UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2012

OR

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

Commission file number: 1-34722

PAA Natural Gas Storage, L.P.

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**27-1679071** (I.R.S. Employer Identification No.)
333 Clay Street, Suite 1500, Houston, Texas (Address of principal executive offices)	**77002** (Zip Code)

(713) 646-4100

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). x Yes o No

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

Large accelerated filer o	Accelerated filer x
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

As of October 31, 2012, there were 59,205,075 common units outstanding.

PAA NATURAL GAS STORAGE, L.P. AND SUBSIDIARIES

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PART I. FINANCIAL INFORMATION

Item 1. UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

PAA Natural Gas Storage, L.P. and Subsidiaries

Condensed Consolidated Balance Sheets

(in thousands, except units)

	September 30, 2012 (unaudited)	December 31, 2011
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	$ 448	$ 496
Accounts receivable	18,064	33,600
Natural gas inventory	50,829	50,942
Other current assets	5,645	8,917
Total current assets	74,986	93,955
PROPERTY AND EQUIPMENT		
Property and equipment	1,352,195	1,311,553
Less: Accumulated depreciation, depletion and amortization	(44,668)	(31,140)
Property and equipment, net	1,307,527	1,280,413
OTHER ASSETS		
Base gas	51,235	48,432
Goodwill	325,470	325,470
Intangibles and other assets, net	86,414	101,729
Total other assets, net	463,119	475,631
Total assets	$ 1,845,632	$ 1,849,999
LIABILITIES AND PARTNERS CAPITAL		
CURRENT LIABILITIES		
Accounts payable and accrued liabilities	$ 24,864	$ 40,884
Short-term debt	80,138	67,992
Accrued taxes	2,471	1,296
Total current liabilities	107,473	110,172
LONG-TERM LIABILITIES		
Note payable to PAA	200,000	200,000
Long-term debt under credit agreements	295,262	253,508
Other long-term liabilities	1,306	693
Total long-term liabilities	496,568	454,201
Total liabilities	604,041	564,373
COMMITMENTS AND CONTINGENCIES (NOTE 12)		
PARTNERS CAPITAL		
Common unitholders (59,205,075 units issued and outstanding at September 30, 2012)	1,016,360	1,037,161
Subordinated unitholders (25,434,351 units issued and outstanding at September 30, 2012)	225,780	230,359
General partner	28,609	28,156
Accumulated other comprehensive income/(loss)	(29,158)	(10,050)

Total partners capital		1,241,591		1,285,626
Total liabilities and partners capital	$	1,845,632	$	1,849,999

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

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PAA Natural Gas Storage, L.P. and Subsidiaries

Condensed Consolidated Statements of Operations

(in thousands, except per unit data)

	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
	(unaudited)		(unaudited)	
REVENUES:				
Firm storage services	$ 36,364	$ 35,536	$ 105,646	$ 100,075
Hub services	2,175	1,830	7,647	6,465
Natural gas sales	26,001	40,718	158,621	74,787
Other	1,587	1,250	3,076	2,791
Total revenues	66,127	79,334	274,990	184,118
COSTS AND EXPENSES:				
Storage-related costs	4,448	5,532	15,468	17,872
Natural gas sales costs	24,736	40,053	152,081	72,785
Field operating costs	2,974	3,070	9,030	9,072
General and administrative expenses	4,641	4,368	14,304	18,193
Depreciation, depletion and amortization	9,461	9,193	27,855	24,602
Total costs and expenses	46,260	62,216	218,738	142,524
OPERATING INCOME	19,867	17,118	56,252	41,594
OTHER INCOME/(EXPENSE):				
Interest expense (net of capitalized interest of $1,573, $2,724, $6,094 and $8,441, respectively)	(1,973)	(1,666)	(5,350)	(3,945)
Other income/(expense), net	(5)	(7)	12	10
NET INCOME	$ 17,889	$ 15,445	$ 50,914	$ 37,659
NET INCOME AVAILABLE TO LIMITED PARTNERS	$ 17,231	$ 14,919	$ 48,995	$ 36,526
NET INCOME PER LIMITED PARTNER UNIT				
Common and Series A subordinated units (1) (Basic)	$ 0.24	$ 0.21	$ 0.69	$ 0.54
Common and Series A subordinated units (1) (Diluted)	$ 0.24	$ 0.21	$ 0.69	$ 0.54
WEIGHTED AVERAGE LIMITED PARTNER UNITS OUTSTANDING				
Common and Series A subordinated units (1) (Basic)	71,136	71,125	71,131	67,279
Common and Series A subordinated units (1) (Diluted)	71,253	71,136	71,248	67,294

(1) Excludes Series B subordinated units. See Note 8, Net Income per Limited Partner Unit.

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

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PAA Natural Gas Storage, L.P. and Subsidiaries

Condensed Consolidated Statements of Comprehensive Income

(in thousands)

	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
	(unaudited)		(unaudited)	
Net income	$ 17,889	$ 15,445	$ 50,914	$ 37,659
Other comprehensive income/(loss)	(4,064)	(3,573)	(19,108)	(3,317)
Comprehensive income	$ 13,825	$ 11,872	$ 31,806	$ 34,342

PAA Natural Gas Storage, L.P. and Subsidiaries

Condensed Consolidated Statement of Changes in Accumulated Other Comprehensive Income/(Loss)

(in thousands)

	Total (unaudited)
Balance, December 31, 2011	$ (10,050)
Reclassification adjustments	(16,904)
Deferred gain/(loss) on cash flow hedges, net	(2,204)
Total period activity	(19,108)
Balance, September 30, 2012	$ (29,158)

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

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PAA Natural Gas Storage, L.P. and Subsidiaries

Condensed Consolidated Statements of Cash Flows

(in thousands)

	Nine Months Ended September 30, 2012	2011
	(unaudited)	
Cash flows from operating activities		
Net income	$ 50,914	$ 37,659
Adjustments to reconcile to cash flow from operations		
Depreciation, depletion and amortization	27,855	24,602
Equity compensation expense	3,601	3,360
Unrealized (gain)/loss on derivative instruments	(72)	(235)
Changes in assets and liabilities, net of acquisitions	(13,385)	(2,359)
Net cash provided by operating activities	68,913	63,027
Cash flows from investing activities		
Additions to property and equipment	(43,444)	(57,662)
Cash paid in connection with acquisition, net of cash acquired		(744,209)
Decrease/(increase) in restricted cash		20,000
Cash received/(paid) related to base gas sales/(purchases), net	(280)	(5,292)
Other investing activities	1	
Net cash used in investing activities	(43,723)	(787,163)
Cash flows from financing activities		
Borrowings under credit agreements	241,900	437,800
Repayments of borrowings under credit agreements	(188,000)	(444,800)
Borrowings from parent		200,000
Net proceeds from issuance of common units		587,347
Costs incurred in connection with financing arrangements	(386)	(2,561)
Contributions from general partner	4	12,004
Distributions paid to unitholders	(76,285)	(64,086)
Distributions paid to general partner	(2,223)	(1,525)
Distribution equivalent right payments	(248)	(47)
Net cash provided by/(used in) financing activities	(25,238)	724,132
Net increase/(decrease) in cash and cash equivalents	(48)	(4)
Cash and cash equivalents, beginning of period	496	346
Cash and cash equivalents, end of period	$ 448	$ 342
Cash paid for interest, net of amounts capitalized	$ 5,169	$ 2,902
Non-cash investing and financing activities		
Increase/(decrease) in non-cash asset purchases included in accounts payable	$ (463)	$ 1,811

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

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PAA Natural Gas Storage, L.P. and Subsidiaries

Condensed Consolidated Statement of Changes in Partners Capital

(in thousands)

	Partners Capital Limited Partners Common	Subordinated Series A	Series B	General Partner	Accumulated Other Comprehensive Income/(Loss)	Total
			(unaudited)			
Balance at December 31, 2011	$ 1,037,161	$ 128,568	$ 101,791	$ 28,156	$ (10,050)	$ 1,285,626
Net income	41,022	8,221		1,671		50,914
Equity compensation expense	2,034			1,001		3,035
Distributions to unitholders and general partner	(63,485)	(12,800)		(2,223)		(78,508)
Distribution equivalent rights paid or accrued	(372)					(372)
Contributions from general partner				4		4
Change in deferred gain/(loss) on cash flow hedges, net					(19,108)	(19,108)
Balance at September 30, 2012	$ 1,016,360	$ 123,989	$ 101,791	$ 28,609	$ (29,158)	$ 1,241,591

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

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PAA Natural Gas Storage, L.P. and Subsidiaries

Notes to the Condensed Consolidated Financial Statements

(unaudited)

Note 1 Organization and Basis of Presentation

PAA Natural Gas Storage, L.P. (the Partnership or PNG) is a Delaware limited partnership formed on January 15, 2010 to own the natural gas storage business of Plains All American Pipeline, L.P. (PAA). The Partnership is a fee-based, growth-oriented partnership engaged in the ownership, acquisition, development, operation and commercial management of natural gas storage facilities.

We currently own and operate three natural gas storage facilities located in Louisiana, Mississippi and Michigan. Our Pine Prairie and Southern Pines facilities are recently constructed, high-deliverability salt cavern natural gas storage complexes located in Evangeline Parish, Louisiana and Greene County, Mississippi, respectively. Our Bluewater facility is a depleted reservoir natural gas storage complex located approximately 50 miles from Detroit in St. Clair County, Michigan. As of September 30, 2012, through these facilities, PNG had a total of nine operational salt storage caverns and two depleted reservoirs used for natural gas storage, with an aggregate owned working gas storage capacity of approximately 93 billion cubic feet (Bcf). We also own PNG Marketing, LLC, a wholly owned commercial optimization company that captures short-term market opportunities by leasing a portion of our storage capacity and engaging in related commercial marketing activities.

As of September 30, 2012, PAA owned approximately 64% of the equity interests in the Partnership, including our 2.0% general partner interest and limited partner interests consisting of 28,155,526 common units, 11,934,351 Series A subordinated units and 13,500,000 Series B subordinated units.

The accompanying condensed consolidated interim financial statements include the accounts of PNG and its subsidiaries, all of which are wholly owned, and should be read in conjunction with our consolidated financial statements and notes thereto presented in our 2011 Annual Report on Form 10-K. The financial statements have been prepared in accordance with the instructions for interim reporting as prescribed by the SEC. All adjustments (consisting only of normal recurring adjustments) that in the opinion of management were necessary for a fair statement of the results for the interim periods have been reflected. All significant intercompany transactions have been eliminated in consolidation, and certain reclassifications have been made to information from previous years to conform to the current presentation. These reclassifications do not affect net income attributable to the Partnership. The condensed balance sheet data as of December 31, 2011 was derived from audited financial statements, but does not include all disclosures required by U.S. GAAP. The results of operations for the three and nine months ended September 30, 2012 should not be taken as indicative of the results to be expected for the full year.

As used in this document, the terms we, us, our and similar terms refer to the Partnership, unless the context indicates otherwise.

Property and Equipment

During the nine months ended September 30, 2011, we received cash of approximately $7.2 million under a state incentive program for jobs creation. This incentive payment, which was determined based on applicable capital expenditures, was accounted for as a refund of sales tax previously paid and reduced the carrying value of our applicable property and equipment.

Note 2 Recent Accounting Pronouncements

Other than as discussed below and in our 2011 Annual Report on Form 10-K, no new accounting pronouncements have become effective during the nine months ended September 30, 2012 that are of significance or potential significance to us.

In July 2012, the FASB issued guidance intended to simplify the impairment test for indefinite-lived intangible assets other than goodwill by giving entities the option to first assess qualitative factors to determine whether it is more likely than not that an indefinite-lived intangible asset is impaired. The results of the qualitative assessment would be used as a basis in determining whether it is necessary to perform the two-step quantitative impairment testing. An entity can choose to perform the qualitative assessment on none, some or all of its indefinite-lived intangible assets, or may bypass the qualitative assessment and proceed directly to the quantitative impairment test. This guidance will be effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012, with early adoption permitted in certain circumstances. We will adopt this guidance on January 1, 2013. Our adoption is not expected to have a material impact on our financial position, results of operations or cash flows.

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In September 2011, the FASB issued guidance with the purpose of simplifying the goodwill impairment test by permitting entities to perform a qualitative assessment to determine whether further impairment testing is necessary. If qualitative factors indicate that it is more likely than not that the fair value of a reporting unit is greater than its carrying amount, an entity need not perform the two-step goodwill impairment test. This guidance became effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. We adopted this guidance on January 1, 2012. Our adoption did not have a material impact on our financial position, results of operations or cash flows.

In June 2011, the FASB issued guidance regarding the presentation of other comprehensive income, which was later amended in December 2011, with the purpose of increasing the prominence of other comprehensive income in financial statements. This guidance, as amended, requires entities to present comprehensive income in either (i) a single continuous statement of comprehensive income or (ii) two separate but consecutive statements. This guidance became effective for interim and annual periods beginning after December 15, 2011. We adopted the guidance, as amended, on January 1, 2012. Since this guidance only impacts the presentation of comprehensive income and does not change the composition or calculation of such financial information, adoption did not have a material impact on our financial position, results of operations or cash flows.

In May 2011, the FASB issued guidance to amend certain fair value measurement and disclosure requirements in an effort to improve consistency with international reporting standards. The amendments generally clarify that the concepts of highest and best use and valuation premise in fair value measurement are relevant only when measuring the fair value of non-financial assets and are not relevant when measuring the fair value of financial assets or of liabilities. In addition, the guidance expanded disclosure requirements associated with (i) unobservable inputs for Level 3 fair value measurements and (ii) items that are not measured at fair value in the financial statements, but for which fair value is required to be disclosed. This guidance became effective prospectively for interim and annual reporting periods beginning after December 15, 2011. We adopted this guidance on January 1, 2012. Other than requiring additional disclosure, which is included in Note 7, our adoption did not have a material impact on our financial position, results of operations or cash flows.

Note 3 Accounts Receivable

We review all outstanding accounts receivable balances on a monthly basis and record a reserve for amounts that we expect will not be fully recovered. We do not apply actual balances against the reserve until we have exhausted substantially all collection efforts. At September 30, 2012 and December 31, 2011, substantially all of our accounts receivable were current and we had no allowance for doubtful accounts.

Our accounts receivable are from a broad mix of customers, including local gas distribution companies, electric utilities, pipelines, direct industrial users, electric power generators, marketers, producers and affiliates of such entities.

To mitigate credit risks related to our accounts receivable, we have in place a rigorous credit review process. We closely monitor market conditions in order to make a determination with respect to the amount, if any, of credit to be extended to any given customer and the form and amount of financial performance assurances we require. Such financial assurances are commonly provided to us in the form of standby letters of credit, parental guarantees or advance cash payments. In addition, we enter into netting arrangements (contractual agreements that allow us and the counterparty to offset receivables and payables against each other) that cover substantially all of our natural gas purchases and sales transactions and also serve to mitigate credit risk.

Note 4 Acquisition

On February 9, 2011, we completed the acquisition of SG Resources Mississippi, L.L.C., owner of the Southern Pines Energy Center natural gas storage facility (the Southern Pines Acquisition). The purchase price was approximately $765 million (approximately $750 million net of cash and other working capital acquired).

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The purchase price allocation was as follows (in millions):

Description		Amount	Average Depreciable Life (in years)
Inventory	$	14	n/a
Property and equipment		340	5 70
Base gas		3	n/a
Other working capital (including approximately $13 million of cash acquired)		15	n/a
Intangible assets		92	2 10
Goodwill		301	n/a
Total	$	765	

In conjunction with the Southern Pines Acquisition, we arranged financing totaling approximately $800 million to fund the purchase price, closing costs and the first 18 months of expected expansion capital. The financing consisted of $200 million of borrowings under a promissory note from PAA (see Note 7) and approximately $600 million from the issuance of our common units (see Note 9).

During the nine months ended September 30, 2011, we incurred approximately $4.1 million of acquisition-related costs associated with the Southern Pines Acquisition. Such costs are reflected as a component of general and administrative expenses in our condensed consolidated statement of operations.

In May 2011, we entered into an agreement with the former owners of SG Resources Mississippi, LLC with respect to certain outstanding issues and purchase price adjustments as well as the distribution of the remaining purchase price that was escrowed at closing. Pursuant to this agreement, we received approximately $10 million and the balance was remitted to the former owners. Funds received by us have been and will continue to be used to fund anticipated facility development and other related costs identified subsequent to closing. None of these funds were spent during the nine months ended September 30, 2012.

Pro Forma Results

Selected unaudited pro forma results of operations for the nine months ended September 30, 2011, assuming the Southern Pines Acquisition had occurred on January 1, 2010, are presented below (in thousands, except per unit amounts):

		Nine Months Ended September 30, 2011
Total revenues	$	188,081
Net income (1)	$	42,963
Limited partner interest in net income (2)	$	41,723
Net income per limited partner unit (2)		
Basic	$	0.59

Diluted	$	0.59

(1) Amount for the period excludes approximately $4.1 million of acquisition costs associated with the Southern Pines Acquisition.

(2) Excludes Series B subordinated units. See Note 8, Net Income per Limited Partner Unit.

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Note 5 Inventory and Base Gas

Inventory and base gas consisted of the following (natural gas volumes in thousands and carrying values in thousands):

	September 30, 2012				December 31, 2011			
	Volumes	Unit of Measure		Carrying Value (1)	Volumes	Unit of Measure		Carrying Value (1)
Inventory								
Natural gas (2)(3)(4)	21,800	Mcf	$	50,829	16,170	Mcf	$	50,942
Base Gas								
Natural gas (5)	15,005	Mcf		51,235	14,105	Mcf		48,432
Total			$	102,064			$	99,374

(1) Carrying value represents a weighted-average associated with various locations; accordingly, these values may not coincide with any published benchmarks for such products.

(2) Includes fuel inventory held for operational purposes.

(3) As of December 31, 2011, the carrying value of natural gas inventory reflects lower of cost or market adjustments of approximately $6.0 million. No lower of cost or market adjustments were included in the carrying value of natural gas inventory as of September 30, 2012. Lower of cost or market adjustments are reflected as a component of natural gas sales costs in our accompanying condensed consolidated statement of operations. The impacts of such adjustments are generally offset by the recognition of unrealized gains on derivative instruments (see Note 11) being utilized to hedge the future sales of our natural gas inventory.

(4) Natural gas inventory balances exclude derivative gains and losses associated with settled derivatives which were entered into to hedge natural gas inventory purchases. As of September 30, 2012, net deferred losses of approximately $27.8 million associated with settled derivatives are reflected as a component of accumulated other comprehensive income/(loss) in our condensed consolidated balance sheet. Such amounts will be reclassified to earnings in conjunction with an earnings impact associated with the applicable purchase inventory (typically when such inventory is sold).

(5) During the quarter ended September 30, 2012, we purchased approximately 0.9 Bcf of base gas for approximately $5.7 million (including approximately $3.2 million related to derivative settlements). Approximately $1.1 million of the purchase price is included as a component of accounts payable and accrued liabilities in our accompanying condensed consolidated balance sheet as of September 30, 2012. Also, during the nine months ended September 30, 2012, we received approximately $4.3 million of cash for base gas sold during 2011.

Note 6 Goodwill

The table below reflects our changes in goodwill for the period indicated (in thousands):

		Total
Balance, December 31, 2011	$	325,470

2012 Goodwill Related Activity:		
Acquisitions		
Purchase price accounting adjustments and other		
Balance, September 30, 2012	$	325,470

Note 7 Debt

On June 1, 2012, the Partnership and PAA entered into an amendment (the PAA Promissory Note Amendment) to the PAA Promissory Note, which was originally entered into during 2011. The PAA Promissory Note Amendment modified the terms of the PAA Promissory Note by (i) reducing the interest rate from 5.25% per annum to 4.00% per annum and (ii) extending the scheduled maturity date from February 9, 2014 to June 1, 2015. The remaining terms of the PAA Promissory Note were unchanged.

On June 27, 2012 we partially exercised the accordion feature of our revolving credit facility, increasing borrowing capacity from $250 million to $350 million. Also on June 27, 2012, we reached an agreement with applicable lenders to amend certain terms and provisions of our senior unsecured credit agreement (the Credit Agreement Amendment). Pursuant to the Credit Agreement Amendment, the revolving credit facility commitments may be further increased to $550 million, subject to, among other terms and conditions, obtaining additional or increased lender commitments. The Credit Agreement Amendment also provides for one or more one-year extensions of the maturity date of the revolving credit facility and the date (the GO Bond Mandatory Put Date) on which the Purchasers of the GO Bond Term Loans have the right to require the Partnership to repurchase such loans, in each case, subject to

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applicable lender approval and other terms and conditions set forth in the credit agreement, as amended. The revolving credit facility will expire and all amounts outstanding under it will mature on August 19, 2016 unless, such maturity date is extended pursuant to the terms of the credit agreement, as amended, and the purchasers of the two GO Bond Term Loans have the right to put, at par, to the Partnership the GO Bond Term Loans on August 19, 2016 unless such GO Bond Mandatory Put Date is extended pursuant to the terms of the credit agreement, as amended. The maturity dates for the GO Bonds, which mature by their terms on May 1, 2032 and August 1, 2035, respectively, were not changed by the Credit Agreement Amendment. Provisions of the credit agreement providing for the calculation and payment of interest or fees and regarding covenants, including the financial covenants, events of default and lender remedies were substantially unchanged by the Credit Agreement Amendment, as were the terms providing for the issuance of letters of credit.

Debt consisted of the following (in thousands):

	September 30, 2012	December 31, 2011
Short-Term Debt		
Senior unsecured revolving credit facility, bearing a weighted-average interest rate of 2.4% at both September 30, 2012 and December 31, 2011(1) (2)	$ 80,138	$ 67,992
Total short-term debt	80,138	67,992
Long-Term Debt		
Senior unsecured revolving credit facility, bearing a weighted-average interest rate of 2.4% at both September 30, 2012 and December 31, 2011(1) (2)	95,262	53,508
GO Bond Term Loans, bearing a weighted-average interest rate of 1.5% at both September 30, 2012 and December 31, 2011 (2)	200,000	200,000
Promissory note due to PAA bearing interest of 4.0% and 5.25% at September 30, 2012 and December 31, 2011, respectively (2)	200,000	200,000
Total long-term debt	495,262	453,508
Total debt (1) (2)	$ 575,400	$ 521,500

(1) We classify as short-term debt any borrowings under our senior unsecured revolving credit facility that have been designated as working capital borrowings and must be repaid within one year. Such borrowings are primarily related to a portion of our funded hedged natural gas inventory or NYMEX margin requirements. Approximately $0.4 million and $0.9 million of interest expense attributable to such borrowings is reflected as a component of natural gas sales costs in the accompanying condensed consolidated statements of operations for the three and nine months ended September 30, 2012, respectively.

(2) We estimate that the fair value of borrowings outstanding under our credit agreement (including the revolving credit facility and GO Bond Term Loans) and the PAA Promissory Note approximate carrying value due to the short maturity of both obligations and the variable interest rate terms set forth under our credit agreement. Our fair value estimate for amounts outstanding under our credit agreement is based upon observable market data and is classified with Level 2 of the fair value hierarchy. With regard to the PAA Promissory Note, our fair valuation estimation process incorporates our estimated credit spread, an unobservable input. As such, we consider this to be a Level 3 measurement within the fair value hierarchy.

Our revolving credit facility includes the ability to issue letters of credit. As of September 30, 2012, we had $1.8 million of outstanding letters of credit under our revolving credit facility.

As of September 30, 2012, we were in compliance with the covenants required by our credit agreement.

Interest payments on the PAA Promissory Note are paid semiannually on the last business day of June and December. Interest paid to PAA during the nine months ended September 30, 2012 was approximately $5.0 million. Accrued interest payable due under the PAA Promissory Note (which is reflected as a component of accounts payable and accrued liabilities on our accompanying condensed consolidated balance sheet) was approximately $2.0 million as of September 30, 2012. There was no accrued interest payable due under the PAA Promissory Note as of December 31, 2011.

Capitalized interest for the three and nine months ended September 30, 2012 was $1.6 million and $6.1 million, respectively, and $2.7 million and $8.4 million for the three and nine months ended September 30, 2011, respectively.

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Note 8 Net Income per Limited Partner Unit

Basic and diluted net income per limited partner unit is determined pursuant to the two-class method for Master Limited Partnerships as prescribed in the FASB guidance. The two-class method is an earnings allocation formula that is used to determine earnings to our general partner, limited partner unit holders and participating securities according to distributions pertaining to the current period s net income and participation rights in undistributed earnings. Under this method, all earnings are allocated to our general partner, limited partner unit holders and participating securities based on their respective rights to receive distributions, regardless of whether those earnings would actually be distributed during a particular period from an economic or practical perspective.

The Partnership calculates basic and diluted net income per limited partner unit by dividing net income, after deducting the amount allocated to the general partner s interest, incentive distribution rights (IDRs) and participating securities, by the basic and diluted weighted-average number of limited partner units outstanding during the period. Participating securities include LTIP awards that have vested distribution equivalent rights (DERs), which entitle the grantee to a cash payment equal to the cash distribution paid on our outstanding common units.

Diluted net income per limited partner unit is computed based on the weighted-average number of units plus the effect of dilutive potential units outstanding during the period using the two-class method. Our LTIP awards that contemplate the issuance of common units are considered dilutive unless (i) vesting occurs only upon the satisfaction of a performance condition and (ii) that performance condition has yet to be satisfied. LTIP awards that are deemed to be dilutive are reduced by a hypothetical unit repurchase based on the remaining unamortized fair value, as prescribed by the treasury stock method in guidance issued by the FASB.

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The following table sets forth the computation of basic and diluted earnings per limited partner unit for the three and nine months ended September 30, 2012 and 2011 (amounts in thousands, except per unit data):

	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Net income	$ 17,889	$ 15,445	$ 50,914	$ 37,659
Less: General partner s incentive distribution	222	222	666	388
Less: General partner s 2% ownership interest	353	304	1,005	745
Less: Amounts attributable to participating securities (1)	83		248	
Net income available to limited partners	$ 17,231	$ 14,919	$ 48,995	$ 36,526
Numerator for basic and diluted earnings per limited partner unit:				
Allocation of net income amongst limited partner interests:				
Net income allocable to common units	$ 14,340	$ 12,416	$ 40,775	$ 30,047
Net income allocable to Series A subordinated units	2,891	2,503	8,220	6,479
Net income allocable to Series B subordinated units (2)				
Net income available to limited partners	$ 17,231	$ 14,919	$ 48,995	$ 36,526
Denominator:				
Basic weighted average number of limited partner units outstanding: (2)(3)(4)				
Common units	59,202	59,191	59,197	55,345
Series A subordinated units	11,934	11,934	11,934	11,934
Series B subordinated units	13,500	13,500	13,500	13,500
Diluted weighted average number of limited partner units outstanding: (2)(3)(4)				
Common units	59,319	59,202	59,314	55,360
Series A subordinated units	11,934	11,934	11,934	11,934
Series B subordinated units	13,500	13,500	13,500	13,500
Basic and diluted net income per limited partner unit: (2)(3)(4)				
Common units	$ 0.24	$ 0.21	$ 0.69	$ 0.54
Series A subordinated units	$ 0.24	$ 0.21	$ 0.69	$ 0.54
Series B subordinated units	$	$	$	$

(1) Participating securities consist of LTIP awards (see Note 10) containing vested distribution equivalent rights which entitle the grantee to a cash payment equal to the cash distribution paid on our outstanding common units.

(2) For each of the periods presented, our Series B subordinated units were not entitled to participate in our earnings, losses or distributions in accordance with the terms of our partnership agreement as necessary performance conditions have not been satisfied. As a result, no earnings were allocated to the Series B subordinated units in our determination of basic and diluted net income per limited partner unit.

(3) The determination of diluted weighted average units outstanding excludes the impact of equity-classified LTIP awards (see Note 10) which contain provisions whereby vesting occurs only upon the satisfaction of a performance condition, none of which had been satisfied during

any of the periods presented.

(4) The conversion of (i) our Series A subordinated units to common units and (ii) our Series B subordinated units to Series A subordinated units or common units is subject to certain performance conditions. None of these performance conditions had been satisfied as of September 30, 2012 therefore, there is no dilutive impact of such units in our determination of diluted net income per limited partner unit.

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Note 9 Partners Capital and Distributions

Modification of Terms of Series B Subordinated Units

In February 2012, we modified the terms of our Series B subordinated units, which modification was approved by PAA, the owner of all of the Series B subordinated units. The Partnership s Series B subordinated units do not participate in quarterly distributions. Instead, the Series B subordinated units convert into Series A subordinated units or common units in five distinct tranches upon the achievement of defined benchmarks tied to the amount of capacity in service at Pine Prairie and increases in our quarterly distributions. The modification increases the quarterly distribution benchmark for the first three of the five tranches, totaling 7.5 million Series B subordinated units in the aggregate, to an annualized level of $1.71 per unit. Previously, the quarterly distribution levels required to cause conversion for these three tranches were at annualized levels of $1.44, $1.53 and $1.63 per unit. The modification, which was made in recognition of the continued challenging market conditions facing the natural gas storage business, benefits our common unitholders by reducing the number of units on which distributions would otherwise be required to be paid in the case of distributions below the annualized level of $1.71. The following table presents the operational and financial benchmarks, as modified, for conversion of the Series B subordinated units into Series A subordinated units for each tranche (units in millions):

	Series B Subordinated Units to Convert into Series A Subordinated Units	Working Gas Storage Capacity (Bcf)	Annualized Distribution Level (1)	
Tranche 1	2.6	29.6	$	1.71
Tranche 2	2.8	35.6	$	1.71
Tranche 3	2.1	41.6	$	1.71
Tranche 4	3	48	$	1.71
Tranche 5	3	48	$	1.80

(1) For satisfaction of this benchmark, PNG must, for two consecutive quarters, (i) generate distributable cash flow sufficient to pay a quarterly distribution of at least the annualized distribution benchmark on the weighted-average number of common units and Series A subordinated units outstanding during such quarter plus all of such Series B subordinated units and (ii) distribute available cash of at least the annualized distribution benchmark on all outstanding common units and Series A subordinated units and the corresponding distributions on PNG s general partner s 2% interest and the related distributions on the incentive distribution rights. See Note 6 to our consolidated financial statements included in Part IV of our 2011 Annual Report on Form 10-K for a complete discussion of our Series B subordinated units.

Outstanding Units

From December 31, 2011 through September 30, 2012, changes in our issued and outstanding common, Series A subordinated or Series B subordinated units were as follows:

		Subordinated		
	Common	Series A	Series B	Total
Balance, December 31, 2011	59,193,825	11,934,351	13,500,000	84,628,176

Vesting of LTIP awards	11,250			11,250
Balance, September 30, 2012	59,205,075	11,934,351	13,500,000	84,639,426

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Distributions

The following table details the distributions on our common and Series A subordinated units declared for 2012 quarterly periods or paid during the nine months ended September 30, 2012 (in millions, except per unit amounts):

		Distributions Paid					
			Series A				
		Common	Subordinated	General Partner			Distribution
Date Declared	Date Paid or To Be Paid	Units	Units	Incentive	2%	Total	per unit
October 4, 2012	November 14, 2012 (1)	$ 21.2	$ 4.3	$ 0.2	$ 0.5	$ 26.2	$ 0.3575
July 10, 2012	August 14, 2012	$ 21.2	$ 4.3	$ 0.2	$ 0.5	$ 26.2	$ 0.3575
April 10, 2012	May 15, 2012	$ 21.2	$ 4.3	$ 0.2	$ 0.5	$ 26.2	$ 0.3575
January 12, 2012	February 14, 2012	$ 21.2	$ 4.3	$ 0.2	$ 0.5	$ 26.2	$ 0.3575

(1) Payable to unitholders of record on November 2, 2012, for the period July 1, 2012 through September 30, 2012.

Equity Offerings

On February 8, 2011, in connection with the Southern Pines Acquisition, we completed the sale in a private placement of approximately 17.4 million common units to third-party purchasers and approximately 10.2 million common units to PAA for total proceeds of approximately $600 million, including PAA s proportionate general partner contribution.

Note 10 Equity Compensation Plans

Long Term Incentive Plan (LTIP)

For discussion of our equity compensation awards, see Note 12 to our consolidated financial statements included in Part IV of our 2011 Annual Report on Form 10-K.

In February 2012, the Board of Directors of our general partner approved the modification of certain equity compensation awards previously granted under the 2010 LTIP Plan. As a result of the modification, 232,500 equity-classified phantom unit awards will now vest in the following manner: (i) 69,750 awards, with distribution equivalent rights also modified to begin payment in February 2012, will vest upon the date we pay an annualized distribution of at least $1.45, (ii) 69,750 awards, with distribution equivalent rights also modified to begin payment in May 2013, will vest upon the date we pay an annualized distribution of at least $1.50 and (iii) 93,000 awards, with distribution equivalent rights also modified to begin payment in May 2014, will vest upon the date we pay an annualized distribution of at least $1.55. Fifty percent of any awards that have not vested as of the November 2016 distribution date will vest at that time and the remainder will expire. Additionally, 232,500 of equity-classified phantom unit awards with vesting terms originally tied to the conversion of our Series A and Series B subordinated units were modified such that all these awards will now fully vest upon conversion of the Series A subordinated units to common units. Distribution equivalent rights were also granted with respect to these awards beginning February 2012.

Our equity compensation activity for awards denominated in PNG units is summarized in the following table (units in thousands):

	Units (1)	**Weighted Average Grant Date Fair Value per Unit**
Outstanding, December 31, 2011	499	$ 19.53
Granted	131	$ 15.33
Vested	(11)	