was \$157.8 million for 2006 and \$160.4 million for 2005.

CNG postretirement benefits were partially funded at December 31, 2006 and 2005.

#### Information for pension plans with an accumulated benefit obligation in excess of plan assets

December 31,	2006	2005
<b>(Thousands)</b>		
Projected benefit obligation	<b>\$176,577</b>	\$180,901
Accumulated benefit obligation	<b>\$157,846</b>	\$160,368
Fair value of plan assets	<b>\$157,589</b>	\$144,059

	Pension Benefits		Postretirement Benefits	
	2006	2005	2006	2005
<b>(Thousands)</b>				
<b>Components of net periodic benefit cost</b>				
Service cost	<b>\$3,352</b>	\$3,149	<b>\$375</b>	\$317
Interest cost	<b>9,725</b>	9,589	<b>1,797</b>	1,806
Expected return on plan assets	<b>(12,667)</b>	(12,141)	<b>(611)</b>	(937)
Amortization of prior service cost	<b>107</b>	75	<b>(6)</b>	(79)
Amortization of net loss	<b>3,926</b>	3,432	-	-
Net periodic benefit cost	<b>\$4,443</b>	\$4,104	<b>\$1,555</b>	\$1,107

## Notes to Financial Statements

### Connecticut Natural Gas Corporation

We include the net periodic benefit cost in other operating expenses. The net periodic benefit cost for postretirement benefits represents the amount expensed for providing health care benefits to retirees and their eligible dependents. The amount of postretirement benefit cost deferred at December 31 was \$15 million for 2006, and \$16 million for 2005. We expect to recover any deferred postretirement costs by 2012. We are amortizing over 20 years the transition obligation for postretirement benefits that resulted from the adoption of Statement 106.

**Amounts expected to be amortized from regulatory assets or regulatory liabilities into net periodic benefit cost for the fiscal year ended December 31, 2007**

	<b>Pension Benefits</b>	<b>Postretirement Benefits</b>
(Thousands)		
Estimated net loss	\$2,971	-
Estimated prior service cost	\$210	\$64

**Weighted-average assumptions used to determine benefit obligations at December 31,**

	<b>Pension Benefits</b>		<b>Postretirement Benefits</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Discount rate	5.75%	5.50%	5.75%	5.50%
Rate of compensation increase	4.00%	4.00%	4.00%	4.00%

As of December 31, 2006, we increased our discount rate from 5.50% to 5.75%. The discount rate is the rate at which the benefit obligations could presently be effectively settled. We determined the discount rate developing a yield curve derived from a portfolio of high grade noncallable bonds that closely matches the duration of the expected cash flows of our benefit obligations.

**Weighted-average assumptions used to determine net periodic benefit cost years ended December 31,**

	<b>Pension Benefits</b>		<b>Postretirement Benefits</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Discount rate	5.50%	5.75%	5.50%	5.75%
Expected return on plan assets	8.75%	8.75%	6.00%	8.75%
Rate of compensation increase	4.00%	4.00%	4.00%	4.00%

We developed our expected long-term rate of return on plan assets assumption based on a review of long-term historical returns for the major asset classes. That analysis considered current capital market conditions and projected conditions. Given the current low interest rate environment, we made assumptions of 8.75% per year for the Pension Benefits plan and 6.00% per year for the Postretirement Benefits plan, which are lower than the rate that would otherwise be determined solely based on historical returns. We amortize unrecognized actuarial gains and losses either over 10 years from the time they are incurred or using the standard amortization methodology, under which amounts in excess of 10% of the greater of the projected benefit obligation or market related value are amortized over the plan participants' average remaining service to retirement.

## Notes to Financial Statements

### Connecticut Natural Gas Corporation

<b>Assumed health care cost trend rates at December 31</b>	<b>2006</b>	<b>2005</b>
Health care cost trend rate assumed for next year	<b>9.0%</b>	10.0%
Rate to which cost trend rate is assumed to decline (the ultimate trend rate)	<b>5.0%</b>	5.0%
Year that the rate reaches the ultimate trend rate	<b>2011</b>	2011

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

	<b>1% Increase</b>	<b>1% Decrease</b>
(Thousands)		
Effect on total of service and interest cost components	\$69	\$(54)
Effect on postretirement benefit obligation	\$830	\$(687)

**Plan assets:** Our weighted-average asset allocations at December 31, 2006 and 2005, by asset category, are:

<b>Asset Category</b>	<b>Pension Benefits</b>			<b>Postretirement Benefits</b>		
	<b>Target Allocation</b>	<b>Actual Allocation 2006</b>	<b>Actual Allocation 2005</b>	<b>Target Allocation</b>	<b>Actual Allocation 2006</b>	<b>Actual Allocation 2005</b>
Equity securities	58%	<b>64%</b>	64%	50%	<b>25%</b>	24%
Debt securities	27%	<b>24%</b>	28%	45%	<b>69%</b>	63%
Real estate	5%	<b>4%</b>	2%	-	-	-
Other	10%	<b>8%</b>	6%	5%	<b>6%</b>	13%
Total	100%	<b>100%</b>	100%	100%	<b>100%</b>	100%

Our pension benefits plan assets are held in a master trust with a trustee and our other postretirement benefits plan assets are held with two trustees in multiple VEBA and 401(h) arrangements. Those assets are invested among and within various asset classes in order to achieve sufficient diversification in accordance with our risk tolerance. This is achieved for our pension benefits plan assets through utilization of multiple asset managers and systematic allocation to investment management styles, providing a broad exposure to different segments of the fixed income and equity markets; and for our postretirement benefits plan assets through the utilization of multiple institutional mutual and money market funds, providing exposure to different segments of the fixed income, equity and short-term cash markets.

Equity securities did not include any Energy East common stock at December 31, 2006 and 2005.

**Contributions:** In accordance with our funding policy we make annual contributions of not less than the minimum required by applicable regulations. We do not anticipate any contributions to our pension benefit plans in 2007 and we expect to contribute approximately \$1 million to our other postretirement benefit plans in 2007.

## Notes to Financial Statements

### Connecticut Natural Gas Corporation

**Estimated future benefit payments:** Our expected benefit payments and expected Medicare Prescription Drug, Improvement and Modernization Act of 2003 (Medicare Act) subsidy receipts, which reflect expected future service, as appropriate, are as follows:

	<b>Pension Benefits</b>	<b>Postretirement Benefits</b>	<b>Medicare Act Subsidy Receipts</b>
<b>(Thousands)</b>			
2007	\$7,839	\$3,667	\$ 262
2008	\$8,162	\$3,914	\$ 289
2009	\$8,506	\$4,133	\$ 319
2010	\$8,769	\$4,356	\$ 341
2011	\$9,074	\$4,613	\$ 354
2012 – 2016	\$50,675	\$24,956	\$2,011