NEW JERSEY RESOURCES CORP
Form 10-Q
February 08, 2018

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 DECEMBER 31, 2017
OR
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE TRANSITION PERIOD FROM TO

Commission file number 001 08359

NEW JERSEY RESOURCES CORPORATION
(Exact name of registrant as specified in its charter)

New Jersey (State or other jurisdiction of incorporation or organization)	22 2376465 (I.R.S. Employer Identification Number)
1415 Wyckoff Road, Wall, New Jersey 07719 (Address of principal executive offices)	732 938 1480 (Registrant's telephone number, including area code)

Securities registered pursuant to Section 12 (b) of the Act:

Common Stock $2.50 Par Value (Title of each class)	New York Stock Exchange (Name of each exchange on which registered)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, 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).
Yes: x No: o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company or an emerging growth company. See definitions of “large accelerated filer,” “accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b 2 of the Exchange Act.

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. o

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

The number of shares outstanding of $2.50 par value Common Stock as of February 6, 2018 was 87,594,863.

New Jersey Resources Corporation

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GLOSSARY OF KEY TERMS

Adelphia	Adelphia Gateway, LLC
AFUDC	Allowance for Funds Used During Construction
AOCI	Accumulated Other Comprehensive Income
ASC	Accounting Standards Codification
ASU	Accounting Standards Update
Bcf	Billion Cubic Feet
BGSS	Basic Gas Supply Service
BPU	New Jersey Board of Public Utilities
CIP	Conservation Incentive Program
CME	Chicago Mercantile Exchange
CR&R	Commercial Realty & Resources Corp.
DM	Dominion Midstream Partners, L.P., a master limited partnership
DM Common Units	Common units representing limited partnership interests in DM
DRP	NJR Direct Stock Purchase and Dividend Reinvestment Plan
Dths	Dekatherms
EE	Energy Efficiency
FASB	Financial Accounting Standards Board
FCM	Futures Commission Merchant
FERC	Federal Energy Regulatory Commission
Financial margin	A non-GAAP financial measure, which represents revenues earned from the sale of natural gas less costs of natural gas sold including any transportation and storage costs, and excludes any accounting impact from the change in the fair value of certain derivative instruments
FMB	First Mortgage Bond
GAAP	Generally Accepted Accounting Principles of the United States
Home Services and Other	Home Services and Other Operations
ICE	Intercontinental Exchange
IEC	Interstate Energy Company, LLC
ISDA	The International Swaps and Derivatives Association
ITC	Federal Investment Tax Credit
MGP	Manufactured Gas Plant
Moody's	Moody's Investors Service, Inc.
Mortgage Indenture	The Amended and Restated Indenture of Mortgage, Deed of Trust and Security Agreement between NJNG and U.S. Bank National Association dated as of September 1, 2014
MW	Megawatts
MWh	Megawatt Hour
NAESB	The North American Energy Standards Board
NFE	Net Financial Earnings
NJ RISE	New Jersey Reinvestment in System Enhancement
NJCEP	New Jersey's Clean Energy Program
NJDEP	New Jersey Department of Environmental Protection
NJNG	New Jersey Natural Gas Company
NJNG Credit Facility	NJNG's $250 million unsecured committed credit facility expiring in May 2019
NJR Credit Facility	NJR's $425 million unsecured committed credit facility expiring in September 2020

NJR or The Company	New Jersey Resources Corporation
NJRHS	NJR Home Services Company
Non-GAAP	Not in accordance with Generally Accepted Accounting Principles of the United States

New Jersey Resources Corporation

GLOSSARY OF KEY TERMS
(cont.)

NPNS	Normal Purchase/Normal Sale
NYMEX	New York Mercantile Exchange
O&M	Operation and Maintenance
OCI	Other Comprehensive Income
OPEB	Other Postemployment Benefit Plans
PennEast	PennEast Pipeline Company, LLC
PPA	Power Purchase Agreement
PTC	Federal Production Tax Credit
RAC	Remediation Adjustment Clause
REC	Renewable Energy Certificate
S&P	Standard & Poor's Financial Services, LLC
SAFE	Safety Acceleration and Facility Enhancement
SAVEGREEN	The SAVEGREEN Project®
SBC	Societal Benefits Charge
SEC	U.S. Securities and Exchange Commission
SREC	Solar Renewable Energy Certificate
SRL	Southern Reliability Link
Steckman Ridge	Collectively, Steckman Ridge GP, LLC and Steckman Ridge, LP
Talen	Talen Energy Marketing, LLC
Tetco	Texas Eastern Transmission
The Exchange Act	The Securities Exchange Act of 1934, as amended
The Tax Act	An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, previously known as The Tax Cuts and Jobs Act of 2017
Trustee	U.S. Bank National Association
U.S.	The United States of America
USF	Universal Service Fund

New Jersey Resources Corporation

INFORMATION CONCERNING FORWARD-LOOKING STATEMENTS

Certain statements contained in this report, including, without limitation, statements as to management expectations, assumptions and beliefs presented in Part I, Item 2. “Management's Discussion and Analysis of Financial Condition and Results of Operations,” Part I, Item 3. “Quantitative and Qualitative Disclosures About Market Risk,” Part II, Item I. “Legal Proceedings” and in the notes to the financial statements are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, Section 21E of the Securities Exchange Act of 1934, as amended, and the Private Securities Litigation Reform Act of 1995. Forward-looking statements can also be identified by the use of forward-looking terminology such as “anticipate,” “estimate,” “may,” “could,” “might,” “intend,” “expect,” “beli “will” “plan,” or “should,” or comparable terminology and are made based upon management's current expectations, assumptions and beliefs as of this date concerning future developments and their potential effect on us. There can be no assurance that future developments will be in accordance with management's expectations, assumptions or beliefs, or that the effect of future developments on us will be those anticipated by management.

We caution readers that the expectations, assumptions and beliefs that form the basis for forward-looking statements regarding customer growth, customer usage, qualifications for ITCs, PTCs and SRECs, future rate case proceedings, financial condition, results of operations, cash flows, capital requirements, future capital expenditures, market risk, effective tax rate and other matters for fiscal 2018 and thereafter include many factors that are beyond our ability to control or estimate precisely, such as estimates of future market conditions, the behavior of other market participants and changes in the debt and equity capital markets. The factors that could cause actual results to differ materially from our expectations, assumptions and beliefs include, but are not limited to, those discussed in Item 1A. Risk Factors of our Annual Report on Form 10-K for the fiscal year ended September 30, 2017, as well as the following:

- risks associated with our investments in clean energy projects, including the availability of regulatory and tax incentives, the availability of viable projects, our eligibility for ITCs and PTCs, the future market for SRECs and electricity prices and operational risks related to projects in service;
- our ability to obtain governmental and regulatory approvals, land-use rights, electric grid connection (in the case of clean energy projects) and/or financing for the construction, development and operation of our unregulated energy investments and NJNG’s infrastructure projects in a timely manner;
- risks associated with acquisitions and the related integration of acquired assets with our current operations;
- volatility of natural gas and other commodity prices and their impact on NJNG customer usage, NJNG’s BGSS incentive programs, our Energy Services segment operations and on our risk management efforts;
- the level and rate at which NJNG’s costs and expenses are incurred and the extent to which they are approved for recovery from customers through the regulatory process, including through future base rate case filings;
- the impact of a disallowance of recovery of environmental-related expenditures and other regulatory changes;
- the performance of our subsidiaries;
- operating risks incidental to handling, storing, transporting and providing customers with natural gas;
- access to adequate supplies of natural gas and dependence on third-party storage and transportation facilities for natural gas supply;
- the regulatory and pricing policies of federal and state regulatory agencies;
- timing of qualifying for ITCs and PTCs due to delays or failures to complete planned solar and wind energy projects and the resulting effect on our effective tax rate and earnings;
- the results of legal or administrative proceedings with respect to claims, rates, environmental issues, gas cost prudence reviews and other matters;
- risks related to cyberattacks or failure of information technology systems;
- changes in rating agency requirements and/or credit ratings and their effect on availability and cost of capital to our Company;
- our ability to comply with current and future regulatory requirements;

- the impact of volatility in the equity and credit markets on our access to capital;
- the impact to the asset values and resulting higher costs and funding obligations of our pension and postemployment benefit plans as a result of potential downturns in the financial markets, lower discount rates, revised actuarial assumptions or impacts associated with the Patient Protection and Affordable Care Act;
- commercial and wholesale credit risks, including the availability of creditworthy customers and counterparties, and liquidity in the wholesale energy trading market;
- accounting effects and other risks associated with hedging activities and use of derivatives contracts;
- our ability to optimize our physical assets;
- any potential need to record a valuation allowance for our deferred tax assets;
- changes to tax laws and regulations;
- weather and economic conditions;
- our ability to comply with debt covenants;
- demographic changes in our service territory and their effect on our customer growth;
- the impact of natural disasters, terrorist activities and other extreme events on our operations and customers;
- the costs of compliance with present and future environmental laws, including potential climate change-related legislation;
- environmental-related and other uncertainties related to litigation or administrative proceedings;
- risks related to our employee workforce; and
- risks associated with the management of our joint ventures and partnerships, and investment in a master limited partnership.

While we periodically reassess material trends and uncertainties affecting our results of operations and financial condition in connection with the preparation of management's discussion and analysis of results of operations and financial condition contained in our Quarterly and Annual Reports on Form 10-Q and Form 10-K, respectively, we do not, by including this statement, assume any obligation to review or revise any particular forward-looking statement referenced herein in light of future events.

New Jersey Resources Corporation
Part I

ITEM 1. FINANCIAL STATEMENTS

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)

	Three Months Ended December 31,	
(Thousands, except per share data)	2017	2016
OPERATING REVENUES		
Utility	$209,787	$185,556
Nonutility	495,518	355,472
Total operating revenues	705,305	541,028
OPERATING EXPENSES		
Gas purchases:		
Utility	77,602	61,320
Nonutility	445,084	337,932
Related parties	2,149	2,111
Operation and maintenance	55,111	52,228
Regulatory rider expenses	11,769	12,601
Depreciation and amortization	21,854	19,260
Energy and other taxes	16,491	14,101
Total operating expenses	630,060	499,553
OPERATING INCOME	75,245	41,475
Other income, net	6,927	3,776
Interest expense, net of capitalized interest	11,905	10,615
INCOME BEFORE INCOME TAXES AND EQUITY IN EARNINGS OF AFFILIATES	70,267	34,636
Income tax (benefit) provision	(50,168)	2,018
Equity in earnings of affiliates	3,264	2,311
NET INCOME	$123,699	$34,929
EARNINGS PER COMMON SHARE		
Basic	$1.42	$0.41
Diluted	$1.42	$0.40
DIVIDENDS DECLARED PER COMMON SHARE	$0.2725	$0.255
WEIGHTED AVERAGE SHARES OUTSTANDING		
Basic	86,996	86,084
Diluted	87,347	86,855

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)

	Three Months Ended December 31,	
(Thousands)	2017	2016
Net income	$123,699	$34,929
Other comprehensive (loss) income, net of tax		
Unrealized (loss) gain on available for sale securities, net of tax of $851 and $(3,786), respectively	(2,290)	5,515
	(3,154)	—

Reclassifications of (gains) to net income on available for sale securities, net of tax of $2,178 and $0, respectively		
Adjustment to postemployment benefit obligation, net of tax of $(136) and $(217), respectively	240	317
Other comprehensive (loss) income	(5,204)	5,832
Comprehensive income	$118,495	$40,761

See Notes to Unaudited Condensed Consolidated Financial Statements

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New Jersey Resources Corporation
Part I

ITEM 1. FINANCIAL STATEMENTS
(Continued)

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

	Three Months Ended December 31,	
(Thousands)	2017	2016
CASH FLOWS USED IN OPERATING ACTIVITIES		
Net income	$123,699	$34,929
Adjustments to reconcile net income to cash flows from operating activities		
Unrealized loss on derivative instruments	34,855	28,302
Gain on sale of available for sale securities, net	(5,332)	(2,581)
Depreciation and amortization	21,854	19,260
Amortization of acquired wholesale energy contracts	3,391	—
Allowance for equity used during construction	(852)	(584)
Allowance for bad debt expense	471	230
Deferred income taxes	(44,114)	16,262
Manufactured gas plant remediation costs	(5,147)	(1,619)
Distributions received from equity investees, net of equity in earnings	(257)	1,101
Cost of removal - asset retirement obligations	(332)	(198)
Contributions to postemployment benefit plans	(1,467)	(1,712)
Tax benefit from stock-based compensation	2,831	1,188
Changes in:		
Components of working capital	(189,528)	(150,480)
Other noncurrent assets	31,038	9,823
Other noncurrent liabilities	5,388	15
Cash flows used in operating activities	(23,502)	(46,064)
CASH FLOWS USED IN INVESTING ACTIVITIES		
Expenditures for:		
Utility plant	(34,638)	(31,396)
Solar and wind equipment	(18,387)	(46,785)
Real estate properties and other	(1,313)	(171)
Cost of removal	(12,752)	(7,459)
Investments in equity investees	(7,202)	(4,636)
Distribution from equity investees in excess of equity in earnings	793	688
Cash paid related to acquisition	(10,000)	—
Withdrawal from restricted cash construction fund	(43)	—
Proceeds from sale of available for sale securities	6,616	3,218
Cash flows used in investing activities	(76,926)	(86,541)
CASH FLOWS FROM FINANCING ACTIVITIES		
Payments of long-term debt	(1,690)	(2,716)
Net proceeds from short-term debt	107,200	162,900
Proceeds from sale-leaseback transaction	7,820	9,587
Payments of common stock dividends	(23,607)	(21,931)
Proceeds from waiver discount issuance of common stock	22,690	—
Proceeds from issuance of common stock	3,846	4,616
Purchases of treasury stock	—	(6,355)
Tax withholding payments related to net settled stock compensation	(13,319)	(4,167)

Cash flows from financing activities	102,940	141,934
Change in cash and cash equivalents	2,512	9,329
Cash and cash equivalents at beginning of period	2,226	37,546
Cash and cash equivalents at end of period	$4,738	$46,875
CHANGES IN COMPONENTS OF WORKING CAPITAL		
Receivables	$(192,253)	$(152,180)
Inventories	(2,561)	(13,954)
Recovery of gas costs	17,102	(2,472)
Gas purchases payable	43,284	47,772
Prepaid and accrued taxes	(12,418)	7,954
Accounts payable and other	(25,527)	(12,405)
Restricted broker margin accounts	(21,694)	(26,173)
Customers' credit balances and deposits	6,093	616
Other current assets	(1,554)	362
Total	$(189,528)	$(150,480)
SUPPLEMENTAL DISCLOSURES OF CASH FLOWS INFORMATION		
Cash paid (received) for:		
Interest (net of amounts capitalized)	$9,758	$8,153
Income taxes	$(191)	$(7,020)
Accrued capital expenditures	$26,034	$28,442

See Notes to Unaudited Condensed Consolidated Financial Statements

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New Jersey Resources Corporation
Part I

ITEM 1. FINANCIAL STATEMENTS
(Continued)

CONDENSED CONSOLIDATED BALANCE SHEETS (Unaudited)

ASSETS

(Thousands)	December 31, 2017	September 30, 2017
PROPERTY, PLANT AND EQUIPMENT		
Utility plant, at cost	$ 2,273,071	$ 2,241,324
Construction work in progress	121,679	119,318
Solar and wind equipment, real estate properties and other, at cost	848,900	843,142
Construction work in progress	28,566	7,286
Total property, plant and equipment	3,272,216	3,211,070
Accumulated depreciation and amortization, utility plant	(501,663)	(489,122)
Accumulated depreciation and amortization, solar and wind equipment, real estate properties and other	(121,260)	(112,207)
Property, plant and equipment, net	2,649,293	2,609,741
CURRENT ASSETS		
Cash and cash equivalents	4,738	2,226
Customer accounts receivable		
Billed	325,406	196,467
Unbilled revenues	70,138	7,202
Allowance for doubtful accounts	(5,274)	(5,181)
Regulatory assets	41,574	50,791
Gas in storage, at average cost	203,447	202,063
Materials and supplies, at average cost	13,121	11,944
Prepaid and accrued taxes	39,581	24,764
Derivatives, at fair value	46,299	30,081
Restricted broker margin accounts	52,850	25,827
Other	34,199	33,260
Total current assets	826,079	579,444
NONCURRENT ASSETS		
Investments in equity method investees	179,429	172,585
Regulatory assets	362,150	375,919
Derivatives, at fair value	5,537	9,164
Available for sale securities	55,995	65,752
Intangible assets	37,693	41,084
Other noncurrent assets	70,752	74,818
Total noncurrent assets	711,556	739,322
Total assets	$ 4,186,928	$ 3,928,507

See Notes to Unaudited Condensed Consolidated Financial Statements

New Jersey Resources Corporation
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ITEM 1. FINANCIAL STATEMENTS
(Continued)

CAPITALIZATION AND LIABILITIES

(Thousands, except share data)	December 31, 2017	September 30, 2017
CAPITALIZATION		
Common stock, $2.50 par value; authorized 150,000,000 shares; outstanding December 31, 2017 — 87,475,456; September 30, 2017 — 86,555,507	$ 225,095	$ 222,258
Premium on common stock	255,142	219,696
Accumulated other comprehensive loss, net of tax	(8,460)	(3,256)
Treasury stock at cost and other; shares December 31, 2017 — 2,507,313; September 30, 2017 — 2,347,380	(91,859)	(70,039)
Retained earnings	967,852	867,984
Common stock equity	1,347,770	1,236,643
Long-term debt	1,001,183	997,080
Total capitalization	2,348,953	2,233,723
CURRENT LIABILITIES		
Current maturities of long-term debt	166,167	165,375
Short-term debt	373,200	266,000
Gas purchases payable	203,401	160,115
Gas purchases payable to related parties	1,150	1,152
Accounts payable and other	75,924	96,878
Dividends payable	23,831	23,586
Accrued taxes	4,430	2,031
Regulatory liabilities	434	78
New Jersey clean energy program	12,626	14,202
Derivatives, at fair value	96,788	46,544
Customers' credit balances and deposits	33,050	26,957
Total current liabilities	991,001	802,918
NONCURRENT LIABILITIES		
Deferred income taxes	238,367	514,708
Deferred investment tax credits	4,216	4,297
Deferred gain	27,531	27,728
Derivatives, at fair value	25,759	11,330
Manufactured gas plant remediation	144,046	149,000
Postemployment employee benefit liability	128,574	128,888
Regulatory liabilities	237,838	14,507
Asset retirement obligation	31,792	31,420
Other	8,851	9,988
Total noncurrent liabilities	846,974	891,866
Commitments and contingent liabilities (Note 12)		
Total capitalization and liabilities	$ 4,186,928	$ 3,928,507

See Notes to Unaudited Condensed Consolidated Financial Statements

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. NATURE OF THE BUSINESS

New Jersey Resources Corporation provides regulated gas distribution services and operates certain unregulated businesses primarily through the following subsidiaries:

New Jersey Natural Gas Company provides natural gas utility service to approximately 534,400 retail customers in central and northern New Jersey and is subject to rate regulation by the BPU. NJNG comprises the Natural Gas Distribution segment;

NJR Clean Energy Ventures Corporation, the Company's clean energy subsidiary, comprises the Clean Energy Ventures segment and consists of the Company's capital investments in commercial and residential solar projects located throughout New Jersey and onshore wind investments in Montana, Iowa, Kansas, Wyoming and Pennsylvania;

NJR Energy Services Company and NJR Retail Services Company comprise the Energy Services segment. Energy Services maintains and transacts around a portfolio of natural gas storage and transportation capacity contracts and provides physical wholesale energy and energy management services in the U.S. and Canada and provides retail natural gas supply and transportation services to commercial and industrial customers in Delaware, Maryland, Pennsylvania and New Jersey;

NJR Midstream Holdings Corporation, which comprises the Midstream segment, invests in energy-related ventures through its subsidiaries, NJR Steckman Ridge Storage Company, which holds the Company's 50 percent combined ownership interest in Steckman Ridge, located in Pennsylvania, NJR Pipeline Company, which holds the Company's 20 percent ownership interest in PennEast and NJNR Pipeline Company, which holds the Company's 1.84 million Common Units of Dominion Midstream Partners, L.P. See Note 6. Investments in Equity Investees for more information; and

NJR Retail Holdings Corporation has two principal subsidiaries, NJR Home Services Company, which provides heating, central air conditioning, standby generators, solar and other indoor and outdoor comfort products to residential homes throughout New Jersey, and Commercial Realty & Resources Corporation, which owns commercial real estate. NJR Home Services Company and Commercial Realty & Resources Corporation are included in Home Services and Other operations.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accompanying Unaudited Condensed Consolidated Financial Statements have been prepared by NJR in accordance with the rules and regulations of the SEC and GAAP. The September 30, 2017 Balance Sheet data is derived from the audited financial statements of the Company. These Unaudited Condensed Consolidated Financial Statements should be read in conjunction with the consolidated financial statements and the notes thereto included in NJR's 2017 Annual Report on Form 10-K.

The Unaudited Condensed Consolidated Financial Statements include the accounts of NJR and its subsidiaries. In the opinion of management, the accompanying Unaudited Condensed Consolidated Financial Statements reflect all adjustments necessary for a fair presentation of the results of the interim periods presented. These adjustments are of a normal and recurring nature. Because of the seasonal nature of NJR's utility and wholesale energy services operations, in addition to other factors, the financial results for the interim periods presented are not indicative of the results that are to be expected for the fiscal year ending September 30, 2018. Intercompany transactions and accounts have been eliminated.

Gas in Storage

The following table summarizes gas in storage, at average cost by company as of:

	December 31, 2017		September 30, 2017	
($ in thousands)	Gas in Storage	Bcf	Gas in Storage	Bcf
Energy Services	$144,456	51.9	$122,884	53.9
Natural Gas Distribution	58,991	16.5	79,179	21.8
Total	$203,447	68.4	$202,063	75.7

Sales Tax Accounting

Sales tax that is collected from customers is presented in both operating revenues and operating expenses on the Unaudited Condensed Consolidated Statements of Operations totaled $13.3 million during the three months ended December 31, 2017, and $11.2 million during the three months ended December 31, 2016. Effective January 1, 2017, the New Jersey sales tax rate decreased from 7 percent to 6.875 percent. Effective January 1, 2018, the New Jersey sales tax rate decreased again to 6.625 percent.

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Continued)

Available for Sale Securities

As of December 31, 2017, included in available for sale securities on the Unaudited Condensed Consolidated Balance Sheets is an investment in a publicly traded energy company. The Company's available for sale securities had a fair value of $56 million and $65.8 million as of December 31, 2017 and September 30, 2017, respectively. Total unrealized gains associated with this investment is included as a part of accumulated other comprehensive income, a component of common stock equity and was $9.9 million, $5.6 million after tax, and $12.8 million, $7.7 million after tax, as of December 31, 2017 and September 30, 2017, respectively.

During the three months ended December 31, 2017 and 2016, NJR received proceeds of approximately $6.6 million and $3.2 million, respectively, from the sale of available for sale securities and realized a pre-tax gain of $5.3 million and $2.6 million, respectively, which is included in other income, net on the Unaudited Condensed Consolidated Statements of Operations. Reclassifications of realized gains out of other comprehensive income into income are determined based on average cost.

Customer Accounts Receivable

Customer accounts receivable include outstanding billings from the following subsidiaries as of:

(Thousands)	December 31, 2017		September 30, 2017	
Energy Services	$246,203	76 %	$150,322	77 %
Natural Gas Distribution (1)	72,067	22	37,432	19
Clean Energy Ventures	3,072	1	2,655	1
NJRHS and other	4,064	1	6,058	3
Total	$325,406	100%	$196,467	100%

(1) Does not include unbilled revenues of $70.1 million and $7.2 million as of December 31, 2017 and September 30, 2017, respectively.

Loans Receivable

NJNG currently provides loans, with terms ranging from three to 10 years, to customers that elect to purchase and install certain energy efficient equipment in accordance with its BPU-approved SAVEGREEN program. The loans are recognized at net present value on the Unaudited Condensed Consolidated Balance Sheets. The Company recorded $9.4 million and $8.9 million in other current assets and $40.7 million and $40.4 million in other noncurrent assets as of December 31, 2017 and September 30, 2017, respectively, on the Unaudited Condensed Consolidated Balance Sheets, related to the loans.

NJNG's policy is to establish an allowance for doubtful accounts when loan balances are in arrears for more than 60 days. As of December 31, 2017 and September 30, 2017, there was no allowance for doubtful accounts established for the SAVEGREEN loans.

Reclassification

Certain prior period activities for the three months ended December 31, 2016, were reclassified to conform to the current period presentation.

Recently Adopted Updates to the Accounting Standards Codification

Inventory

In July 2015, the FASB issued ASU No. 2015-11, an amendment to ASC 330, Inventory, which requires entities to measure most inventory "at the lower of cost or net realizable value," thereby simplifying the current guidance under which an entity must measure inventory at the lower of cost or market. The Company adopted the new guidance in the first quarter of fiscal 2018 and applied the new provisions on a prospective basis, which did not impact its financial position, results of operations or cash flows upon adoption.

Other Recent Updates to the Accounting Standards Codification

Revenue

In May 2014, the FASB issued ASU No. 2014-09, and added Topic 606, Revenue from Contracts with Customers, to the ASC. ASC 606 supersedes ASC 605, Revenue Recognition, as well as most industry-specific guidance, and prescribes a single, comprehensive revenue recognition model designed to improve financial reporting comparability across entities, industries, jurisdictions and capital markets. In August 2015, the FASB issued ASU No. 2015-14, which defers the implementation of the

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Continued)

new guidance for one year. The new guidance will not be early adopted and will be effective for the Company's fiscal year ending September 30, 2019, and interim periods within that year.

The Company has concluded that its tariff based sales of natural gas will be within the scope of the new guidance. However, it does not anticipate any modification to the pattern of revenue recognition from such sales. The Company has also evaluated its renewable asset PPA arrangements and does not anticipate any modification to the pattern of revenue recognition of the related electricity, capacity and REC sales. Revenues from RECs sold as part of a bundled arrangement will be recognized in the same period as the related generation, consistent with current practice.

Based on the review of customer contracts to date, the Company is not anticipating a material impact to its financial position, results of operations or cash flows upon adoption. The Company anticipates significant new disclosures as a result of the implementation of ASC 606 and currently expects to transition to the new guidance using the modified retrospective approach. The Company is also monitoring industry specific developments that may have an impact.

Financial Instruments

In January 2016, the FASB issued ASU No. 2016-01, an amendment to ASC 825, Financial Instruments, to address certain aspects of the recognition, measurement, presentation and disclosure of financial instruments. The standard affects investments in equity securities that do not result in consolidation and are not accounted for under the equity method and the presentation of certain fair value changes for financial liabilities measured at fair value. It also simplifies the impairment assessment of equity investments without a readily determinable fair value by requiring a qualitative assessment. The guidance is effective for the Company's fiscal year ending September 30, 2019, and interim periods within that year. Upon adoption, the amendment will be applied on a modified retrospective basis. The Company evaluated the amendment and noted that, upon adoption, subsequent changes to the fair value of the Company's available for sale securities will be recorded in the Consolidated Statement of Operations as opposed to other comprehensive income. The Company does not expect any other material impacts to its financial position, results of operations or cash flows upon adoption.

In June 2016, the FASB issued ASU No. 2016-13, an amendment to ASC 326, Financial Instruments - Credit Losses, which changes the impairment model for certain financial assets that have a contractual right to receive cash, including trade and loan receivables. The new model requires recognition based upon an estimation of expected credit losses rather than recognition of losses when it is probable that they have been incurred. An entity will apply the amendment through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective. The guidance is effective for the Company's fiscal year ending September 30, 2021, and interim periods within that year, with early adoption permitted. The Company is currently evaluating the amendment to understand the impact on its financial position, results of operations and cash flows upon adoption and will apply the new guidance to its trade and loan receivables on a modified retrospective basis.

Leases

In February 2016, the FASB issued ASU No. 2016-02, an amendment to ASC 842, Leases, which provides for a comprehensive overhaul of the lease accounting model and changes the definition of a lease within the accounting literature. Under the new standard, all leases with a term greater than one year will be recorded on the balance sheet. Amortization of the related asset will be accounted for using one of two approaches prescribed by the guidance.

Additional disclosures will be required to allow the user to assess the amount, timing and uncertainty of cash flows arising from leasing activities. A modified retrospective transition approach is required for leases existing at the time of adoption. The guidance is effective for the Company’s fiscal year ending September 30, 2020, and interim periods within that year, with early adoption permitted. The Company continues to evaluate the provisions of ASC 842 and is actively monitoring industry specific developments including the exposure draft issued by the FASB that would introduce a land easement practical expedient to ASC 842. At this time, the Company does not plan to early adopt the new guidance and expects to elect the practical expedient package in the new guidance during transition.

Statement of Cash Flows

In August 2016, the FASB issued ASU No. 2016-15, an amendment to ASC 230, Statement of Cash Flows, which addresses eight specific cash flow issues for which there has been diversity in practice. The guidance is effective for the Company’s fiscal year ending September 30, 2019, and interim periods within that year with early adoption permitted. Upon adoption, the amendment will be applied on a retrospective basis. The Company does not expect any material impacts to its cash flows upon adoption.

In November 2016, the FASB issued ASU No. 2016-18, an amendment to ASC 230, Statement of Cash Flows, which requires that any amounts that are deemed to be restricted cash or restricted cash-equivalents be included in cash and cash-equivalent

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balances on the cash flow statement and, therefore, transfers between cash and restricted cash accounts will no longer be recognized within the statement of cash flows. The guidance is effective for the Company’s fiscal year ending September 30, 2019, with early adoption permitted. Upon adoption, the amendment will be applied on a retrospective basis. Based on the Company's historical restricted cash balances, it does not expect any material impacts to its financial position, results of operations or cash flows upon adoption.

Business Combinations

In January 2017, the FASB issued ASU No. 2017-01, an amendment to ASC 805, Business Combinations, clarifying the definition of a business in the ASC, which is intended to reduce the complexity surrounding the assessment of a transaction as an asset acquisition or business combination. The amendment provides an initial fair value screen to reduce the number of transactions that would fit the definition of a business, and when the screen threshold is not met, provides an updated model that further clarifies the characteristics of a business. The guidance is effective for the Company’s fiscal year ending September 30, 2019, and interim periods within that year, with early adoption permitted. Upon adoption, the amendment will be applied on a prospective basis. The amendment could potentially have material impacts on future transactions that the Company may enter into by altering the Company’s conclusion on the accounting applied to acquisitions.

Gains and Losses from the Derecognition of Nonfinancial Assets

In February 2017, the FASB issued ASU No. 2017-05, an amendment to ASC 610-20, Other Income - Gains and Losses from the Derecognition of Nonfinancial Assets, which clarifies the scope and accounting related to the derecognition of nonfinancial assets, including partial sales and contributions of nonfinancial assets to a joint venture or other non-controlled investee. The guidance is effective concurrently with ASC 606, which is effective for the Company’s fiscal year ending September 30, 2019, and interim periods within that year with early adoption permitted. ASU No. 2017-05 may be applied retrospectively for all periods presented or retrospectively with a cumulative-effect adjustment at the date of adoption. The Company has determined that to the extent a deferred gain exists related to nonfinancial assets on the balance sheet upon adoption, it would be recognized under the new accounting guidance as a cumulative effect adjustment to the opening balance of retained earnings for the first quarter of fiscal 2019.

Compensation - Retirement Benefits

In March 2017, the FASB issued ASU No. 2017-07, an amendment to ASC 715, Compensation - Retirement Benefits, which changes the presentation of net periodic benefit cost on the income statement by requiring companies to present all components of net periodic benefit cost, other than service cost, outside a subtotal of income from operations. The amendment also states that only the service cost component of net periodic benefits costs is eligible for capitalization, when applicable. The guidance is effective for the Company’s fiscal year ending September 30, 2019, and interim periods within that year, with early adoption permitted. Upon adoption, the amendment will be applied on a retrospective basis for presentation and changes to capitalization of costs will be applied on a prospective basis. The Company is continuing to evaluate the amendment to fully understand the impact on its financial position, results of operations and cash flows upon adoption. The Company is also monitoring industry specific developments on the new guidance to determine the appropriate treatment of these changes in a rate regulated environment.

Stock Compensation

In May 2017, the FASB issued ASU No. 2017-09, an amendment to ASC 718, Compensation - Stock Compensation, which clarifies the accounting for changes to the terms or conditions of share-based payments. The guidance is effective for the Company's fiscal year ending September 30, 2019, and interim periods within that year, with early adoption permitted. Upon adoption, the amendments will be applied prospectively to awards modified on or after the adoption date. The Company is currently evaluating the amendments to understand the impact on its financial position, results of operations and cash flows upon adoption.

Derivatives and Hedging

In August 2017, the FASB issued ASU No. 2017-12, an amendment to ASC 815, Derivatives and Hedging, which is intended to make targeted improvements to the accounting for hedging activities by better aligning an entity's risk management activities and financial reporting for hedging relationships. These amendments modify the accounting for both nonfinancial and financial risk components and align the recognition and presentation of the effects of the hedging instrument and the hedged item in the financial statements. Additionally, the amendments are intended to simplify the application of the hedge accounting guidance and provide relief to companies by easing certain hedge documentation requirements. The guidance is effective for the Company's fiscal year ending September 30, 2020, and interim periods within that year, with early adoption permitted. Upon adoption, the

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transition requirements and elections will be applied to hedging relationships existing on the date of adoption. The Company does not currently apply hedge accounting to any of its risk management activities and thus does not expect the amendments to have any impact on its financial position, results of operations and cash flows upon adoption.

3. REGULATION

NJNG is subject to cost-based regulation, therefore, it is permitted to recover authorized operating expenses and earn a reasonable return on its utility capital investments based on the BPU's approval. The impact of the ratemaking process and decisions authorized by the BPU allows NJNG to capitalize or defer certain costs that are expected to be recovered from its customers as regulatory assets and to recognize certain obligations representing amounts that are probable future expenditures as regulatory liabilities in accordance with accounting guidance applicable to regulated operations.

NJNG's recovery of costs is facilitated through its base rates, BGSS and other regulatory tariff riders. NJNG is required to make annual filings to the BPU for review of its BGSS, CIP and various other programs and related rates. Annual rate changes are typically requested to be effective at the beginning of the following fiscal year. All rate and program changes are subject to proper notification and BPU review and approval. In addition, NJNG is also permitted to implement certain BGSS rate changes on an interim basis with proper notification to the BPU.

Regulatory assets and liabilities included on the Unaudited Condensed Consolidated Balance Sheets are comprised of the following:

(Thousands)	December 31, 2017	September 30, 2017
Regulatory assets-current		
New Jersey Clean Energy Program	$ 12,626	$ 14,202
Underrecovered gas costs	490	9,910
Derivatives at fair value, net	18,471	9,010
Conservation Incentive Program	9,987	17,669
Total current regulatory assets	$ 41,574	$ 50,791
Regulatory assets-noncurrent		
Environmental remediation costs		
Expended, net of recoveries	$ 31,236	$ 28,547
Liability for future expenditures	144,046	149,000
Deferred income taxes	16,356	21,795
SAVEGREEN	13,419	16,302
Postemployment and other benefit costs	138,681	141,433
Deferred Post-Tropical Cyclone Sandy costs	12,487	13,030
Other noncurrent regulatory assets	5,925	5,812
Total noncurrent regulatory assets	$ 362,150	$ 375,919
Regulatory liability-current		
Derivatives at fair value, net	$ 434	$ 78
Total current regulatory liabilities	$ 434	$ 78
Regulatory liabilities-noncurrent		
Deferred income taxes [1]	$ 229,315	$ —

Cost of removal obligation	—	7,902
Derivatives at fair value, net	—	146
New Jersey Clean Energy Program	7,527	5,795
Other noncurrent regulatory liabilities	996	664
Total noncurrent regulatory liabilities	$ 237,838	$ 14,507

(1) Includes an adjustment related to the re-measurement of NJNG's net deferred tax liabilities to reflect the change in federal tax rates enacted in the Tax Act. For a more detailed discussion of the Tax Act, see Note 11. Income Taxes.

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Regulatory filings and/or actions that occurred during the current fiscal year include the following:

- On October 20, 2017, the BPU approved NJNG's filing to decrease its EE recovery rate, which will result in an annual decrease of $3.9 million, effective November 1, 2017.

- On November 17, 2017, NJNG filed its annual SBC application requesting to recover remediation expenses incurred through June 30, 2017, a reduction in the RAC, which will result in an annual decrease of $2.4 million and to increase the NJCEP factor, which will result in an annual increase of $1.8 million, effective April 1, 2018.

- On December 22, 2017, the Tax Act was signed into law, which resulted in a reduction in the federal corporate tax rate. As a result, NJNG recorded a regulatory liability of $228 million, which includes $164.3 million for the revaluation of its deferred income taxes and $63.7 million for the accounting of the income tax effects on the revaluation. The revaluation is based on certain assumptions and estimations NJNG made with respect to its deferred taxes, as well as the effects from the Tax Act, and as such are subject to change if and when assumptions are updated. See Note 11. Income Taxes for a more detailed discussion on the Tax Act. On January 31, 2018, the BPU issued an Order directing the New Jersey utilities to submit filings by March 2, 2018, proposing the prospective change in rates as a result of the Tax Act to be effective April 1, 2018, the method to return to customers the rate difference from January 1, 2018, through March 31, 2018, and an outline of the method by which the excess deferred taxes would be returned to customers. The excess deferred taxes are primarily related to timing differences associated with utility plant depreciation and are subject to IRS normalization rules, which require amortization over the remaining life of the utility plant. The return to customers of the plant-related excess deferred taxes, as well as any non-plant related excess deferred taxes will be addressed in NJNG’s filing to the BPU.

4. DERIVATIVE INSTRUMENTS

The Company is subject to commodity price risk due to fluctuations in the market price of natural gas, SRECs and electricity. To manage this risk, the Company enters into a variety of derivative instruments including, but not limited to, futures contracts, physical forward contracts, financial options and swaps to economically hedge the commodity price risk associated with its existing and anticipated commitments to purchase and sell natural gas, SRECs and electricity. In addition, the Company may utilize foreign currency derivatives to hedge Canadian dollar denominated gas purchases and/or sales. Therefore, the Company's primary underlying risks include commodity prices, interest rates and foreign currency. These contracts are accounted for as derivatives. Accordingly, all of the financial and certain of the Company's physical derivative instruments are recorded at fair value on the Unaudited Condensed Consolidated Balance Sheets. For a more detailed discussion of the Company's fair value measurement policies and level disclosures associated with NJR's derivative instruments, see Note 5. Fair Value.

Energy Services

Energy Services chooses not to designate its financial commodity and physical forward commodity derivatives as accounting hedges or to elect NPNS. The changes in the fair value of these derivatives are recorded as a component of gas purchases or operating revenues, as appropriate for Energy Services, on the Unaudited Condensed Consolidated Statements of Operations as unrealized gains or losses. For Energy Services at settlement, realized gains and losses on all financial derivative instruments are recognized as a component of gas purchases and realized gains and losses on all physical derivatives follow the presentation of the related unrealized gains and losses as a component of either gas purchases or operating revenues.

Energy Services also enters into natural gas transactions in Canada and, consequently, is exposed to fluctuations in the value of Canadian currency relative to the U.S. dollar. Energy Services may utilize foreign currency derivatives to lock in the exchange rate associated with natural gas transactions denominated in Canadian currency. The derivatives may include currency forwards, futures, or swaps and are accounted for as derivatives. These derivatives are typically used to hedge demand fee payments on pipeline capacity, storage and gas purchase agreements.

As a result of Energy Services entering into transactions to borrow natural gas, commonly referred to as “park and loans,” an embedded derivative is recognized relating to differences between the fair value of the amount borrowed and the fair value of the amount that will ultimately be repaid, based on changes in the forward price for natural gas prices at the borrowed location over the contract term. This embedded derivative is accounted for as a forward sale in the month in which the repayment of the borrowed gas is expected to occur, and is considered a derivative transaction that is recorded at fair value on the Unaudited Condensed Consolidated Balance Sheets, with changes in value recognized in current period earnings.

Expected production of SRECs is hedged through the use of forward and futures contracts. All contracts require the Company to physically deliver SRECs through the transfer of certificates as per contractual settlement schedules. The Company applies NPNS accounting to SREC forward and futures contracts entered into on or before December 31, 2015. Effective for contracts executed on or after January 1, 2016, Energy Services no longer elects NPNS accounting treatment on all SREC forward sales contracts and recognizes changes in the fair value of these derivatives as a component of operating revenues. Upon settlement of the contract, the related revenue is recognized when the SREC is transferred to the counterparty.

NPNS is a contract-by-contract election and, where it makes sense to do so, we can and may elect normal accounting for certain contracts.

Natural Gas Distribution

Changes in fair value of NJNG's financial commodity derivatives are recorded as a component of regulatory assets or liabilities on the Unaudited Condensed Consolidated Balance Sheets. The Company elects NPNS accounting treatment on all physical commodity contracts that NJNG entered into on or before December 31, 2015, and accounts for these contracts on an accrual basis. Accordingly, physical natural gas purchases are recognized in regulatory assets or liabilities on the Unaudited Condensed Consolidated Balance Sheets when the contract settles and the natural gas is delivered. The average cost of natural gas is charged to expense in the current period earnings based on the BGSS factor times the therm sales. Effective for contracts executed on or after January 1, 2016, NJNG no longer elects NPNS accounting treatment on all physical forward commodity contracts. However, since NPNS is a contract-by-contract election, where it makes sense to do so, we can and may elect certain contracts to be normal. Because NJNG recovers these amounts through future BGSS rates as increases or decreases to the cost of natural gas in NJNG’s tariff for gas service, the changes in fair value of these contracts are deferred as a component of regulatory assets or liabilities on the Unaudited Condensed Consolidated Balance Sheets.

In June 2015, NJNG entered into a BPU-approved treasury lock transaction to fix a benchmark treasury rate of 3.26 percent associated with a forecasted $125 million debt issuance expected in May 2018. This forecasted debt issuance coincides with the maturity of NJNG's existing $125 million, 5.6 percent notes due May 15, 2018. The change in fair value of NJNG's treasury lock agreement is recorded as a component of regulatory assets or liabilities on the Unaudited Condensed Consolidated Balance Sheets since NJNG believes that the market value upon settlement will be recovered in future rates. Upon settlement, any gain or loss will be amortized into earnings over the life of the future underlying debt issuance.

Fair Value of Derivatives

The following table reflects the fair value of NJR's derivative assets and liabilities recognized on the Unaudited Condensed Consolidated Balance Sheets as of:

		Fair Value			
		December 31, 2017		September 30, 2017	
(Thousands)	Balance Sheet Location	Asset Derivatives	Liability Derivatives	Asset Derivatives	Liability Derivatives

Derivatives not designated as hedging instruments:					
Natural Gas Distribution:					
Physical commodity contracts	Derivatives - current	$ 487	$ 53	$ 151	$ 72
Financial commodity contracts	Derivatives - current	—	3,478	—	1,149
Interest rate contracts	Derivatives - current	—	12,534	—	8,467
Energy Services:					
Physical commodity contracts	Derivatives - current	13,247	24,531	14,588	16,589
	Derivatives - noncurrent	2,801	14,256	7,127	8,710
Financial commodity contracts	Derivatives - current	32,559	56,188	15,302	20,267
	Derivatives - noncurrent	2,706	11,477	2,033	2,620
Foreign currency contracts	Derivatives - current	6	4	40	—
	Derivatives - noncurrent	30	26	4	—
Total fair value of derivatives		$ 51,836	$ 122,547	$ 39,245	$ 57,874

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Offsetting of Derivatives

The Company transacts under master netting arrangements or equivalent agreements that allow it to offset derivative assets and liabilities with the same counterparty. However, the Company's policy is to present its derivative assets and liabilities on a gross basis at the contract level unit of account on the Unaudited Condensed Consolidated Balance Sheets.

The following table summarizes the reported gross amounts, the amounts that the Company has the right to offset but elects not to, financial collateral, as well as the net amounts the Company could present on the Unaudited Condensed Consolidated Balance Sheets but elects not to.

(Thousands)	Amounts Presented on Balance Sheets (1)	Offsetting Derivative Instruments (2)	Financial Collateral Received/Pledged (3)	Net Amounts (4)
As of December 31, 2017:				
Derivative assets:				
Energy Services				
Physical commodity contracts	$16,048	$(3,137)	$ (200)	$12,711
Financial commodity contracts	35,265	(29,434)	(5,327)	504
Foreign currency contracts	36	(30)	—	6
Total Energy Services	$51,349	$(32,601)	$ (5,527)	$13,221
Natural Gas Distribution				
Physical commodity contracts	$487	$(25)	$ —	$462
Total Natural Gas Distribution	$487	$(25)	$ —	$462
Derivative liabilities:				
Energy Services				
Physical commodity contracts	$38,787	$(3,137)	$ —	$35,650
Financial commodity contracts	67,665	(29,434)	(38,231)	—
Foreign currency contracts	30	(30)	—	—
Total Energy Services	$106,482	$(32,601)	$ (38,231)	$35,650
Natural Gas Distribution				
Physical commodity contracts	$53	$(25)	$ —	$28
Financial commodity contracts	3,478	—	(3,478)	—
Interest rate contracts	12,534	—	—	12,534
Total Natural Gas Distribution	$16,065	$(25)	$ (3,478)	$12,562
As of September 30, 2017:				
Derivative assets:				
Energy Services				
Physical commodity contracts	$21,715	$(2,173)	$ (200)	$19,342
Financial commodity contracts	17,335	(14,121)	—	3,214
Foreign currency contracts	44	—	—	44
Total Energy Services	$39,094	$(16,294)	$ (200)	$22,600
Natural Gas Distribution				

Physical commodity contracts	$151	$(20)	$ —	$131
Total Natural Gas Distribution	$151	$(20)	$ —	$131
Derivative liabilities:				
Energy Services				
Physical commodity contracts	$25,299	$(2,173)	$ —	$23,126
Financial commodity contracts	22,887	(14,121)	(8,766)	—
Total Energy Services	$48,186	$(16,294)	$ (8,766)	$23,126
Natural Gas Distribution				
Physical commodity contracts	$72	$(20)	$ —	$52
Financial commodity contracts	1,149	—	(1,149)	—
Interest rate contracts	8,467	—	—	8,467
Total Natural Gas Distribution	$9,688	$(20)	$ (1,149)	$8,519

(1) Derivative assets and liabilities are presented on a gross basis on the balance sheet as the Company does not elect balance sheet offsetting under ASC 210-20.

(2) Includes transactions with NAESB netting election, transactions held by FCMs with net margining and transactions with ISDA netting.

(3) Financial collateral includes cash balances at FCMs as well as cash received from or pledged to other counterparties.

(4) Net amounts represent presentation of derivative assets and liabilities if the Company were to elect balance sheet offsetting under ASC 210-20.

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Energy Services utilizes financial derivatives to economically hedge the gross margin associated with the purchase of physical gas to be used for storage injection and its subsequent sale at a later date. The gains or (losses) on the financial transactions that are economic hedges of the cost of the purchased gas are recognized prior to the gains or (losses) on the physical transaction, which are recognized in earnings when the natural gas is delivered. Therefore, mismatches between the timing of the recognition of realized gains or (losses) on the financial derivative instruments and gains or (losses) associated with the actual sale of the natural gas that is being economically hedged along with fair value changes in derivative instruments creates volatility in the results of Energy Services, although the Company's intended economic results relating to the entire transaction are unaffected.

The following table reflects the effect of derivative instruments on the Unaudited Condensed Consolidated Statements of Operations as of:

(Thousands)	Location of gain (loss) recognized in income on derivatives	Amount of gain (loss) recognized in income on derivatives Three Months Ended December 31,	
Derivatives not designated as hedging instruments:		2017	2016
Energy Services:			
Physical commodity contracts	Operating revenues	$1,210	$1,743
Physical commodity contracts	Gas purchases	(22,697)	(8,799)
Financial commodity contracts	Gas purchases	(25,997)	(30,611)
Foreign currency contracts	Gas purchases	(48)	(86)
Total unrealized and realized gains (losses)		$(47,532)	$(37,753)

NJNG's derivative contracts are part of the Company's risk management activities that relate to its natural gas purchases, BGSS incentive programs and debt financing. These transactions are entered into pursuant to regulatory approval. At settlement, the resulting gains and/or losses are payable to or recoverable from utility customers and are deferred in regulatory assets or liabilities resulting in no impact to earnings. The following table reflects the (losses) gains associated with NJNG's derivative instruments as of:

	Three Months Ended December 31,	
(Thousands)	2017	2016
Natural Gas Distribution:		
Physical commodity contracts	$(2,976)	$1,050
Financial commodity contracts	(8,808)	11,178
Interest rate contracts	(4,067)	20,371
Total unrealized and realized (losses) gains	$(15,851)	$32,599

NJNG and Energy Services had the following outstanding long (short) derivatives as of:

Volume (Bcf)	
December 31, 2017	September 30, 2017

Natural Gas Distribution	Futures	20.4	18.2
	Physical	26.8	32.1
Energy Services	Futures	(33.4)	(16.4)
	Physical	(4.6)	(13.1)

Not included in the previous table are Energy Services' gross notional amount of foreign currency transactions of approximately $9.7 million, NJNG's treasury lock agreement as previously discussed and 403,000 SRECs at Energy Services that are open as of December 31, 2017.

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Broker Margin

Futures exchanges have contract specific margin requirements that require the posting of cash or cash equivalents relating to traded contracts. Margin requirements consist of initial margin that is posted upon the initiation of a position, maintenance margin that is usually expressed as a percent of initial margin, and variation margin that fluctuates based on the daily marked-to-market relative to maintenance margin requirements. The Company maintains separate broker margin accounts for the Natural Gas Distribution and Energy Services segments. The balances are as follows:

(Thousands)	Balance Sheet Location	December 31, 2017	September 30, 2017
Natural Gas Distribution	Broker margin - Current assets	$ 4,632	$ 2,661
Energy Services	Broker margin - Current assets	$ 48,218	$ 23,166

Wholesale Credit Risk

NJNG, Energy Services and Clean Energy Ventures are exposed to credit risk as a result of their sales/wholesale marketing activities. As a result of the inherent volatility in the prices of natural gas commodities, derivatives, SRECs, electricity and RECs, the market value of contractual positions with individual counterparties could exceed established credit limits or collateral provided by those counterparties. If a counterparty fails to perform the obligations under its contract (e.g., failed to deliver or pay for natural gas, SRECs, electricity or RECs), then the Company could sustain a loss.

NJR monitors and manages the credit risk of its wholesale operations through credit policies and procedures that management believes reduce overall credit risk. These policies include a review and evaluation of current and prospective counterparties' financial statements and/or credit ratings, daily monitoring of counterparties' credit limits and exposure, daily communication with traders regarding credit status and the use of credit mitigation measures, such as collateral requirements and netting agreements. Examples of collateral include letters of credit and cash received for either prepayment or margin deposit. Collateral may be requested due to NJR's election not to extend credit or because exposure exceeds defined thresholds. Most of NJR's wholesale marketing contracts contain standard netting provisions. These contracts include those governed by ISDA and the NAESB. The netting provisions refer to payment netting, whereby receivables and payables with the same counterparty are offset and the resulting net amount is paid to the party to which it is due.

Internally-rated exposure applies to counterparties that are not rated by S&P or Moody's. In these cases, the counterparty's or guarantor's financial statements are reviewed, and similar methodologies and ratios used by S&P and/or Moody's are applied to arrive at a substitute rating. Gross credit exposure is defined as the unrealized fair value of physical and financial derivative commodity contracts, plus any outstanding wholesale receivable for the value of natural gas delivered and/or financial derivative commodity contract that has settled for which payment has not yet been received.

The following is a summary of gross credit exposures grouped by investment and noninvestment grade counterparties, as of December 31, 2017. The amounts presented below have not been reduced by any collateral received or netting and exclude accounts receivable for NJNG retail natural gas sales and services and Clean Energy Ventures residential solar installations.

(Thousands)	Gross Credit Exposure
Investment grade	$182,514
Noninvestment grade	25,079
Internally rated investment grade	25,435
Internally rated noninvestment grade	61,714
Total	$294,742

Conversely, certain of NJNG's and Energy Services' derivative instruments are linked to agreements containing provisions that would require cash collateral payments from the Company if certain events occur. These provisions vary based upon the terms in individual counterparty agreements and can result in cash payments if NJNG's credit rating were to fall below its current level. NJNG's credit rating, with respect to S&P, reflects the overall corporate credit profile of NJR. Specifically, most, but not all, of these additional payments will be triggered if NJNG's debt is downgraded by the major credit agencies, regardless of investment grade status. In addition, some of these agreements include threshold amounts that would result in additional collateral payments if the values of derivative liabilities were to exceed the maximum values provided for in relevant counterparty agreements. Other provisions include payment features that are not specifically linked to ratings, but are based on certain financial metrics.

Collateral amounts associated with any of these conditions are determined based on a sliding scale and are contingent upon the degree to which the Company's credit rating and/or financial metrics deteriorate, and the extent to which liability amounts exceed

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applicable threshold limits. The aggregate fair value of all derivative instruments with credit-risk-related contingent features that were in a liability position on December 31, 2017 and September 30, 2017, was $14 million and $8.7 million, respectively, for which the Company had not posted collateral. If all thresholds related to the credit-risk-related contingent features underlying these agreements had been invoked on December 31, 2017 and September 30, 2017, the Company would have been required to post an additional $13.1 million and $8.6 million, respectively, to its counterparties. These amounts differ from the respective net derivative liabilities reflected on the Unaudited Condensed Consolidated Balance Sheets because the agreements also include clauses, commonly known as “Rights of Offset,” that would permit the Company to offset its derivative assets against its derivative liabilities for determining additional collateral to be posted, as previously discussed.

5. FAIR VALUE

Fair Value of Assets and Liabilities

The fair value of cash and cash equivalents, accounts receivable, current loan receivables, accounts payable, commercial paper and borrowings under revolving credit facilities are estimated to equal their carrying amounts due to the short maturity of those instruments. Non-current loan receivables are recorded based on what the Company expects to receive, which approximates fair value. The Company regularly evaluates the credit quality and collection profile of its customers to approximate fair value.

The estimated fair value of long-term debt at NJNG and NJR, including current maturities, excluding capital leases, debt issuance costs and solar asset financing obligations, is as follows:

(Thousands)	December 31, 2017	September 30, 2017
Carrying value (1) (2) (3)	$ 1,097,045	$ 1,097,045
Fair market value	$ 1,111,265	$ 1,107,676

(1) Excludes capital leases of $45 million and $39.7 million as of December 31, 2017 and September 30, 2017, respectively.

(2) Excludes NJNG's debt issuance costs of $6.2 million and $6.3 million as of December 31, 2017 and September 30, 2017, respectively.

(3) Excludes NJR's debt issuance costs of $804,000 and $770,000 as of December 31, 2017 and September 30, 2017, respectively.

NJR utilizes a discounted cash flow method to determine the fair value of its debt. Inputs include observable municipal and corporate yields, as appropriate for the maturity of the specific issue and the Company's credit rating. As of December 31, 2017, NJR discloses its debt within Level 2 of the fair value hierarchy.

Fair Value Hierarchy

NJR applies fair value measurement guidance to its financial assets and liabilities, as appropriate, which include financial derivatives and physical commodity contracts qualifying as derivatives, available for sale securities and other financial assets and liabilities. In addition, authoritative accounting literature prescribes the use of a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value based on the source of the data used to develop the price inputs. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities and the lowest priority to inputs that are based on unobservable market data and include the following:

Level 1	Unadjusted quoted prices for identical assets or liabilities in active markets. NJR's Level 1 assets and liabilities include exchange traded natural gas futures and options contracts, listed equities and money market funds. Exchange traded futures and options contracts include all energy contracts traded on the NYMEX, CME and ICE that NJR refers internally to as basis swaps, fixed swaps, futures and financial options that are cleared through a FCM.
Level 2	Other significant observable inputs such as interest rates or price data, including both commodity and basis pricing that is observed either directly or indirectly from publications or pricing services. NJR's Level 2 assets and liabilities include over-the-counter physical forward commodity contracts and swap contracts, SREC forward sales or derivatives that are initially valued using observable quotes and are subsequently adjusted to include time value, credit risk or estimated transport pricing components for which no basis price is available. Level 2 financial derivatives consist of transactions with non-FCM counterparties (basis swaps, fixed swaps and/or options). NJNG's treasury lock is also considered Level 2 as valuation is based on quoted market interest and swap rates as inputs to the valuation model. Inputs are verifiable and do not require significant management judgment. For some physical commodity contracts the Company utilizes transportation tariff rates that are publicly available and that it considers to be observable inputs that are equivalent to market data received from an independent source. There are no significant judgments or adjustments applied to the transportation tariff inputs and no market perspective is required. Even if the transportation tariff input were considered to be a “model,” it would still be considered to be a Level 2 input as the data is:

- widely accepted and public;

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- non-proprietary and sourced from an independent third party; and
- observable and published.

These additional adjustments are generally not considered to be significant to the ultimate recognized values.

Level 3 Inputs derived from a significant amount of unobservable market data. These include NJR's best estimate of fair value and are derived primarily through the use of internal valuation methodologies.

Assets and liabilities measured at fair value on a recurring basis are summarized as follows:

(Thousands)	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total	
As of December 31, 2017:					
Assets:					
Physical commodity contracts	$—	$ 16,535	$ —	$16,535	
Financial commodity contracts	35,265	—	—	35,265	
Financial commodity contracts - foreign exchange	—	36	—	36	
Available for sale equity securities - energy industry	55,995	—	—	94.0	100.4
	$ 640.5	$ 602.4	$ 532.1		
Gross profit					
Fuel Specialties	$ 145.6	$ 124.7	$ 106.2		
Active Chemicals	12.5	24.6	22.7		
Octane Additives	28.3	48.1	57.8		
	$ 186.4	$ 197.4	$ 186.7		
Operating income					
Fuel Specialties	$ 80.0	$ 63.6	$ 45.7		
Active Chemicals	(5.0)	6.1	5.8		
Octane Additives	1.2	19.9	34.5		
FAS 158/87 pension (charge)	(2.3)	(4.6)			
Corporate costs	(24.9)	(22.0)	(22.1)		
Restructuring charge	(2.1)	(3.0)	(4.5)		
Impairment of Octane Additives business goodwill	(3.7)	(12.1)	(36.7)		
Profit on disposals (net)	0.4		9.2		

Total operating income	$ 43.6	$ 47.9	$ 31.9
Identifiable assets at year end			
Fuel Specialties	$ 247.9	$ 216.7	
Active Chemicals	104.2	124.2	
Octane Additives	124.6	206.8	
Corporate	17.6	3.4	
	$ 494.3	$ 551.1	

The Company includes within the corporate costs line item the costs of:

managing the Group as a company with securities listed on the NASDAQ and registered with the SEC;

the President/CEO s office, group finance, group human resources, corporate secretary, legal fees and investor relations;

running the corporate offices in the U.S. and Europe;

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

the corporate development function since they do not relate to the current trading activities of our other business segments; and

the corporate share of the information technology, accounting and human resources departments.

Sales by geographic area are reported by source (where the transaction originates) and by destination (where the final sale to customers is made). Intercompany sales are priced to recover cost plus an appropriate mark-up for profit and are eliminated in the consolidated financial statements.

Identifiable assets are those directly associated with the operations of the geographical area.

Goodwill has not been allocated by geographical location on the grounds that it would be impracticable to do so.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(in millions)	2008	2007	2006
Net sales by source			
United States	$ 222.9	$ 192.8	$ 167.1
United Kingdom	383.2	333.6	307.6
Rest of Europe	115.6	154.6	144.9
Other	0.8	0.4	2.1
Sales between areas	(82.0)	(79.0)	(89.6)
	$ 640.5	$ 602.4	$ 532.1
Net sales by destination			
United States	$ 236.6	$ 210.9	$ 173.7
United Kingdom	22.2	25.1	22.8
Rest of Europe	240.5	205.1	189.0
Other	141.2	161.3	146.6
	$ 640.5	$ 602.4	$ 532.1
Income before income taxes			
United States	$ 10.0	$ 22.1	$ 38.8
United Kingdom	7.8	25.7	13.7
Rest of Europe	4.5	13.3	17.4
Other	0.2	(1.3)	(1.4)
Impairment of Octane Additives business goodwill	(3.7)	(12.1)	(36.7)
	$ 18.8	$ 47.7	$ 31.8
Long-lived assets at year end			
United States	$ 9.4	$ 8.9	
United Kingdom	33.9	45.9	
Rest of Europe	10.2	11.4	
	$ 53.5	$ 66.2	
Identifiable assets at year end			
United States	$ 111.7	$ 82.1	
United Kingdom	183.4	227.5	
Rest of Europe	50.4	89.2	
Other	0.6	0.5	
Goodwill	148.2	151.8	
	$ 494.3	$ 551.1	

Note 4. Share Based Compensation Plans

The Company has five stock option plans, four of which expired by their respective terms in May 2008 at the end of their 10 year life. The Company submitted new plans for stockholder approval to replace those that expired and requested approval to reserve common stock for issuance under each of those plans. Two of these plans provide for the grant of stock options

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

to key employees and one provides for the grant of stock options to non-employee directors. The fourth plan is a savings plan which provides for the grant of stock options to all Company employees provided they commit to make regular savings over a pre-defined period which can then be used to purchase common stock upon vesting of the options. Under the new plans vesting periods range from 27 months to 6 years and in all cases stock options granted expire within 10 years of the date of grant. All grants are at the sole discretion of the Compensation Committee of the Board of Directors. Grants may be priced at market value or at a premium or discount. The fifth plan provides for the grant of stock options to key executives on a matching basis provided they use a proportion of their annual bonus to purchase common stock in the Company on the open market. All four of the plans submitted for stockholder approval were approved at the Company s Annual Meeting of Stockholders on May 6, 2008. The aggregate number of shares of common stock reserved for issuance which can be granted under all five plans is 1,790,000.

Under the rules of the plans which expired in May 2008 no further stock options will be granted and un-awarded shares of common stock previously allocated to these plans cannot be used for further grants. Stock options granted under the plans prior to the expiration date of the plan expire within 10 years of the date of grant.

On January 1, 2006 the Company adopted FAS 123R, *Share-Based Payment*. FAS 123R requires a company to estimate the number of forfeitures expected to occur and record expense based upon the number of awards expected to vest. Prior to adoption, the Company accounted for forfeitures as they occurred as permitted under previous accounting standards. The cumulative effect of adopting the change in estimating forfeitures was not material to the Company s financial statements for year ended December 31, 2006.

The fair value of these options is calculated using the Black-Scholes model. In some cases certain performance related options are dependent upon external factors such as the Company s share price. The fair value of these options is calculated using a Monte Carlo model.

The following assumptions were used to determine the fair value of options calculated using the Black-Scholes model:

	2008	2007	2006
Dividend yield	0.5%	0.3%	0.4%
Expected life	4 years	4 years	4 years
Volatility	50.1%	48.9%	43.5%
Risk free interest rate	2.73%	4.47%	4.26%

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table summarizes the transactions of the Company s stock option plans for the year ended December 31, 2008:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Fair Value
Options outstanding at January 1, 2008	1,104,893	$ 3.56	
Granted at discount	178,923	$	$ 14.46
at market value	66,472	$ 20.29	$ 7.81
Exercised	(349,830)	$ 5.28	
Forfeitures	(15,160)	$	
Expired	(1,717)	$ 13.23	
Options outstanding at December 31, 2008	983,581	$ 3.47	

The following table summarizes information about options outstanding at December 31, 2008:

Range of Exercise Price	Number Outstanding at December 31, 2008	Weighted Average Remaining Life in Years	Weighted Average Exercise Price	Number Exercisable and Fully Vested at December 31, 2008	Weighted Average Remaining Life in Years	Weighted Average Exercise Price
$0-$5	746,781	6.72	$ 0.14	64,226	3.59	$ 1.68
$5-$10	140,162	4.09	$ 8.42	90,410	2.42	$ 7.57
$10-$15	2,300	5.36	$ 11.50	2,300	5.36	$ 11.50
$20-$25	66,472	9.15	$ 20.29			$
$25-$30	27,866	8.15	$ 27.09			$
	983,581			156,936		

The aggregate intrinsic value of fully vested stock options is $0.4 million. Of the 156,936 stock options that are exercisable, 30,460 have performance conditions attached. The total compensation cost for 2008 and 2007 was $4.1 million and $3.3 million, respectively. The total compensation cost related to nonvested stock options not yet recognized at December 31, 2008 is $6.2 million and this cost is expected to be recognized over the weighted-average period of 2.46 years.

We have not modified any stock option awards in 2008, 2007 or 2006. The total intrinsic value of options exercised in 2008 and 2007 was $1.3 million and $1.9 million, respectively. The amount of cash received from the exercise of stock option awards in 2008, 2007 and 2006 was $1.8 million, $4.1 million and $3.0 million, respectively. The Company s policy is to issue shares from Treasury stock to holders of stock options who exercise those options. During 2008 and 2007 the new total fair value of shares vested was $1.2 million and $2.2 million, respectively.

The total options vested in 2008 were 264,588 (2007 328,660, 2006 276,584).

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

An additional long term incentive plan designed to reward selected executives for delivering exceptional performance was recommended by the Compensation Committee, working with its advisors, and approved by the Board of Directors. Under this plan a discretionary bonus will be payable to eligible executives if the Innospec share performance out-performs that of competitors, as measured by the Russell 2000 Index, by a minimum of 10% over the three years from January 2008 to December 2010. The amount of bonus which can be earned will be a set cash amount for each one percentage point of out-performance. The maximum bonus under this plan, of $12 million in respect of the current participants, will be payable for an out-performance versus the Russell 2000 Index of 30%. No bonus is payable under this plan if the Innospec share price does not out-perform the Russell 2000 Index by more than 10% over the three year period. The fair value of these liability cash-settled stock appreciation rights is calculated on a quarterly basis using a Monte Carlo model. A corresponding compensation charge and liability of $0.1 million was recognized in 2008.

The following assumptions were used in the Monte Carlo model:

	2008	2007	2006
Dividend yield	1.7%	0.3%	0.4%
Volatility	80.2%	48.9%	43.5%
Risk free interest rate	1.00%	4.47%	4.26%

Note 5. Earnings Per Share

Basic earnings per share is based on the weighted average number of common shares outstanding during the period. Diluted earnings per share includes the effect of options that are dilutive and outstanding during the period. Per share amounts are computed as follows:

	2008	2007	2006
Numerator (in millions):			
Net income available to common stockholders	$ 12.5	$ 29.5	$ 11.4
Denominator (in thousands):			
Weighted average common shares outstanding	23,595	23,920	24,141
Dilutive effect of stock options and awards	796	918	1,198
Denominator for diluted earnings per share	24,391	24,838	25,339

Net income per share, basic:			
Net income available to common shares	$ 0.53	$ 1.23	$ 0.47
Net income per share, diluted:			
Net income available to common shares	$ 0.51	$ 1.19	$ 0.45

In 2008, 2007 and 2006 the average number of anti-dilutive options excluded from the calculation of diluted earnings per share were 98,880, 17,729 and 4,125, respectively.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 6. Pension Plans

The Company s principal pension arrangement is a contributory defined benefit pension plan (the Plan) covering a number of its current and former employees in the United Kingdom though it does also have other much smaller pension arrangements in the United Kingdom and overseas. The Plan is closed to new entrants without trustee discretion. The Projected Benefit Obligation (PBO) is based on final salary and years of credited service reduced by social security benefits according to a plan formula. Normal retirement age is 65 but provisions are made for early retirement. The Plan s assets are invested by two investment management companies in funds holding United Kingdom and overseas equities, United Kingdom and overseas fixed interest securities, index linked securities, property unit trusts and cash or cash equivalents.

The Company is contributing amounts to the Plan to cover service costs to date. Employee and employer contributions from January 1, 2004 to January 1, 2007 were at 5% and 22.6%, respectively, of pensionable pay. From January 1, 2007, employee and employer contributions were at 7% and 29%, respectively. In addition, since March 2007, the Company has been contributing £1.5 million per calendar year in accordance with a 10 year deficit recovery plan. From January 1, 2008, employee and employer contributions remained at 7% and 29% though employee contributions were paid by the employer through a salary sacrifice arrangement. The estimated level of Company contributions into the Plan for 2009 is $5.8 million.

A full tri-annual actuarial valuation of the Plan was performed as at December 31, 2005 and an update performed as at December 31, 2008, 2007 and 2006, the results of which are reflected in these consolidated financial statements. At December 31, 2008 the underlying plan asset value and PBO were $557.4 million and $571.2 million, respectively, resulting in a deficit of $13.8 million. A full tri-annual actuarial valuation of the Plan as at December 31, 2008 will be performed in 2009. The results of this valuation will be reflected in the consolidated financial statements as at December 31, 2009.

Effective for fiscal year 2006, the Company adopted the provisions of FAS 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans*. FAS 158 requires that the funded status of defined-benefit postretirement plans be recognized on the Company s consolidated balance sheets, and certain changes in the funded status be reflected in comprehensive income. FAS 158 also requires the measurement date of the Plan s funded status to be the same as the Company s fiscal year-end. Although the measurement date provision was not required to be adopted until fiscal year 2008 the Company early-adopted this provision for fiscal year 2006. The effect of applying FAS 158 was to record a total reduction to equity through recognition in other comprehensive loss of $97.0 million on an after-tax basis.

The Company had previously used a measurement date of October 5. Accordingly, accounting and disclosure for the Plan had been as at and for the 12 months ending October 5. In

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

accordance with FAS 158 the net pension charge of $1.5 million for the transition period of three months to December 31, 2006 has been included in the total reduction to equity of $97.0 million.

(in millions)	12 months to December 31 2008	12 months to December 31 2007	3 months to December 31 2006	12 months to October 5 2006
Plan net pension charge:				
Service cost	$ 5.3	$ 5.4	$ 1.3	$ 5.0
Interest cost on PBO	45.7	45.7	10.5	39.7
Expected return on plan assets	(48.7)	(48.5)	(11.2)	(44.7)
Amortization of net actuarial losses		2.0	0.9	
	$ 2.3	$ 4.6	$ 1.5	$
Plan assumptions:				
Discount rate	6.50%	5.80%	5.10%	5.00%
Rate of increase in compensation levels	3.75%	3.95%	3.55%	3.55%
Rate of return on plan assets overall	6.20%	5.45%	5.25%	5.30%
Rate of return on plan assets equity securities	7.80%	7.50%	7.60%	8.50%
Rate of return on plan assets debt securities	5.10%	4.60%	4.60%	4.60%
Plan asset allocation by category:				
Equity securities	22%	29%	32%	29%
Debt securities	76%	71%	67%	70%
Other	2%		1%	1%
	100%	100%	100%	100%

The discount rate used represents the annualized yield on medium and longer term AA rated corporate bonds in the United Kingdom and has been determined by reference to the iBoxx corporate bond index published by International Index Company. The rate of increase in compensation levels assumes that real salary growth in Innospec will be restricted to 0.75% above an assumed level of price inflation of 3.0%. A 0.25% change in either the discount rate assumption, or level of price inflation assumption, would change the PBO by approximately $19 million and the net pension charge for 2009 by approximately $1.4 million.

The current investment strategy of the Plan is to obtain an asset allocation of 70% in favor of debt securities and 30% equity securities in order to achieve a more predictable return on assets.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The projected net pension charge for the year ending December 31, 2009 is as follows:

(in millions)	
Service cost	$ 3.5
Interest cost on PBO	35.9
Expected return on plan assets	(33.5)
	$ 5.9

The following benefit payments, which reflect expected future service as appropriate, are expected to be made:

(in millions)	
2009	$ 36.5
2010	$ 37.7
2011	$ 38.8
2012	$ 40.0
2013	$ 41.1
2014 2018	$ 224.6

Company contributions to defined contribution schemes during 2008 were $2.8 million (2007 $3.0 million).

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Movements in PBO and fair value of Plan assets are as follows:

(in millions)	12 months to December 31 2008	12 months to December 31 2007
Change in PBO		
Opening balance	$ 854.3	$ 897.9
Interest cost	45.7	45.7
Service cost	5.3	5.4
Contributions by participants		1.0
Benefits paid	(46.1)	(51.1)
Actuarial (gains)/losses	(66.3)	(58.5)
Exchange effect	(221.7)	13.9
Closing balance	571.2	854.3
Fair value of plan assets		
Opening balance	889.1	875.4
Actual benefits paid	(46.1)	(51.1)
Actual contributions by employer	7.5	7.6
Actual contributions by participants		1.0
Actual return on assets	(74.0)	43.1
Exchange effect	(219.1)	13.1
Closing balance	557.4	889.1
Plan assets excess/(deficit) over PBO	(13.8)	34.8
Unrecognized net loss	124.3	83.5
Amortization of net actuarial losses		(2.0)
Amount recognized in other comprehensive loss	(124.3)	(81.5)
Pension asset/(liability)	$ (13.8)	$ 34.8

The accumulated benefit obligation for the Plan was $555.9 million and $826.3 million at December 31, 2008 and 2007, respectively.

Note 7. Income Taxes

On January 1, 2007, the Company adopted FASB Interpretation No 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

On adoption of FIN 48 the Company recognized an increase in its liability for unrecognized tax benefits of $3.1 million which was accounted for as an adjustment to opening retained earnings; and reclassifications of $21.0 million from other liabilities, $3.8 million from deferred income taxes and $7.8 million from accrued income taxes. A roll-forward of unrecognized tax benefits and associated accrued interest and penalties is as follows:

(in millions)	Interest and penalties	Unrecognized tax benefits	Total
Opening balance at January 1, 2007	$ 2.3	$ 33.4	$ 35.7
Additions related to tax positions taken in the current period		1.5	1.5
Additions for tax positions of prior periods	1.4	1.0	2.4
Exchange effect	0.1	1.7	1.8
Settlements		(1.4)	(1.4)
Closing balance at December 31, 2007	3.8	36.2	40.0
Current	(1.7)	(10.9)	(12.6)
Non-current	$ 2.1	$ 25.3	$ 27.4
Opening balance at January 1, 2008	$ 3.8	$ 36.2	$ 40.0
Additions related to tax positions taken in the current period		2.2	2.2
Additions for tax positions of prior periods	0.7	11.6	12.3
Reductions for tax positions of prior periods		(9.5)	(9.5)
Exchange effect	(0.5)	(5.7)	(6.2)
Settlements	(0.5)	(3.5)	(4.0)
Closing balance at December 31, 2008	3.5	31.3	34.8
Current	(1.7)	(7.5)	(9.2)
Non-current	$ 1.8	$ 23.8	$ 25.6

All of the $34.8 million of unrecognized tax benefits would impact our effective tax rate if recognized.

We recognize accrued interest and penalties associated with uncertain tax positions as part of income taxes in our consolidated statements of income.

The Company or one of its subsidiaries files income tax returns in the U.S. federal jurisdiction, and various state and foreign jurisdictions. As at December 31, 2008, the Company s subsidiaries in France, Germany and the United Kingdom are subject to tax authority investigations into their respective transfer pricing policies. The Company does not anticipate that adjustments arising out of these investigations would result in a material change to its financial position as at December 31, 2008.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company and its U.S. subsidiaries remain open to examination by the IRS for years 1998 onwards due to the net operating losses in the period 1998 to 2002, although no examination is currently underway. The Company s subsidiaries in other major tax jurisdictions are open to examination including France (2005 onwards), Germany (2002 onwards), Switzerland (2007 onwards) and the United Kingdom (2002 onwards). We are currently under examination in various foreign jurisdictions.

The sources of income before income taxes were as follows:

(in millions)	2008	2007	2006
Domestic (U.S.)	$ 10.0	$ 22.2	$ 20.2
Foreign	8.8	25.5	11.6
	$ 18.8	$ 47.7	$ 31.8

The components of income tax charges are summarized as follows:

(in millions)	2008	2007	2006
Current:			
Federal	$ 5.6	$ 16.9	$ 5.9
Foreign	1.4	7.7	15.5
	$ 7.0	$ 24.6	$ 21.4
Deferred:			
Federal	$ 4.5	$ (6.4)	$ 0.5
Foreign	(5.2)		(1.5)
	(0.7)	(6.4)	(1.0)
	$ 6.3	$ 18.2	$ 20.4

Cash payments/(receipts) for income taxes were $24.6 million, $22.7 million and $(0.7) million during 2008, 2007 and 2006, respectively.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The effective tax rate varies from the U.S. federal statutory rate because of the factors indicated below:

	2008	2007	2006
Statutory rate	35.0%	35.0%	35.0%
Foreign income inclusion	47.6	5.6	
Impairment of Octane Additives business goodwill	7.1	8.9	40.4
Foreign tax credit	(21.3)	(73.9)	(29.5)
FAS 158/87 pension charge	(18.2)	(1.0)	(6.2)
Foreign tax rate differential	(15.2)	(4.6)	(5.0)
Unrecognized net operating losses	(10.0)	(2.1)	(31.6)
Permanent tax adjustments	(8.9)	9.8	7.3
Amortization	(4.2)		(0.4)
Tax (credit)/charge from previous years	22.0	(14.6)	4.2
Dividend inclusion		80.0	47.1
Other items and adjustments (net)	(0.4)	(4.9)	2.9
	33.5%	38.2%	64.2%

Significant factors affecting the variation to the statutory rate include the use of tax losses for which no deferred tax asset was recognized and foreign income inclusion net of foreign tax credits. The $3.7 million charge in respect of the impairment of Octane Additives business goodwill has no cash or taxation impact and represents a further factor in the variation from the U.S. federal statutory rate. The mix of taxable profits generated in the different geographical localities in which the Group operates had a positive impact on the effective tax rate in 2008 partially offset by foreign income inclusions.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Details of deferred tax assets and liabilities are as follows:

(in millions)	2008	2007
Deferred tax assets:		
Excess of tax over book basis in property, plant and equipment	$ 2.9	$ 3.8
Net operating loss carry forwards	2.6	3.6
Pension liability	4.1	
Goodwill amortization		2.9
Foreign tax credits	5.4	6.5
Other	10.0	4.2
	25.0	21.0
Valuation allowance	(7.3)	(8.8)
Total deferred tax assets	17.7	12.2
Deferred tax liabilities:		
Pension asset		(9.7)
Intangible assets	(5.2)	(5.9)
Other	(1.9)	(4.0)
Goodwill amortization	(3.4)	
	(10.5)	(19.6)
Total net deferred asset/(liability)	$ 7.2	$ (7.4)

Details of the deferred tax asset valuation allowance are as follows:

(in millions)	2008	2007
At January 1	$ (8.8)	$ (1.0)
Change in foreign tax credits	1.1	(6.5)
Change in net operating loss carry forwards	0.4	(1.3)
At December 31	$ (7.3)	$ (8.8)

As a result of the Company s assessment of its net deferred tax assets at December 31, 2008, the Company considers it more likely than not that no valuation allowance is required for $0.7 million (2007 $1.3 million) of its net operating loss carry forwards and that a full valuation allowance is required against its foreign tax credits carry forwards. The net operating loss carry forwards arose in 2008 and were generated in Germany as a result of losses in the year. It is expected that sufficient taxable profits will be generated against which these net operating loss carry forwards can be relieved and there is no time limitation to use these losses. Should it be determined in the future that it is no longer more likely than not that these assets will be realized an additional valuation allowance would be required and the Company s operating results would be adversely affected during the period in which such a determination would be made.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company has not made provision for deferred tax on unremitted earnings from overseas subsidiaries on the grounds that they will not be remitted as they are required in the entities concerned or will continue to be used to fund further investment into other territories. The amount of unremitted earnings at December 31, 2008 and 2007 was approximately $691 million and $805 million, respectively. Any determination of the potential amount of unrecognized deferred taxes is not practicable due to the complexities associated with its hypothetical calculation.

Note 8. Goodwill

Goodwill comprises the following:

(in millions)	Fuel Specialties	Active Chemicals	Octane Additives	Total
Gross cost at January 1, 2007	$ 117.2	$ 30.4	$ 314.3	$ 461.9
Exchange effect	0.1			0.1
Impairment			(12.1)	(12.1)
Gross cost at December 31, 2007	117.3	30.4	302.2	449.9
Accumulated amortization at January 1 and December 31, 2007	(8.3)	(0.3)	(289.5)	(298.1)
Net book amount at December 31, 2007	$ 109.0	$ 30.1	$ 12.7	$ 151.8
Gross cost at January 1, 2008	117.3	30.4	302.2	449.9
Exchange effect	0.1			0.1
Impairment			(3.7)	(3.7)
Gross cost at December 31, 2008	117.4	30.4	298.5	446.3
Accumulated amortization at January 1 and December 31, 2008	(8.3)	(0.3)	(289.5)	(298.1)
Net book amount at December 31, 2008	$ 109.1	$ 30.1	$ 9.0	$ 148.2

The Company s reporting units are generally consistent with the operating segments underlying the segments identified in Note 3.

The Company adopted FAS 142, *Goodwill and Other Intangible Assets*, effective January 1, 2002. This requires that goodwill deemed to have an indefinite life should no longer be amortized, but subject to an annual impairment review, or between years if events occur or circumstances change which suggest that an impairment may have occurred.

The Company elected to perform its annual tests in respect of Fuel Specialties and Active Chemicals goodwill as of December 31 each year. In reviewing for any impairment charge the fair value of the reporting units underlying the segments is estimated using an after tax cash flow methodology based on management s best estimates at that time. At December 31, 2008 we had $139.2 million of goodwill relating to our Fuel Specialties and Active Chemicals

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businesses. At this date we performed annual impairment reviews and concluded that there has been no impairment of goodwill in respect of those reporting segments.

In light of the continuing decline in the Octane Additives market globally, as the Company makes sales of Octane Additives in each quarter, the remaining sales and corresponding cash flows that can be derived from the Octane Additives business are reduced, and accordingly the fair value of the Octane Additives reporting unit is reduced. As a result the Company determined that quarterly impairment reviews be performed from January 1, 2004 and any impairment charge arising be recognized in the relevant quarter. As a result of the Octane Additives impairment reviews performed during 2008, 2007 and 2006 impairment charges of $3.7 million, $12.1 million and $36.7 million, respectively, were recognized. These charges are non-cash in nature and have no impact on taxation. There is $9.0 million of goodwill remaining at December 31, 2008 which relates to the Octane Additives business. Given the quantum and predictability of the remaining future cash flows from the Octane Additives business the Company expects goodwill impairment charges to be recognized in the income statement on an approximate straight-line basis to December 31, 2012. Effective October 1, 2008 the Company extended its estimate for the future life of the Octane Additives business from December 31, 2010 to December 31, 2012.

We believe that the assumptions used in our annual and quarterly impairment reviews are reasonable, but that they are judgmental, and that variations in any of the assumptions may result in materially different calculations of impairment charges, if any. At December 31, 2008, the sum of the fair values of our reporting units was in excess of the Company s market capitalization (based upon our stock price at the same date) due primarily to an estimated control premium. The control premium reflects the fact that management has access to information, such as future projections, and the power to make investment, financing and resource allocation decisions. Management do not believe that any further goodwill impairment charges are required to be recognized in addition to those already recognized in respect of the Octane Additives reporting unit.

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Note 9. Intangible Assets

Intangible assets comprise the following:

(in millions)	2008	2007
Gross cost		
Ethyl	$ 22.1	$ 28.4
Veritel	60.6	60.6
Technology	7.1	7.1
Customer relationships	16.0	16.0
Patents	2.9	2.9
Other	0.3	0.3
	109.0	115.3
Accumulated amortization		
Ethyl	(8.9)	(4.2)
Veritel	(60.6)	(60.6)
Technology	(3.2)	(2.5)
Customer relationships	(6.6)	(5.0)
Patents	(1.1)	(0.9)
Other	(0.3)	(0.2)
	(80.7)	(73.4)
	$ 28.3	$ 41.9

<u>Ethyl</u>

An intangible asset of $28.4 million was recognized in the second quarter of 2007 in respect of Ethyl foregoing their entitlement effective April 1, 2007 to a share of the future income stream under the sales and marketing agreements (TMAs) to market and sell tetra ethyl lead (TEL). In 2008 contract provisions no longer deemed necessary of $6.3 million were offset against the intangible asset. The TMAs covered the sale of TEL for use in automotive gasoline and aviation gasoline which we disclose within our Octane Additives business segment and our Fuel Specialties business segment, respectively. We allocated the individual components of the intangible asset attributable to TEL for use in automotive gasoline and aviation gasoline by reference to the forecast future income streams and associated cash flows from those markets which Ethyl would have shared in. No residual value was attributed to the intangible asset. Accordingly, commencing April 1, 2007, the amount attributed to the Octane Additives business segment was being amortized straight-line to December 31, 2010 and the amount attributed to the Fuel Specialties business segment is being amortized straight-line to December 31, 2017. Effective October 1, 2008 the Company extended its estimate for the future life of the Octane Additives business from December 31, 2010 to December 31, 2012 and therefore prospectively adjusted the amortization period for the amount attributed to the Octane Additives business segment. An amortization charge of $4.7 million was recognized in 2008 (2007 $4.2 million).

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Veritel

An intangible asset of $60.6 million was recognized in 2001, and amortized straight-line to December 31, 2007, in relation to amounts payable to Veritel Chemicals BV by our Swiss subsidiary pursuant to a marketing agreement effective July 1, 2001. The asset was fully amortized as at December 31, 2007 and December 31, 2008. No amortization was recognized in 2008 (2007 $10.0 million).

Technology

Following the acquisition of the remaining 50% of Innospec Fuel Specialties LLC (previously known as Octel Starreon LLC) on July 8, 2004, the Company recognized an intangible asset of $2.3 million in respect of various technological approvals the business has received from certain military and civilian authorities. The approvals act as a barrier to entry to any potential competitor in the market who would wish to supply these products.

An intangible asset of $4.8 million was recognized in respect of a number of specialized manufacturing processes carried out by Innospec Widnes Limited (previously known as Aroma Fine Chemicals Limited) following the acquisition of that entity in August 2004.

Both of these assets have an expected life of ten years and will be amortized on a straight-line basis over this period. No residual value is anticipated.

Customer relationships

Following the acquisition of Finetex (now merged into Innospec Active Chemicals LLC), the Company recognized an intangible asset totaling $7.1 million, $4.2 million of which was in relation to customer lists acquired. This asset has an expected life of thirteen years and will be amortized on a straight-line basis over this period. No residual value is anticipated.

Intangible assets were recognized in 2004 in respect of both the Innospec Fuel Specialties LLC (previously known as Octel Starreon LLC) ($9.0 million), and Innospec Widnes Limited (previously known as Aroma Fine Chemicals

Limited) ($2.8 million) acquisitions. These relate to ongoing customer relationships. These have an expected life of ten years and will be amortized on a straight-line basis over that period. No residual value is anticipated.

Patents

Following the acquisition of Finetex (now merged into Innospec Active Chemicals LLC), the Company recognized an intangible asset of $2.9 million in respect of patents and trademarks. These have an expected life of ten years and will be amortized on a straight-line basis over that period.

Other

The remaining balance relates chiefly to software costs which are amortized over 3 years.

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Intangible asset amortization expense was $7.4 million, $16.9 million and $12.7 million in 2008, 2007 and 2006, respectively.

Future amortization expense is estimated to be $4.7 million per annum for the four years to 2012.

Note 10. Deferred Finance Costs

The Company entered into a three and one half year finance facility on December 13, 2005. On February 6, 2009 we entered into a new three-year finance facility. This new finance facility replaced the previous finance facility which was in place at December 31, 2008 (see Note 13).

In 2008 and 2006, $0.6 million and $0.5 million of refinancing costs were capitalized, respectively. These will be amortized over the expected life of the relevant finance facility using the effective interest method.

(in millions)	2008	2007
Gross cost	$ 3.1	$ 2.6
Accumulated amortization	(2.6)	(2.1)
Exchange effect		(0.2)
	$ 0.5	$ 0.3

Amortization expense was $0.5 million, $1.1 million and $1.1 million in 2008, 2007 and 2006, respectively. The charge is included in interest expense (see Note 2).

Note 11. Property, Plant and Equipment

Property, plant and equipment consists of the following:

(in millions)	2008	2007
Land	$ 6.8	$ 8.3
Buildings	5.0	5.0
Equipment	97.3	100.3
Work in progress	4.1	5.8
	113.2	119.4
Less accumulated depreciation	(59.7)	(53.2)
	$ 53.5	$ 66.2

Of the total net book value of equipment at December 31, 2008 and 2007 no amounts are in respect of assets held under capital leases.

Depreciation charges were $15.1 million, $13.3 million and $13.6 million in 2008, 2007 and 2006, respectively.

The estimated additional cost to complete work in progress is $1.4 million (2007 $1.6 million).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 12. Plant Closure Provisions

The principal sites giving rise to environmental remediation liabilities are the former Octane Additives manufacturing sites at Paimboeuf in France, Doberitz and Biebesheim in Germany, together with the Ellesmere Port site in the United Kingdom, which is the last ongoing manufacturer of TEL. The liability for estimated closure costs of Innospec s Octane Additives manufacturing facilities includes costs for personnel reductions (severance), decontamination and environmental remediation activities (remediation) when demand for TEL diminishes. Severance provisions have also been made in relation to the Fuel Specialties and the Active Chemicals businesses.

Movements in the provisions are summarized as follows:

(in millions)	Severance	Other Restructuring	Remediation	Total
Total at January 1, 2007	$ 3.8	$ 0.3	$ 23.7	$ 27.8
Charge for the period	0.5	2.5	1.3	4.3
Expenditure	(2.0)	(2.2)	(1.7)	(5.9)
Exchange effect	0.1		0.5	0.6
Total at December 31, 2007	2.4	0.6	23.8	26.8
Due within one year	(1.9)	(0.3)	(2.2)	(4.4)
Balance at December 31, 2007	$ 0.5	$ 0.3	$ 21.6	$ 22.4
Total at January 1, 2008	$ 2.4	$ 0.6	$ 23.8	$ 26.8
Charge for the period	0.9	1.2	2.8	4.9
Expenditure	(1.6)	(1.7)	(1.6)	(4.9)
Exchange effect	(0.1)	0.1	0.1	0.1
Total at December 31, 2008	1.6	0.2	25.1	26.9
Due within one year	(1.5)		(2.6)	(4.1)
Balance at December 31, 2008	$ 0.1	$ 0.2	$ 22.5	$ 22.8

Amounts due within one year refer to provisions where expenditure is expected to arise within one year of the balance sheet date. Severance charges are recognized in the income statement as restructuring costs along with other restructuring costs. Remediation costs are recognized in cost of goods sold.

Severance

A charge of $0.9 million was recognized in respect of a reduction in EMEA ($0.7 million) and Americas ($0.2 million) headcount.

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Other restructuring

The $1.2 million charge relates to United Kingdom site clearance ($0.6 million), U.S. site clearance ($0.3 million) and relocation of our European Headquarters to the Ellesmere Port site ($0.3 million).

Remediation

Total costs for remediation are evaluated on a regular basis to take account of expenditure incurred and to amend the scope of future activities in the light of findings from projects carried out. A detailed review of the expected future costs of decontamination and remediation at the Ellesmere Port site was concluded in December 2004. The results were summarized in a discounted cash flow model and the results are reflected herein.

Remediation expenditure against provisions was $1.6 million, $1.7 million and $1.3 million in 2008, 2007, and 2006, respectively.

The remediation provision represents the fair value of the Company s liability recognized under FAS 143, *Accounting for Asset Retirement Obligations*. The accretion expense recognized under FAS 143 in 2008 was $2.3 million. This charge was increased in 2008 by $0.5 million in respect of an increase in the scope and cost of future activities to be performed in the light of findings from projects carried out.

The Company records environmental liabilities when they are probable and costs can be estimated reasonably. The Company has to anticipate the program of work required and the associated future costs, and has to comply with environmental legislation in the relevant countries. The Company views the costs of vacating our main United Kingdom site as a contingent liability because there is no present intention to exit the site. The Company has further determined that, due to the uncertain product life of TEL, particularly in the market for aviation gas, there exists such uncertainty as to the timing of such cash flows that it is not possible to estimate these flows sufficiently reliably to recognize a provision.

Note 13. Long-Term Debt

Long-term debt consists of the following:

(in millions)	2008	2007
Senior term loan	$ 55.0	$ 75.0
Revolving credit	18.0	6.0
	73.0	81.0
Less current portion	(73.0)	(20.0)
	$	$ 61.0

On December 13, 2005 the Company entered into a finance facility with a syndicate of banks for a term loan of $100 million, repayable over three and one half years, and revolving credit

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

facility of $100 million. Of this term loan $10 million, $15 million and $20 million was repaid on July 31, 2006, January 31, 2007, and January 31, 2008, respectively. A final repayment of $55 million was due on June 12, 2009. The revolving credit facility was due to expire on June 12, 2009 when the finance facility was due to expire. As of December 31, 2008, the Company had $73.0 million of debt outstanding under this finance facility and was in compliance with all financial covenants therein. The facility was secured by a number of fixed and floating charges over certain assets of the Company and its subsidiaries. The weighted average rate of interest on borrowings was 5.2% at December 31, 2008 and 5.6% at December 31, 2007.

On February 6, 2009 we entered into a new three-year finance facility which provides for borrowings by us of up to $150 million including a term loan of $50 million and revolving credit facility of $100 million. The revolving credit facility can be drawn down until the finance facility expires on February 6, 2012. The term loan is repayable as follows: $10 million is due on February 5, 2010; $15 million on February 7, 2011; and $25 million on February 6, 2012. This new finance facility replaced the previous finance facility which was in place at December 31, 2008.

The Company s new finance facility contains restrictive clauses which may constrain our activities and limit our operational and financial flexibility. The new facility obliges the lenders to comply with a request for utilization of finance unless there is an event of default outstanding. Events of default are defined in the finance facility and include a material adverse change to our business, properties, assets, financial condition or results of operations. The new facility contains a number of restrictions that limit our ability, amongst other things, and subject to certain limited exceptions, to incur additional indebtedness, pledge our assets as security, guarantee obligations of third parties, make investments, undergo a merger or consolidation, dispose of assets, or materially change our line of business.

In addition, the new facility also contains terms which, if breached, would result in the loan becoming repayable on demand. It requires, among other matters, compliance with two financial covenant ratios. These ratios are (1) the ratio of net debt to EBITDA and (2) the ratio of net interest to EBITDA. EBITDA is a non U.S. GAAP measure of liquidity defined in the finance facility.

Payments of interest on long-term debt were $3.8 million, $6.4 million and $9.3 million in 2008, 2007 and 2006, respectively.

The net cash outflow in respect of refinancing costs was $0.4 million and $0.5 million in 2008 and 2006, respectively.

No assets held under capital leases were capitalized during 2008 (2007 $nil). No capital repayments were made during 2008 (2007 $0.1 million).

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Note 14. Deferred Income

Movements in deferred income are summarized as follows:

(in millions)	2008	2007
Deferred income	$ 0.9	$ 0.9
Less: current portion	(0.1)	(0.1)
	$ 0.8	$ 0.8

Deferred income relates to $0.8 million of post acquisition government grants received by Innospec Leuna GmbH and $0.1 million of government grants and advance rental payments received by Innospec Widnes Limited (previously known as Aroma Fine Chemicals Limited).

Note 15. Stockholders Equity

	Common Stock			Treasury Stock		
(number of shares in thousands)	2008	2007	2006	2008	2007	2006
At January 1	29,555	29,555	29,555	5,777	5,749	4,904
Exercise of options				(354)	(786)	(405)
Stock purchases				533	814	1,250
At December 31	29,555	29,555	29,555	5,956	5,777	5,749

At December 31, 2008, the Company had authorized common stock of 40,000,000 shares (December 31, 2007 40,000,000). Issued shares at December 31, 2008, were 29,554,500 (December 31, 2007 29,554,500) including treasury stock of 5,956,384 shares (December 31, 2006 5,777,417).

Note 16. Fair Value of Financial Instruments

Effective January 1, 2008 the Company partially adopted FAS 157, *Fair Value Measurements* in respect of our pension plan assets and derivative instruments and this had no material impact on the Company s financial statements. The fair values of our pension plan assets and derivative instruments are valued based on quoted prices available in active markets for identical assets or liabilities (level 1 measurement) and have not changed on adoption of FAS 157. FAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. FAS 157 permits companies that have not already issued either interim or annual financial statements reflecting its adoption to delay the effective adoption date in respect of non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for items within the scope of FAS 157. Non-financial assets and non-financial liabilities would include all assets and liabilities other than those meeting the definition of a *financial asset* or *financial liability* as defined in FAS 159. The

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non-recurring, non-financial assets and liabilities for which FAS 157 has been deferred for adoption by the Company are property, plant and equipment, goodwill, intangible assets and plant closure provisions. The Company does not believe that the adoption of FAS 157 for non-recurring, non-financial assets and liabilities will have a material impact on its financial statements.

As defined in FAS 157, fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price). As permitted under FAS 157, the Company utilizes a mid-market pricing convention for valuing the majority of its assets and liabilities measured and reported at fair value. The Company utilizes market data or assumptions that market participants would use in pricing the asset or liability, including assumptions about risk and the risks inherent in the inputs to the valuation technique. These inputs can be readily observable, market corroborated or generally unobservable. The Company primarily applies the market approach for recurring fair value measurements and endeavors to utilize the best available information. Accordingly, the Company utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs. The Company is able to classify fair value balances based on the observability of those inputs. FAS 157 establishes a fair value hierarchy that prioritizes the inputs used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurement) and the lowest priority to unobservable inputs (level 3 measurement). As required by FAS 157, financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. The Company s assessment of the significance of a particular input to the fair value measurement requires judgment and may affect the valuation of fair value assets and liabilities and their placement within the fair value hierarchy levels.

Effective January 1, 2008, the Company adopted FAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. FAS 159 expands the scope of what entities may carry at fair value by offering an irrevocable option to record many types of financial assets and liabilities at fair value. The Company chose not to implement this option and accordingly the adoption of FAS 159 had no material impact on the Company s financial statements.

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The following table presents the carrying amount and fair values of the Company s financial instruments at December 31, 2008 and 2007:

(in millions)	2008 Carrying Amount	2008 Fair Value	2007 Carrying Amount	2007 Fair Value
Non-derivatives:				
Cash and cash equivalents	$ 13.9	$ 13.9	$ 24.3	$ 24.3
Long-term debt (including current portion)	73.0	73.0	81.0	81.0
Derivatives (all level 1 measurement):				
Interest rate swaps	(0.7)	(0.7)	(0.5)	(0.5)
Foreign exchange contracts	(12.3)	(12.3)	(0.4)	(0.4)
Commodity swaps	$ (1.3)	$ (1.3)	$ (0.5)	$ (0.5)

The following methods and assumptions were used to estimate the fair values of financial instruments:

Cash and cash equivalents: The carrying amount approximates fair value because of the short-term maturities of such instruments.

Long-term debt: The carrying amount of long-term borrowings at variable interest rates approximates fair value.

Derivatives: The fair value of derivatives that relates to interest rate swaps, foreign exchange contracts and commodity swaps was estimated based on current settlement prices and comparable contracts using current assumptions.

The cumulative gains and losses on the interest rate swaps and commodity swaps are summarized as follows:

(in millions)	2008	2007
Balance at January 1	$ (1.0)	$ 0.4

Change in fair value	(1.0)	(1.4)
Balance at December 31	$ (2.0)	$ (1.0)

The interest rate swaps have been designated as a cash flow hedge against $50.0 million of underlying floating rate debt obligations that stood at $73.0 million at December 31, 2008. All of the swaps mature on June 12, 2009.

The commodity swaps are used to manage the Company s cash flow exposure to raw material price volatility. They have been designated as cash flow hedges and all the commodity swaps qualify for hedge accounting as at December 31, 2008.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The interest rate and commodity hedges were determined to be effective and consequently the unrealized loss of $2.0 million in 2008 (2007 $1.0 million loss) has been recorded in other comprehensive income. Ineffectiveness was determined to be immaterial in 2008 and 2007 and accordingly no gain or loss was recognized in earnings in either period. The Company does not expect any significant portion of the loss to be reclassified into earnings in the next 12 months.

Foreign exchange contracts primarily relate to contracts entered into to hedge future known transactions or hedge balance sheet net cash positions. The movements in the carrying and fair values of these contracts is largely due to changes in exchange rates against the U.S. dollar. The U.S. dollar has strengthened significantly against other major currencies in the latter part of 2008.

Note 17. Derivative Instruments and Risk Management

The Company has limited involvement with derivative instruments and does not trade them. The Company does use derivatives to manage certain interest rate, foreign exchange exposures and raw material pricing exposures.

The Company uses interest rate swaps, floors, collar and cap agreements to reduce the impact of changes in interest rates on its floating rate debt. The swap agreements are contracts to exchange floating rate for fixed interest payments periodically over the life of the agreements without the exchange of the underlying notional amounts. The notional amounts are used to calculate interest to be paid or received and do not represent the amount of exposure to credit loss.

The Company has determined to hedge a proportion of the outstanding floating rate debt obligation. As at December 31, 2008 and 2007 the Company had the following interest rate instruments in effect (notional amounts in millions):

(in millions)	Notional Amount	Strike Rate	Expiry date
Interest swap	$ 20.0	4.7675%	June 12, 2009
	$ 15.0	4.7800%	June 12, 2009
	$ 15.0	4.7550%	June 12, 2009

The Company has hedged the price of certain raw materials with commodity swaps. As at December 31, 2008 and 2007 the Company had the following summarized commodity swaps:

(in millions)		2008 Carrying Amount	2008 Fair Value	2007 Carrying Amount	2007 Fair Value
Notional quantity	3,101 tonnes	$ (1.3)	$ (1.3)		
Notional quantity	450 tonnes			$ (0.5)	$ (0.5)

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We enter into various foreign currency forward exchange contracts to minimize currency exposure from expected future cash flows. The contracts have maturity dates of up to 12 months at the date of inception. At December 31, 2008, the fair value of outstanding foreign currency forward exchange contracts amounted to a $12.3 million loss (2007 $0.4 million loss).

The Company sells a range of Fuel Specialties, Active Chemicals and Octane Additives to major oil refineries and chemical companies throughout the world. Credit limits, ongoing credit evaluation and account monitoring procedures are used to minimize bad debt risk. Collateral is not generally required.

Note 18. Commitments and Contingencies

Operating Leases

The Company has commitments under operating leases primarily for office space, motor vehicles and various items of computer and office equipment. The leases are expected to be renewed and replaced in the normal course of business. Rental expense was $2.2 million in 2008, $2.1 million in 2007 and $1.9 million in 2006. Future commitments under non-cancellable operating leases are as follows:

(in millions)	
2009	$ 1.5
2010	1.3
2011	1.0
2012	0.6
2013	0.4
Thereafter	2.1
	$ 6.9

Commitments in respect of environmental remediation obligations are disclosed in Note 12.

Contingencies

Oil for Food Program and related investigations

On February 7, 2006, the Securities and Exchange Commission (SEC) notified the Company that it had commenced an investigation to determine whether any violations of law had occurred in connection with certain transactions conducted by or involving the Company, including those conducted by its wholly owned indirect Swiss subsidiary, Alcor Chemie Vertriebs GmbH (Alcor), under the United Nations Oil for Food Program (OFFP) between June 1, 1999 and December 31, 2003. As part of its investigation, the SEC issued a subpoena requiring the production of certain documents, including documents relating to these transactions, by the Company and Alcor. Upon receipt of the SEC s notification and initial subpoena, the Company undertook a review of its participation in the OFFP.

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On October 10, 2007 and November 1, 2007, the SEC served two additional subpoenas on the Company. These additional subpoenas required the production of documents relating primarily to the OFFP, but also relating to transactions conducted by the Company or its subsidiaries with state owned or state controlled entities between June 1, 1999 and the date of such subpoenas, concerning the use of foreign agents and the possibility of extra-contractual payments to secure business with foreign governmental entities in the context of the U.S. Foreign Corrupt Practices Act (FCPA) and other laws. In a co-ordinated investigation, the Company was also notified by the U.S. Department of Justice (DOJ) regarding the possibility of violations by the Company or its subsidiaries arising under other laws stemming from matters covered by the SEC investigation as well as certain preliminary inquiries regarding compliance with anti-trust laws applicable to the U.S. and international tetra-ethyl lead markets. The subjects into which the SEC and DOJ have inquired include areas that concern certain former and current executives of the Company, including the current CEO. The Company, and its officers and directors, are cooperating with the SEC and DOJ investigations.

On February 19, 2008, the Board of Directors of the Company formed a committee comprised of the chairmen of the Board, the Audit Committee and the Nominating and Governance Committee, all of whom were independent directors. (The chairman of the Nominating and Governance Committee retired as a director of the Company effective May 6, 2008, but his services have been retained in an independent capacity as a member of the committee). External counsel to the Company, reporting to the committee has, on behalf of the committee, conducted and will continue to conduct an investigation into the circumstances giving rise to the SEC and DOJ investigations. External counsel reports directly to the committee and assists in connection with communications and interactions with the SEC and DOJ.

On March 5, 2008, a letter was received by the Company from the DOJ in which a request for a wider and more detailed range of documents was made. The Company and its officers and directors intend to continue to co-operate with the SEC and DOJ.

Separately, on May 21, 2008, the United Kingdom s Serious Fraud Office (SFO) notified Innospec Limited, a wholly owned subsidiary of the Company, that it had commenced an investigation into certain contracts involving British companies under the OFFP. As part of this investigation, the SFO has asked the Company to produce documents in respect of the Company s participation in the OFFP between January 1, 1996 and December 31, 2003. Following receipt of the SFO s notice the Company has instructed external legal counsel to advise and assist in relation to the investigation and the Company and its directors and officers intend to co-operate with the SFO. On October 16, 2008, the Company was further notified that the scope of the SFO s investigation would extend to matters relating to potential bribery involving overseas commercial agents that are already in the large part the subject of the ongoing DOJ and SEC investigations.

The outcome of these investigations remains uncertain to the Company. On the facts available to us it is not yet possible to form any reasonable estimate of the potential disgorgement,

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

penalties and fine payments, either by reference to a range of possible outcomes or by reference to the lower end of such a range of outcomes. The amount of any disgorgements, penalties or fines that the Company could face would depend on a number of eventual factors which are not currently known to the Company, including findings by relevant authorities regarding the amount, nature and scope of any improper payments, the amount of any pecuniary gain involved, the Company s ability to pay, and the level of co-operation provided to government authorities during the investigations.

Because of the uncertainties associated with the ultimate outcome of these investigations and the costs to the Company of responding and participating in them, no assurance can be given that the ultimate costs incurred and sanctions that may be imposed will not have a material adverse effect on the Company s results of operations, financial position and/or cash flows from operating activities.

At December 31, 2007 we had accrued $3.7 million in respect of estimated probable future legal and other professional expenses and provided no additional accruals in respect of the investigations. As part of our continuing commitment to co-operate and comply with the SEC and DOJ investigations, including the request for documents set out in the DOJ letter dated March 5, 2008, we accrued a further $6.8 million during the quarter ended March 31, 2008 in respect of estimated probable future legal and other professional expenses. During the quarter ended June 30, 2008, the Company provided no additional accruals in respect of these matters.

During the quarter ended September 30, 2008 the Company accrued an additional $8.7 million in respect of estimated probable legal and other professional fees and expenses. The provision for probable future legal and other professional fees and expenses amounted to $3.4 million at December 31, 2008. These accruals are made on the basis of the Company s then current best estimate, working in consultation with the committee of the Board of Directors, external legal counsel to the Company and its other professional advisors. Should any underlying assumptions prove incorrect or should any of the DOJ, SEC and/or the SFO alter the scope of the investigations, then the actual costs incurred by the Company could differ materially from current estimates.

The Company continues to keep the amount of such accrual provisions under review as it has been doing, including through working with the committee of the Board and external legal counsel and other professional advisors.

Bycosin Disposal

Voluntary disclosure of possible violations of the Cuban Assets Control Regulations to the Office of Foreign Assets Control. Given the international scope of its operations, the Company is subject to laws of many different jurisdictions, including laws relating to the imposition of restrictions on trade and investment with various entities, persons and countries, some of which laws are conflicting. In 2004 the Company reviewed, as it does periodically, aspects of its operations in respect of such restrictions, and determined to dispose of certain non-core,

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

non-U.S. subsidiaries of Bycosin AB. Bycosin s non-U.S. subsidiaries had been engaged in transactions and activities involving Cuban persons and entities before the acquisition of the Bycosin Group by the Company in June 2001, and such subsidiaries were continuing to engage in such transactions and activities at the time of the disposal of the non-core Fuel Specialties business and related assets in November 2004. On November 15, 2004, Bycosin AB, a wholly-owned subsidiary of the Company organized under the laws of Sweden (now known as Innospec Sweden AB, the Seller), entered into a Business and Asset Purchase Agreement (the Agreement) with Pesdo Swedcap Holdings AB (the Purchaser), Håkan Byström and others as the Purchaser s guarantors, and Octel Petroleum Specialties Limited (now known as Innospec Fuel Specialties Limited) as the Seller s guarantor, and completed the all-cash transaction contemplated thereby (together with related transactions, the Transaction). The Agreement provided for, amongst other things: (i) the disposal of certain non-core Fuel Specialties business and related manufacturing and other assets of the Seller; and (ii) the supply and distribution of certain power products to certain geographic regions. The net consideration paid by the Purchaser was approximately $2.9 million.

Following completion of the Transaction, the Company made a voluntary disclosure to the U.S. Office of Foreign Assets Control (OFAC) regarding transactions and activities engaged in by certain non-U.S. subsidiaries of the Company. Disclosures, amongst other items, included that the aggregate monetary value of the transactions involving Cuban persons and entities conducted by the Company s non-U.S. subsidiaries since January 1999 was approximately $26.6 million.

At this time, however, management believes that it would be speculative and potentially misleading for the Company to predict the specific nature or amount of penalties that OFAC might eventually assess against it. While penalties could be assessed on different bases, if OFAC assessed penalties against the Company on a performance of contracts basis , the applicable regulations provide for penalties, in the case of civil violations of the Cuban Assets Control Regulations (31 CFR. Part 515) (CACR), of the lesser of $65,000 per violation or the value of the contract. Since January 1999, non-U.S. subsidiaries of the Company have entered into 43 contracts with Cuban entities, each of which could be considered a separate violation of the CACR by OFAC. OFAC may take the position that the CACR should be interpreted or applied in a different manner, potentially even to permit the assessment of penalties equal to or greater than the value of the business conducted with Cuban persons or entities.

The Company has considered the range of possible outcomes and potential penalties payable. In accordance with the Company s accounting policies, provision has been made for management s current best estimate of the potential liability, including anticipated legal costs. However, should the underlying assumptions prove incorrect, the actual outcome could differ materially from management s current expectations. Management is not able to estimate the amount of any additional loss, if any.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

If the Company or its subsidiaries (current or former) were found not to have complied with the CACR, the Company believes that it could be subject to fines or other civil or criminal penalties which could be material.

Other Legal Matters

We are involved from time to time in claims and legal proceedings that result from, and are incidental to, the conduct of our business including product liability claims. There are no other material pending legal proceedings to which the Company or any of its subsidiaries is a party, or of which any of their property is subject, other than ordinary, routine litigation incidental to their respective businesses.

Guarantees

The Company and certain of the Company s consolidated subsidiaries are contingently liable for certain obligations of affiliated companies primarily in the form of guarantees of debt and performance under contracts entered into as a normal business practice. This included guarantees of non-U.S. excise taxes and customs duties. As at December 31, 2008, such contingent liabilities amounted to $6.9 million.

Under the terms of the guarantee arrangements, generally the Company would be required to perform should the affiliated company fail to fulfill its obligations under the arrangements. In some cases, the guarantee arrangements have recourse provisions that would enable the Company to recover any payments made under the terms of the guarantees from securities held of the guaranteed parties assets.

The Company and its affiliates have numerous long-term sales and purchase commitments in their various business activities, which are expected to be fulfilled with no adverse consequences material to the Company.

Indemnities and Warranties

In connection with the disposal of Octel Waste Management Limited on June 26, 2003, the Company provided certain warranties. The Company would be required to perform should the contingent liabilities in respect of the warranties become actual and could be required to make maximum future payments of £3.59 million ($5.2 million). There are no recourse provisions enabling recovery of any amounts from third parties nor are any assets held as collateral in respect of the warranties.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 19. Profit on Disposals, net

(in millions)	2008	2007	2006
Profit on disposal of surplus U.S. real estate	$ 0.4	$	$
Prepaid disposal costs			(0.4)
Profit on disposal of surplus United Kingdom real estate			9.6
	$ 0.4	$	$ 9.2

The profit on disposal of the surplus U.S. real estate relates to the sale in May 2008 of the Company s former manufacturing site in Elmwood Park, N.J.. Prepaid disposal costs in 2006 relate to expenditure being incurred in advance of this real estate being marketed and disposed of.

The profit on disposal of surplus United Kingdom real estate relates to the sale in August 2006 of the Company s former Fuel Technology Centre in Bletchley and sale in July 2006 of the Company s former sports and social club.

Note 20. Other Balance Sheet Information

The Company holds investments that are not consolidated or equity accounted since we do not have a controlling financial interest and they are not material, respectively. These investments are held at cost less provision for impairment. The principal affiliate is as follows:

	Ownership interest
Ferrous Corp	46.5%

In 2007 the Company sold its 27.5% share of PotatoPak Limited for $0.1 million generating a profit of $0.1 million. In 2006 the Company sold its 20% share of Deurex and 50.0% share of Octel Chemay (Pty) Limited, both for no profit or loss.

All of the unconsolidated affiliates are privately held companies and as such quoted market prices are not available. No dividends were received during 2008, 2007 and 2006.

Note 21. Recently Issued Accounting Pronouncements

In April 2008, the FASB issued FASB Staff Position FAS 142-3, *Determination of Useful Life of Intangible Assets* (FSP FAS 142-3). FSP FAS 142-3 amends the factors that should be considered in developing the renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FAS 142, *Goodwill and Other Intangible Assets*. FSP FAS 142-3 also requires expanded disclosure related to the determination of intangible asset useful lives. FSP FAS 142-3 is effective for the Company as of January 1, 2009. The Company does not believe that the adoption of FSP FAS 142-3 will have a material impact on its financial statements.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In March 2008, the FASB issued FAS 161, *Disclosures about Derivative Instruments and Hedging Activities*. FAS 161 requires enhanced disclosures surrounding the use and financial reporting of derivative instruments and hedging activities. This statement is effective for the Company as of January 1, 2009. The Company does not believe that the adoption of FAS 161 will have a material impact on its financial statements.

In December 2007, the FASB issued FAS 160, *Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51*. This statement establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. This statement is effective for the Company as of January 1, 2009. The Company does not believe that the adoption of FAS 160 will have a material impact on its financial statements.

In December 2007, the FASB issued FAS 141R, *Business Combinations a replacement of FASB Statement No. 141*, which significantly changes the principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. The statement also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. FAS 141R is effective for the Company beginning January 1, 2009, and will change the accounting for business combinations on a prospective basis.

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Item 9 Changes in and Disagreements With Accountants on Accounting and Financial Disclosure

None.

Item 9A Controls and Procedures

Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by this report the Company carried out an evaluation under the supervision and with the participation of our management, including the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of the Company s disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities and Exchange Act of 1934).

Based upon this evaluation of disclosure controls and procedures, the Company s Chief Executive Officer and Chief Financial Officer have concluded that the Company s disclosure controls and procedures were effective as of December 31, 2008, in timely making known material information relating to the Company and the Company s consolidated subsidiaries required to be disclosed in the Company s reports filed or submitted under the Exchange Act.

Management s Report On Internal Control Over Financial Reporting

The Company s management is responsible for establishing and maintaining adequate internal control over financial reporting. The Company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. In addition, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The Company s management assessed the effectiveness of the Company s internal control over financial reporting as of December 31, 2008. In making this assessment, management used the criteria in *Internal Control Integrated*

Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Based on the evaluation the Company concluded that the Company maintained effective internal control over financial reporting as of December 31, 2008, based on criteria in the *Internal Control Integrated Framework* issued by the COSO.

Management s assessment of the effectiveness of internal control over financial reporting as of December 31, 2008 has been audited by PricewaterhouseCoopers LLP, United Kingdom (PwC), an independent registered public accounting firm, as stated in their report that is included in Item 8 of this Annual Report on Form 10-K.

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Changes in Internal Controls over Financial Reporting

The Company is continuously seeking to improve the efficiency and effectiveness of its operations and of its internal controls. This results in refinements to processes throughout the Company. However, there has been no change in the Company s internal control over financial reporting during the most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

Item 9B Other Information

None.

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PART III

Item 10 Directors, Executive Officers and Corporate Governance

Information under the heading Management set out in the Proxy Statement for the Annual Meeting of Stockholders to be held on May 7, 2009 (the Proxy Statement) is incorporated herein by reference.

At its Board Meeting on February 24, 2004, the Company formally adopted a Code of Ethics. Any stockholder who requires a copy of the Code of Ethics, Corporate Governance Guidelines or any of the Board Committee Charters may obtain one by writing to the General Counsel, Innospec Inc., Innospec Manufacturing Park, Oil Sites Road, Ellesmere Port, Cheshire, CH65 4EY, e-mail investor@innospecinc.com. These documents can also be accessed via the Company s website, www.innospecinc.com.

Information regarding the composition and the workings of the Audit Committee are included under the headings Corporate Governance Committees of the Board of Directors Audit Committee and Audit Committee Report in the Proxy Statement and is incorporated herein by reference.

Item 11 Executive Compensation

The information under the heading Compensation Discussion and Analysis in the Proxy Statement is incorporated herein by reference.

Item 12 Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information under the heading Security Ownership of Certain Beneficial Owners and Management in the Proxy Statement is incorporated herein by reference.

Shares Authorized for Issuance Under Equity Compensation Plans

The information contained in the table entitled Equity Compensation Plan Information under the heading Equity Compensation Plans in the Proxy Statement is incorporated herein by reference.

The current limit for the total amount of shares which can be issued or awarded under the Company s five share option plans is 1,790,000.

Item 13 Certain Relationships and Related Transactions, and Director Independence

The information under the headings Transactions with Executives, Officers, Directors and Others and Certain Other Transactions and Relationships in the Proxy Statement is incorporated herein by reference.

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Item 14 Principal Accountant Fees and Services

Information with respect to fees and services related to the Company s independent registered public accounting firm, PricewaterhouseCoopers LLP, is contained in the Audit Committee Report under the heading Principal Accountant Fees and Services in the Proxy Statement and is incorporated herein by reference.

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PART IV

Item 15 Exhibits and Financial Statement Schedules

(a) (1) Financial Statements

The Consolidated Financial Statements of Innospec Inc. and its subsidiaries and related notes thereto, together with the report thereon of PricewaterhouseCoopers LLP dated February 20, 2009, appear on pages 52 through 97 of the 2008 Form 10-K to stockholders, are incorporated in Item 8.

(2) Financial Statement Schedules

All financial statement schedules have been omitted since the information required to be submitted has been included in the financial statements or because they are either not applicable or not required under the Rules of Regulations S-X.

(3) Exhibits

2.1	Transfer and Distribution Agreement, dated as of April 24, 1998, between Great Lakes Chemical Corporation (GLCC) and the Registrant. (3)
3.1	Amended and Restated Certificate of Incorporation of the Registrant. (1)
3.2	Amended and Restated By-laws of the Registrant. (1)
4.1	Form of Common Stock Certificate. (2)
4.2	Form of Certificate of Designations, Rights and Preferences of Series A Junior Participating Preferred Stock of the Registrant. (2)
4.3	Registration Rights Agreement dated as of April 30, 1998 among the Registrant, Octel Developments PLC and the initial purchasers. (1)
4.4	Purchase Agreement dated as of April 30, 1998 among the Initial Purchasers, Octel Developments PLC and the Registrant. (4)
4.5	Share purchase agreement between OBOAdler Holdings Limited and The Associated Octel Company Limited relating to the sale and purchase of the whole of the issued share capital of OBOAdler Company Limited, dated June 1, 1999. (5)
4.6	Share Repurchase Plan between the Company and J.P. Morgan Securities Inc. dated February 29, 2008. (6)

10.1 Innospec Inc. 2004 Non Employee Directors Stock Plan. (9)

10.2 Innospec Inc. 2004 Executive Co-Investment Plan. (9)

10.3	Innospec Inc. Performance Related Stock Option Plan, as amended. (9)
10.4	Innospec Inc. Company Share Option Plan, as amended. (9)
10.5	Innospec Inc. Savings Related Share Option Scheme, as amended. (9)
10.6	Employment offer letter from The Associated Octel Company Limited to Philip J Boon. (7)
10.7	Executive Services agreement, Richard Shone. (8)
10.8	Contract of Employment, Ian McRobbie. (8)
10.9	Contract of Employment, Paul Jennings. (8)
10.10	Contract of Employment, Dr. Catherine Hessner. (11)
10.11	Contract of Employment, Andrew Hartley. (11)
10.12	Business and Asset Purchase Agreement, dated November 15, 2004, between Bycosin AB, Håkan Byström and others, and Octel Petroleum Specialties Limited. (10)
10.13	Supply Agreement, dated November 15, 2004, between Bycosin AB and Pesdo Swedcap Holdings AB. (10)
10.14	Contract of Employment, Paul W. Jennings, dated September 21, 2005. (12)
10.15	Contract of Employment, Patrick Williams, dated October 11, 2005. (13)
10.16	Contract of Employment, Ian Cleminson, dated June 30, 2006. (14)
10.17	Innospec Inc. Performance Related Stock Option Plan 2008. (15)
10.18	Innospec Inc. Company Share Option Plan 2008. (15)
10.19	Innospec Inc. Non Employee Directors Stock Option Plan 2008. (15)
10.20	Innospec Inc. Sharesave Plan 2008. (15)
10.21	U.S. $150,000,000 three year Facilities Agreement dated February 6, 2009 with Lloyds TSB plc as agent, Company term loan facility of $50,000,000 and revolving loan of $100,000,000. (16)
12.1	Statement Regarding Computation of Financial Ratios (filed herewith).
14	The Innospec Inc. Code of Ethics. (9)
21.1	Principal Subsidiaries of the Registrant (filed herewith).
23.1	Consent of Independent Registered Public Accounting Firm (filed herewith).
24.1	Powers of Attorney of Directors and Officers of the Registrant. (4)

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31.1	Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
31.2	Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
32.1	Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith).
32.2	Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith).

Notes

(1) Incorporated by reference to the Company s amendment dated April 21, 1998, to a previously filed Form 10-12B/A.

(2) Incorporated by reference to the Company s Form 10-12B/A previously filed on April 10, 1998.

(3) Incorporated by reference to the Company s amendment dated May 4, 1998 to a previously filed Form 10-12B/A.

(4) Incorporated by reference to the Company s Form S-4 previously filed on October 1, 1998.

(5) Filed with the Company s Form 8-K on November 12, 1999.

(6) Filed with the Company s Form 8-K on March 3, 2008.

(7) Filed with the Company s Form 10-K on March 26, 2001.

(8) Filed with the Company s Form 10-K on March 28, 2003.

(9) Filed with the Company s Proxy Statement on March 15, 2004.

(10) Filed with the Company s Form 8-K on November 19, 2004.

(11) Filed with the Company s Form 10-K on March 31, 2005.

(12) Filed with the Company s Form 8-K on September 27, 2005.

(13) Filed with the Company s Form 8-K on October 12, 2005.

(14) Filed with the Company s Form 8-K on June 30, 2006.

(15) Filed with the Company s Proxy Statement on March 31, 2008.

(16) Filed with the Company s 8-K on February 10, 2009.

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SIGNATURES

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

INNOSPEC INC. (Registrant) Date: February 20, 2009	By:	/s/ Paul W. Jennings PAUL W. JENNINGS President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities indicated as of February 20, 2009:

/s/ Ian P. Cleminson Ian P. Cleminson	Executive Vice President and Chief Financial Officer
/s/ Robert E. Bew Dr Robert E. Bew	Chairman and Director
/s/ Hugh G. C. Aldous Hugh Aldous	Director
/s/ Peter H. C. Fearn Peter Fearn	Director
/s/ Martin M. Hale Martin M. Hale	Director
/s/ James M. C. Puckridge James Puckridge	Director
/s/ Joachim Roeser Joachim Roeser	Director