

Consolidated Financial Statements

**Pacific Northern Gas Ltd.**

December 31, 2006



## MANAGEMENT'S REPORT

To the Shareholders of  
**Pacific Northern Gas Ltd.**

The consolidated financial statements and all information in this report are the responsibility of management and have been approved by the Board of Directors. These consolidated financial statements have been prepared by management in conformity with accounting principles generally accepted in Canada ("Canadian GAAP") and, where appropriate, include certain estimated amounts that are based on informed judgements to ensure fair representation in all material respects. When alternative accounting methods exist, management has chosen those it considers most appropriate. Financial information contained elsewhere in this Annual Report is consistent with the consolidated financial statements.

Management has prepared Management's Discussion and Analysis which is based on the Company's financial results prepared in accordance with Canadian GAAP. It compares the Company's financial performance in 2006 to 2005 and should be read in conjunction with the consolidated financial statements and accompanying notes.

Management has developed and maintains a system of internal controls and formal policies and procedures to ensure the consistency, integrity and reliability of accounting and financial reporting, and to provide reasonable assurance that assets are safeguarded and that transactions are properly executed in accordance with management's authorization. The internal accounting control process includes management's communication to employees of policies which govern ethical business conduct.

The Board of Directors is responsible for ensuring that management fulfills its responsibility for financial reporting and for final approval of the consolidated financial statements. The Board of Directors performs this responsibility primarily through its Audit Committee.

The Audit Committee is comprised solely of unrelated, independent directors and meets regularly with management and the external auditors as well as independently with the external auditors to review the consolidated financial statements, the Auditors' Report and other auditing and accounting matters. The Audit Committee reviews the Annual Report, including the consolidated financial statements, before the consolidated financial statements are submitted to the Board of Directors for approval. The Audit Committee reports its findings to the Board of Directors. The external auditors have free access to the Audit Committee without obtaining prior management approval.

With respect to the external auditors, Deloitte & Touche LLP, the Audit Committee approves the terms of engagement and reviews the annual audit plan, the Auditors'

Report and results of the audit. It also recommends to the Board of Directors the external audit firm to be appointed by the shareholders.

The independent external auditors, Deloitte & Touche LLP, have been appointed by the shareholders to express an opinion as to whether the consolidated financial statements present fairly, in all material respects, the Company's financial position, results of operations and cash flows in accordance with Canadian GAAP. The auditors' report of Deloitte & Touche LLP outlines the scope of their examination and their opinion on the consolidated financial statements

*[signed]* \_\_\_\_\_

Roy G. Dyce  
President and Chief Executive Officer

*[signed]* \_\_\_\_\_

Elizabeth A. Fletcher  
Chief Financial Officer

February 19, 2007

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## Auditors' report

To the Shareholders of  
Pacific Northern Gas Ltd.

We have audited the consolidated balance sheets of Pacific Northern Gas Ltd. as at December 31, 2006 and 2005 and the consolidated statements of income, retained earnings and cash flows for each of the years in the three year period ended December 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2006 and 2005 and the results of its operations and its cash flows for each of the years in the three year period ended December 31, 2006 in accordance with Canadian generally accepted accounting principles.

*Deloitte & Touche LLP*

Chartered Accountants  
February 12, 2007

**Pacific Northern Gas Ltd.**

**CONSOLIDATED STATEMENTS OF INCOME**

Years ended December 31

[\$ in thousands, except for per share data]	2006	2005	2004
<b>Operating revenues</b>			
Gas sales and transportation services	100,104	103,280	93,295
Off system sales	32,713	56,159	43,949
Other [note 3]	6,031	511	511
	<b>138,848</b>	159,950	137,755
<b>Cost of sales</b>			
Gas sales	58,405	55,128	45,005
Off system sales	32,713	56,159	43,949
	<b>91,118</b>	111,287	88,954
<b>Operating margin</b>	<b>47,730</b>	48,663	48,801
Operating and maintenance	10,386	10,756	12,093
Administrative and general	6,640	6,410	6,623
Amortization of deferred charges	691	755	763
Municipal and other taxes	4,755	4,120	3,941
Depreciation	7,687	8,011	7,877
	<b>30,159</b>	30,052	31,297
<b>Operating income</b>	<b>17,571</b>	18,611	17,504
Investment and other income	787	27	48
	<b>18,358</b>	18,638	17,552
Income deductions			
Interest on long term debt	6,694	7,083	7,564
Interest on short term debt	750	316	460
Project development expenditures and other income deductions [note 12]	3,016	165	—
	<b>10,460</b>	7,564	8,024
<b>Income before income taxes</b>	<b>7,898</b>	11,074	9,528
Income taxes [note 5] - current	10,052	2,775	2,646
- deferred	(7,105)	1,639	1,474
	<b>2,947</b>	4,414	4,120
<b>Net income for the year</b>	<b>4,951</b>	6,660	5,408
<b>For common shares</b>			
Net income for the year	4,951	6,660	5,408
Dividends on preferred shares	337	337	337
<b>Net income applicable to common shares, basic and diluted</b>	<b>4,614</b>	6,323	5,071
<b>Earnings per common share [note 1]</b>			
Basic	\$1.27	\$1.75	\$1.41
Diluted	\$1.26	\$1.72	\$1.38
<b>Weighted average number of common shares outstanding</b>			
Basic	3,631,464	3,619,579	3,596,706
Effect of dilutive stock options	45,213	56,592	70,389
Diluted	<b>3,676,677</b>	3,676,171	3,667,095

See accompanying notes

**Pacific Northern Gas Ltd.**

**CONSOLIDATED BALANCE SHEETS**

As at December 31

[\$ in thousands]	2006	2005
<b>ASSETS</b> <i>[notes 7 and 8]</i>		
<b>Current assets</b>		
Cash and short term investments	11,574	—
Accounts receivable <i>[note 3]</i>	29,907	28,831
Income taxes recoverable <i>[note 5]</i>	—	375
Inventories of supplies and natural gas	2,603	2,688
Prepaid expenses	4,334	1,800
	<b>48,418</b>	<b>33,694</b>
<b>Plant, property and equipment</b> <i>[note 4]</i>	<b>172,996</b>	<b>171,351</b>
<b>Deferred charges</b> <i>[note 2]</i>		
Debt costs	499	615
Rate stabilization adjustment mechanism	2,936	2,311
Pipeline rehabilitation costs	859	1,011
Deactivated assets	4,667	5,050
Other	(310)	1,178
	<b>8,651</b>	<b>10,165</b>
	<b>230,065</b>	<b>215,210</b>
<b>LIABILITIES</b> Commitments and guarantees <i>[notes 15, and 16]</i>		
<b>Current liabilities</b>		
Bank indebtedness <i>[note 7]</i>	5,075	10,159
Accounts payable and accrued liabilities	22,094	21,121
Gas purchase variance payable <i>[note 2]</i>	3,115	881
Income and other taxes payable	10,377	3,263
Methanex termination payment deferral, current portion <i>[note 3]</i>	4,065	—
Long term debt due within one year <i>[note 8]</i>	4,880	4,880
	<b>49,606</b>	<b>40,304</b>
Non-current liabilities <i>[note 6]</i>	477	224
Methanex termination payment deferral, non-current portion <i>[note 3]</i>	8,096	—
Long term debt <i>[note 8]</i>	71,679	76,560
Deferred income taxes <i>[note 5]</i>	15,430	15,430
	<b>95,682</b>	<b>92,214</b>
	<b>145,288</b>	<b>132,518</b>
<b>SHAREHOLDERS' EQUITY</b>		
Preferred shares <i>[note 9]</i>	5,000	5,000
Common shares <i>[notes 10 and 11]</i>	9,103	9,065
Contributed surplus <i>[notes 10 and 11]</i>	3,168	2,828
Retained earnings	67,506	65,799
Common shareholders' equity	<b>79,777</b>	<b>77,692</b>
	<b>84,777</b>	<b>82,692</b>
	<b>230,065</b>	<b>215,210</b>

*See accompanying notes*

On behalf of the Board:

Director

Director

**Pacific Northern Gas Ltd.**

**CONSOLIDATED STATEMENTS OF  
RETAINED EARNINGS**

Years ended December 31

[\$ in thousands]	2006	2005	2004
<b>Balance, beginning of year</b>	<b>65,799</b>	62,374	60,183
Net income for the year	<b>4,951</b>	6,660	5,408
	<b>70,750</b>	69,034	65,591
Preferred share dividends	<b>337</b>	337	337
Common share dividends	<b>2,907</b>	2,898	2,880
	<b>3,244</b>	3,235	3,217
<b>Balance, end of year</b>	<b>67,506</b>	65,799	62,374

*See accompanying notes*

**Pacific Northern Gas Ltd.**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

Years ended December 31

[\$ in thousands]	2006	2005	2004
<b>OPERATING ACTIVITIES</b>			
Net income for the year	4,951	6,660	5,408
Add (deduct) items not involving cash:			
Deferred income taxes	(7,105)	1,639	1,474
Depreciation and amortization <i>[note 17]</i>	8,494	8,905	8,800
Amortization of Methanex termination payment deferral, net of income taxes <i>[note 3]</i>	(3,890)	—	—
Stock option expense <i>[note 11]</i>	179	132	93
Deferred income taxes on deferred charges	7,105	(1,639)	(1,474)
Imputed interest on deferred charges	416	62	(25)
Other	253	(63)	358
Operating cash flow	10,403	15,696	14,634
Non-cash working capital changes <i>[note 17]</i>	7,171	(3,827)	1,708
<b>Net cash provided by operating activities</b>	<b>17,574</b>	<b>11,869</b>	<b>16,342</b>
<b>INVESTING ACTIVITIES</b>			
Additions to plant, property and equipment <i>[note 4]</i>	(8,093)	(6,753)	(11,276)
Increase in deferred charges and credits <i>[note 2]</i>	(269)	(1,799)	(1,071)
Methanex termination payment deferral, net of income taxes <i>[note 3]</i>	15,372	—	—
<b>Net cash provided by (used in) investing activities</b>	<b>7,010</b>	<b>(8,552)</b>	<b>(12,347)</b>
<b>FINANCING ACTIVITIES</b>			
Increase (decrease) in bank indebtedness	(5,084)	4,113	3,146
Repayment of long term debt	(4,881)	(4,380)	(4,380)
Issue of common shares <i>[note 10]</i>	199	185	143
Dividends paid	(3,244)	(3,235)	(3,217)
<b>Net cash used in financing activities</b>	<b>(13,010)</b>	<b>(3,317)</b>	<b>(4,308)</b>
<b>Decrease in cash and cash equivalents during the year</b>	<b>11,574</b>	<b>—</b>	<b>(313)</b>
Cash and cash equivalents, beginning of year	—	—	313
<b>Cash and cash equivalents, end of year</b>	<b>11,574</b>	<b>—</b>	<b>—</b>

Supplemental cash flow information *[note 17]*

*See accompanying notes*

## **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

December 31, 2006, 2005 and 2004

### **1. SUMMARY OF ACCOUNTING POLICIES**

#### **Regulation and related disclosure**

Pacific Northern Gas Ltd. and its wholly owned subsidiary, Pacific Northern Gas (N.E.) Ltd., are regulated utilities engaged in the transportation and distribution of natural gas. Their accounting records and practices conform to the requirements of the British Columbia Utilities Commission (the "Commission"). The Commission exercises statutory authority over matters such as rates, including rate of return on equity and capital structure, construction and operation of facilities, accounting practices, tolls, charges and contractual agreements with customers. In order to comply with orders issued by the Commission, the timing of recognition of certain revenues and expenses may differ from that which would otherwise be required under Canadian generally accepted accounting principles for non rate-regulated entities.

The financial effects of rate regulation relate principally to balances and the accounting policies noted below. Disclosure of the impact of rate regulation on these balances and policies are included in the related notes as referenced:

- Deferred charges and liabilities [notes 2 and 4]
- Property, plant and equipment and related depreciation rates [note 4]
- Income taxes [notes 2 and 5]
- Employee future benefit plans for post-retirement non-pension benefits [notes 2 and 6]
- Hedges, derivatives and other financial instruments [note 2]

#### **Principles of consolidation**

The financial statements of entities which are controlled by the Company through voting equity interest, referred to as subsidiaries, are consolidated. Variable interest entities ("VIEs"), which include, but are not limited to, special purpose entities, trusts, partnerships and other legal structures, as defined by the Accounting Standards Board in Accounting Guideline 15 "Consolidation of Variable Interest Entities", are entities in which equity investors do not have the characteristics of a "controlling financial interest" or there is not sufficient equity at risk for the entity to finance its activities without additional subordinated financial support. VIEs are subject to consolidation by the primary beneficiary who will absorb the majority of the entities' expected losses and/or residual returns. The Company has determined that it is not the primary economic beneficiary of any VIEs.

The consolidated financial statements include the accounts of Pacific Northern Gas Ltd., its wholly owned subsidiary Pacific Northern Gas (N.E.) Ltd., as well as the Company's proportionate interest in the assets, liabilities, revenue and expenses of all incorporated and unincorporated joint ventures, to the extent that the Company is not the primary economic beneficiary and they are subject to joint control. All intercompany transactions and balances are eliminated on a pro rata basis for joint ventures.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 1. SUMMARY OF ACCOUNTING POLICIES (cont'd.)

Significant subsidiaries and joint ventures are as follows, as at December 31:

	<b>Direct and Indirect Interest Held by the Company (percent)</b>	
	<b>2006</b>	<b>2005</b>
<b>Subsidiaries:</b>		
Pacific Northern Gas (N.E.) Ltd.	100	100
<b>Joint Ventures and Non-Controlled Partnerships [note 12]:</b>		
Pacific Trail Pipelines Limited Partnership	50	—
Pacific Trail Pipelines Management Inc.	50	—

#### Use of estimates

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses and disclosure of contingent assets and liabilities.

Significant balances impacted by estimates include operating revenues which include estimates of customer usage from the last meter reading date to the end of the reporting period, and accounts receivable which are recorded net of an estimated allowance for doubtful accounts. Actual results could differ from these estimates.

#### Revenue recognition

The Company's operations are subject to rate-regulation and accordingly there are circumstances where the revenues recognized do not match the amounts billed. Revenue is recognized in a manner that is consistent with the underlying rate-setting mechanism as mandated by the Commission. This may result in the recognition of regulatory assets and liabilities.

Operating revenues include natural gas sales that are recorded on the basis of regular meter readings and estimates of customer usage from the last meter reading date to the end of the year. Operating revenues also include transportation services revenues that are recorded as service is provided, as well as sales of gas surplus to the needs of the Company's sales customers ("off system sales") that are recognized when the gas is delivered.

## **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

December 31, 2006, 2005 and 2004

### **1. SUMMARY OF ACCOUNTING POLICIES (cont'd.)**

#### **Cash and cash equivalents**

Cash and cash equivalents are held for the purpose of meeting short-term cash commitments and include bank balances, and bankers' acceptances and term deposits with maturities of less than 90 days.

#### **Inventories of supplies and natural gas**

Inventories of natural gas (line-pack) are valued at the supply rate approved by the Commission. The rate is adjusted quarterly in accordance with a method approved by the Commission whereby all costs are billed entirely to customers, including the impact of the risk management activities related to the price of natural gas. Inventory of supplies are valued at the lower of cost determined on a first-in, first-out basis and net realizable value. Inventories of natural gas in storage are valued at the lower of average cost and net realizable value.

Included in, or deducted from, inventories of natural gas are amounts for natural gas to be received from, or returned to transportation service customers. This amount represents the difference between natural gas received on behalf of the transportation service customers and natural gas delivered to them.

#### **Deferred charges and liabilities**

The Company defers certain charges which the Commission or contractual arrangement require or permit to be recovered through future rates. Deferred charges and credits are amortized over various periods as approved by the Commission, depending on the nature of the charges or credits [see note 2].

Deferred charges include long-term debt issue costs which are amortized over the term of the related debt which approximates the effective interest method.

#### **Development activities**

The costs related to development activities are capitalized except in those cases where the Company does not have reasonable assurance that these costs will be recovered in the future.

#### **Plant, property and equipment**

Plant, property and equipment are recorded at cost less contributions in aid of construction. Cost includes an allowance for funds used during construction calculated at the Company's cost of capital. As directed by the Commission, the cost of depreciable assets retired, together with removal costs, less salvage is charged to accumulated depreciation. Gains or losses on disposal are not taken into income unless the disposal is outside the normal course of business or involves a major item of plant.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 1. SUMMARY OF ACCOUNTING POLICIES (cont'd.)

Depreciation is provided on a straight-line basis for plant in service at the commencement of each fiscal year at rates approved by the Commission [note 4].

#### **Asset retirement obligations**

The fair value of asset retirement obligations associated with the retirement of long-lived assets is recognized in the period when it can be reasonably determined. The fair value, which approximates the cost a third party would charge in performing the tasks necessary to retire such assets, is recognized at the present value of expected future cash flows and is added to the carrying value of the associated asset and depreciated over the asset's useful life. The liability is accreted over time through periodic charges to earnings and is reduced by actual costs of decommissioning and reclamation.

The Company's natural gas transmission and distribution long-lived assets are comprised principally of mains, service lines, compressors, and measuring and regulating equipment. No amount has been recorded for asset retirement obligations relating to the Company's assets as it is not possible to make a reasonable estimate of the fair value of the liability due to the indeterminate timing and scope of the asset retirements. Management expects all retirement costs associated with the regulated assets will be recovered through tolls in future periods and therefore any liability recorded would be offset by an asset.

#### **Income taxes**

The Company provides for income taxes using the income taxes currently payable method as directed by the Commission, except as described below. Under the income taxes currently payable method, no provisions are made for income taxes deferred as a result of differences in timing between the treatment for income tax and accounting purposes of various income and expenditure items [see note 5].

The Commission has directed that the deferral method of accounting for income taxes be followed for certain transactions within the Company. Under the deferral method of accounting for income taxes, reported earnings are charged with the income taxes related to those earnings. Differences between these taxes and taxes currently payable, arising mainly from differences in the timing of expense deductions, are recorded as deferred income taxes.

#### **Employee future benefit plans**

The Company accrues its pension obligations under employee benefit plans and the related costs, net of plan assets. The actuarial determination of the accrued benefit obligation uses the projected benefit method prorated on service (which incorporates management's best estimate of future salary levels, other cost escalations, retirement ages of employees, and other actuarial factors).

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 1. SUMMARY OF ACCOUNTING POLICIES (cont'd.)

For the purpose of calculating the expected return on plan assets, those assets are valued at a market-related value. The market-related value of assets is determined as the average of the fair value of plan assets and four projected values. The projected values are determined by projecting the fair value as at a particular time (1 year, 2 years, 3 years and 4 years prior to the measurement date) to the measurement date using actual non-investment cash flows and an assumed investment return equal to the average market-related value return on three month T-Bills plus 2.5%.

Actuarial gains (losses) arise from the difference between the actual long term rate of return on plan assets for a period and the expected long term rate of return on plan assets for the period, or from changes in actuarial assumptions used to determine the accrued benefit obligation. The excess of the net unamortized cumulative actuarial gain or loss over 10 percent of the greater of the benefit obligation and the fair value of the plan asset at the beginning of the year is amortized over the average remaining service period of the active employees. Past service costs from plan amendments are amortized on a straight-line basis over the average remaining service period of employees active at the date of amendment.

The average remaining service period of the active employees covered by the pension plan is 14 years. For the defined contribution plan maintained by the Company, contributions payable by the Company are expensed as pension costs.

Other retirement benefit plans are non-contributory health care and life insurance plans. Prior to 2004, the Company used the pay-as-you-go method of accounting for non-pension benefits as directed by the Commission. Beginning in 2004, both the current service cost and the benefits paid to retirees are expensed and recovered in customer rates. The accrued benefit obligation is included on the balance sheet in non-current liabilities.

### **Financial instruments**

The Company uses derivative and other financial instruments in connection with the management of gas supply and interest rates. The Company enters into forward, future, swap, fixed price and option contracts to manage the exposure to the volatility of natural gas prices for sales customers. The prices paid for natural gas are based on variable indices. The instruments used make it possible to fix, or define, the price of natural gas for delivery to customers. The gains or losses on these instruments are included in gas supply costs as these costs are recognized, and are recovered through the gas supply rate in accordance with the method approved by the Commission.

Credit risk is the risk of loss from non-performance of suppliers, customers or financial counterparties to a contract. The Company maintains credit policies which management believes significantly minimize overall credit risk. These policies include a review of a counterparty's financial condition, measurement of credit exposure and monitoring of concentration of exposure to any one customer or counterparty.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 1. SUMMARY OF ACCOUNTING POLICIES (cont'd.)

#### Earnings per common share

Basic earnings per common share are calculated using the weighted average number of common shares outstanding during the year. Diluted earnings per share are calculated using the treasury stock method whereby the weighted average number of common shares outstanding during the year is adjusted to reflect the potential exercise of dilutive share purchase options.

There are 135,100 [2005 – 96,000; 2004 – 84,200] stock options outstanding during the year that could potentially dilute basic earnings per share in the future that were not included in the computation of diluted earnings per share because the options' exercise prices were greater than the average market price of the common shares.

#### Stock based compensation

Stock options granted after January 1, 2003 are accounted for under the fair value method. Under this method, compensation expense is measured at fair value at the grant date using the Black-Scholes option pricing model and recognized over the vesting period with a corresponding credit to contributed surplus. Stock options granted prior to January 1, 2003 continue to be accounted for as capital transactions when the options are exercised, which does not give rise to compensation expense.

#### New accounting standards

##### Applied in 2005

Effective December 31, 2005, the Company adopted, on a prospective basis, the new Accounting Guideline AcG-19, *Disclosure by Entities subject to Rate Regulation*, which applies to years ending on or after December 31, 2005. AcG-19 provides guidance about certain aspects of the disclosure and presentation of information of entities providing services or products for which customer rates are established or approved by a regulator. The objective is to ensure that financial statement users are better informed about the existence, nature and effects of all forms of rate regulation. If rate regulation has an impact on the accounting treatment of a transaction, the entity should make mention of it and provide additional information about the impact on its financial statements [see note 2].

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 1. SUMMARY OF ACCOUNTING POLICIES (cont'd.)

#### **Applicable in 2007**

##### *Comprehensive income*

In April 2005, the Canadian Institute of Chartered Accountants (CICA) issued Section 1530 of the CICA Handbook, "Comprehensive Income", which applies to years beginning on or after October 1, 2006. The Section establishes standards for reporting and display of comprehensive income, which is the change in equity (net assets) of an enterprise during a period from transactions from non-owners sources. The Company intends to comply with the new presentation standards as of January 1, 2007.

##### *Financial instruments – recognition and measurement*

In April 2005, the CICA issued Section 3855 of the CICA Handbook, "Financial Instruments – Recognition and Measurement", which applies to years beginning on or after October 1, 2006. This Section establishes when a financial instrument should be recognized in the balance sheet and the valuation method – fair value or cost-based value. It also specifies the presentation of gains and losses on financial instruments. The Company does not expect that the adoption of this standard will have a material impact on net income.

##### *Hedges*

In April 2005, the CICA issued Section 3865 of the CICA Handbook, "Hedges", effective for years beginning on or after October 1, 2006. This Section establishes standards for when and how hedge accounting may be applied. Hedging is an activity designed to modify an entity's exposure to one or more risks. Hedge accounting modifies the normal basis for recognizing the gains, losses, revenues and expenses associated with a hedged item or a hedging item in an entity's income statement. It ensures that counterbalancing gains, losses, revenues and expenses are recognized in the same period. The Company does not expect that the adoption of this standard will have a material impact on its net income.

#### **Comparative figures**

Certain of the prior year's figures have been reclassified to conform to the current year's presentation.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 2. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION

#### General information on rate regulation and its economic effects

The Company and its subsidiary are regulated by the Commission. Customer rates are set under a cost of service methodology that allows revenues to be set to recover the Company's forecast costs and to earn a rate of return on common equity. Applications for changes to rates are made annually and are submitted to the Commission for their review and approval.

Forecast costs include gas commodity and transportation, operation and maintenance, depreciation, property taxes, interest and income taxes. The rate base is the average level of investment in all recoverable assets used in gas transmission and distribution, and an allowance for working capital. Under cost of service regulation, it is the responsibility of the Company to demonstrate to the Commission the prudence of the costs it has incurred. For 2006, the Company's average approved rate of return on the rate base was 8.58 percent after tax, and the average approved rate of return on common equity was 9.40 percent after tax, based on weighting using the respective rate bases of the Company and its subsidiary. The Company's deemed common equity was 40 percent, but the deemed common equity of its subsidiary was 36 percent in 2006.

#### Regulatory assets and liabilities

Certain regulatory assets represent future revenues associated with certain costs, incurred in the current period or in prior periods that are expected to be recovered from customers in future periods through the rate-setting process. In the absence of rate regulated accounting, generally accepted accounting principles would not permit deferral of regulatory assets and therefore the earnings impact would be recorded in the period of recovery. Long-term regulatory assets are recorded in deferred charges in the consolidated balance sheets.

Regulatory liabilities represent future reductions or limitations of increases in revenues associated with amounts that are expected to be refunded to customers as a result of the rate-setting process. The treatment under generally accepted accounting principles of regulatory liabilities and the resulting earnings impact is the same as that under rate regulated accounting because the liabilities represent contractual obligations. Regulatory liabilities are shown on the consolidated balance sheets in liabilities.

## **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

December 31, 2006, 2005 and 2004

### **2. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION (cont'd)**

#### **Regulatory risk and uncertainties affecting recovery or settlement**

The regulatory assets and liabilities recorded in the financial statements are based upon an expectation of the future actions of the regulator. To the extent that the regulator's future actions are different from the Company's expectations, the timing and amount of recovery or settlement of amounts recorded on the consolidated balance sheets could be significantly different from the timing and amounts that are eventually recovered or settled.

#### **Financial statement effects**

In order to recognize the economic effects of the actions or expected actions of the regulator, the timing of recognition of certain revenues and expenses may differ from that otherwise expected under generally accepted accounting principles ("GAAP") for non rate-regulated entities.

The income statement effects noted in the following table indicates the effect, either increase or (decrease), on 2006 or 2005 after tax net income as a result of the treatment under rate regulated accounting as compared to the corresponding treatment under GAAP for non rate-regulated entities.. The carrying amount for 2006 and 2005 is the cost amount of the deferral, less income taxes and accumulated amortization, at December 31, 2006 and December 31, 2005, respectively.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 2. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION (cont'd)

#### Deferred charges and liabilities

[\$ in thousands]

Description	Period of Recovery	Increase (decrease) in net income 2006	Carrying Amount December 31 2006	Increase (decrease) in net income 2005	Carrying Amount December 31 2005
<i>Deferrals included in rate base</i>					
Rate Stabilization Adjustment Mechanism <sup>1</sup>	Over three-years, based on forecast customer deliveries	1,341	2,936	876	2,311
<b>Pipeline rehabilitation costs<sup>2</sup>:</b>					
Extraordinary pipeline losses	Straight-line over 10 years, between 2007 and 2014	—	53	—	62
Pipeline breaks	Straight-line over 10 years, between 2007 and 2014	—	647	21	739
Stress Corrosion Cracking	Straight-line over 10 years, between 2007 and 2016	8	159	42	210
<b>Total pipeline rehabilitation costs</b>		<b>8</b>	<b>859</b>	<b>63</b>	<b>1,011</b>
<b>Other rate base deferrals:</b>					
Preliminary surveys and investigations <sup>3</sup>	Depreciated over the life of the related asset commencing when placed into service	(350)	5	350	355
Property taxes <sup>4</sup>	1 year, 2007	(47)	(47)	80	80
Industrial customer deliveries <sup>5</sup>	Straight-line over 3 years, 2007 to 2009	30	264	311	696
Commission hearing costs <sup>6</sup>	1 year, 2007	(107)	361	485	409
Other	Straight-line over 3 to 10 years	99	79	143	252
<b>Total other rate base deferrals</b>		<b>(375)</b>	<b>662</b>	<b>1,369</b>	<b>1,792</b>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 2. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION (cont'd)

[ \$ in thousands ]		Increase (decrease) in net income 2006	Carrying Amount December 31, 2006	Increase (decrease) in net income 2005	Carrying Amount December 31, 2005
Description	Period of Recovery				
<b><i>Deferrals excluded from rate base</i></b>					
Deactivated assets <sup>7</sup>	Straight-line over 10 years, to 2015	285	4,667	5,050	5,050
<b>Other deferrals excluded from rate base:</b>					
Depreciation adjustment liability for prior year retirements <sup>8</sup>	Straight-line over 1 to 2 years	(1,293)	(1,272)	(637)	(637)
Propane air plant <sup>9</sup>	Straight-line over 10 years, to 2014	26	376	(318)	412
Interest <sup>10</sup>	Straight-line over 2 years, 2007 to 2008	101	8	(186)	(315)
Other	1 year, 2007	(85)	(84)	(59)	(74)
<b>Other deferrals excluded from rate base</b>		<b>(1,251)</b>	<b>(972)</b>	<b>(1,200)</b>	<b>(614)</b>
<b><i>Total deferred charges</i></b>		<b>8</b>	<b>8,152</b>	<b>6,158</b>	<b>9,550</b>
<b><i>Regulatory liabilities excluded from rate base</i></b>					
Gas purchase variance payable <sup>11</sup>	Based on forecast deliveries over 1 year	(3,615)	(3,115)	(283)	(2,232)
Methanex Termination Payment	Straight-line over the period March 1, 2006 to October 31, 2009	(12,161)	(12,161)	—	—
<b>Total regulatory liabilities excluded from rate base</b>		<b>(15,776)</b>	<b>(15,276)</b>	<b>(283)</b>	<b>(2,232)</b>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 2. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION (cont'd)

#### 1. Rate Stabilization Adjustment Mechanism

The Company is authorized by the Commission to maintain a rate stabilization adjustment mechanism ("RSAM") deferral account to mitigate the effect on its earnings of volatility in deliveries to certain customers caused principally by weather and natural gas cost volatility. The RSAM deferral account accumulates the margin impact of variations in the actual versus forecast use for residential and small commercial customers. Balances in the RSAM deferral account are recovered in customer rates over a three year period based on forecast deliveries. During 2006, approximately \$716,000 of the December 31, 2005 RSAM balance was recovered in customer rates [2005 – \$353,000; 2004 – \$282,000].

#### 2. Pipeline rehabilitation costs

The cost of carrying out temporary repairs of pipeline breaks as well as the related undepreciated net book value of pipeline assets destroyed as a result of pipeline breaks is recorded in deferral accounts for future recovery from customers. In addition, the cost of investigative work and repair of pipeline assets at risk due to stress corrosion cracking or other material defects is deferred for future recovery in customer rates.

#### 3. Preliminary surveys and investigations

The Company defers costs associated with the development of new projects that would be beneficial to its customers. In 2005 the Company commenced preliminary study and investigation of a project to loop its main line transmission system from Kitimat to Summit Lake (the "KSL Project"). The KSL Project would be required to provide gas transportation services for liquefied natural gas to be imported and regasified at the proposed Kitimat LNG Inc. terminal to be located on the Douglas Channel approximately 15 kilometers southwest of Kitimat. In 2005 the Company incurred costs of \$0.9 million associated with the KSL Project, which were deferred with the approval of the Commission. On July 17, 2006, the Company announced the formation of Pacific Trail Pipelines Limited Partnership ("the partnership"), a partnership between the Company and Galveston LNG Inc., the parent company of Kitimat LNG Inc., for the purpose of developing the KSL Project. The development costs deferred prior to the formation of the partnership were transferred as part of the Company's initial investment in the partnership and subsequently expensed by the partnership, pursuant to the partnership agreement. As the partnership is not a regulated utility, there is no longer reasonable assurance that these costs will be recovered in the future.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 2. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION (cont'd)

#### 4. Property taxes

As directed by the Commission, a deferral account is used to recover the difference between actual and forecast property taxes, to be recovered from (or refunded to) customers in rates over the following year.

#### 5. Industrial Customer Deliveries

As directed by the Commission, a deferral account is used to recover the lost margin from certain large industrial customers whose deliveries varied from the forecast used for rate setting. The amount deferred during the year ended December 31, 2003 is being amortized over three years, commencing in 2004. The credit amount deferred in 2004 was amortized entirely in 2005. Amortization of \$476,000 has been included in net income during 2006 related to these deferred costs [2005 – \$230,000]. The Company has applied to the Commission for a three-year amortization period for the 2006 deferral, commencing in 2007.

#### 6. Commission hearing costs

The Company's annual revenue requirements application contains a forecast of the costs that the Company will incur relating to the Commission's review of the application. The total actual costs are usually not known by the Company until a few months after the conclusion of the Commission's review process and the implementation of new customer rates. Therefore, customer rates reflect forecast costs of the review process and the Company records in a deferral account the difference between forecast and actual costs for future recovery from or refund to customers.

#### 7. Deactivated assets

In its 2006 revenue requirements application, the Company identified plant, property and equipment assets which would not be required on an ongoing basis to provide service to its customers, having regard to the closure of the Methanex Corporation plant in late 2005 [see note 3]. In 2006, the Commission approved the removal from rate base of compressor facilities, pipeline loops and various other fixed assets with a net book value of \$5.05 million. This amount was transferred to a non-rate base, interest bearing deferral account effective December 31, 2005. The deferral account is being amortized on a straight-line basis over ten years commencing in 2006.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 2. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION (cont'd)

#### 8. Depreciation adjustment for prior year retirements

As a result of detailed analysis of property, plant and equipment cost and retirement records conducted in 2005 and 2006, various assets were identified as retired or disposed in prior years, between 1989 and 2001; however, no retirement was recorded at the time. Approximately \$1,239,000 [2005 - \$637,000] of accumulated depreciation was identified which should not have been recorded in the years 1989 to 2005. The Company reversed this accumulated depreciation in 2005 and 2006, and transferred the balance to a deferred credit. The deferred credit recorded in 2005 was refunded to customers, with the approval of the Commission, in 2006. The Company has applied to the Commission to allow the deferred credit recorded in 2006 to be refunded to customers over a one or two year period, commencing in 2007. The ultimate realization of this deferred credit is subject to a future decision of the Commission.

#### 9. Propane air plant

In 2004, the net book value of a propane air plant which is no longer in service with an undepreciated value of \$966,000 was removed from fixed assets and transferred to a deferral account for future recovery from customers over a period of twenty years commencing in 2005. As part of the negotiated settlement process for determining 2005 customer rates, the Company agreed to expense \$165,000 of the relocation expenses previously deferred in 2004. This amount has been included in other income deductions in the 2005 statement of income. In addition, \$242,000 of the amounts deferred in 2004 were returned to rate base and reclassified to plant property and equipment, effective January 1, 2005.

#### 10. Interest

As directed by the Commission, the Company has an interest deferral mechanism that mitigates exposure to fluctuations in floating interest rates on both short term and long term debt instruments.

#### 11. Gas purchase variance payable

Gas purchase variance payable amounts arise due to unanticipated commodity cost and demand fluctuations between actual natural gas costs and forecast natural gas costs as recovered in rates. As directed by the Commission, gas purchase variance payable amounts are being refunded to customers on a straight-line basis generally over one year of forecast deliveries. The amount of such credits included in cost of sales in 2006 was \$2,096,000 before income taxes [2005 - \$2,466,000; 2004 - \$2,319,000].

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 2. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION (cont'd)

#### Other items affected by rate regulation

##### Future income taxes

The Company recovers tax expense based on the taxes payable method, as prescribed by the Commission, for rate-setting purposes. Under the income taxes currently payable method, no provisions are made for future or deferred income taxes as a result of differences in timing between the treatment for income tax and accounting purposes of the various income and expenditure items. Therefore, rates do not include the recovery of future income taxes related to temporary differences. Consequently, the Company does not record future income taxes for its regulated activities as the Company expects that all future income taxes will be recovered in rates when they become payable. Generally accepted accounting principles require the recognition of future income tax liabilities and future income tax assets in the absence of rate regulation.

Deferred income tax expenses shown on the consolidated statements of income arise from temporary differences related to the regulatory deferral accounts identified above. The regulatory deferral accounts are recorded on the balance sheet at December 31, 2006 net of deferred income tax assets of \$5.4 million [2005 – liabilities of \$2.0 million]. In the absence of rate regulated accounting, regulatory deferrals would not be recorded nor would the associated deferred or future income tax liabilities or assets. However, future income taxes associated with certain assets, primarily property, plant and equipment, would be recorded, in the absence of rate regulated accounting, resulting in the recognition of \$21.0 million [2005 – \$20.2 million] in future income tax liabilities. As a result of these impacts, earnings would decrease by \$0.8 million in the year ended December 31, 2006 [2005 – increase by \$1.1 million].

From July 1, 1978 until its suspension on November 1, 1986, the deferral method was followed by the Company. Had the liability method of accounting for income taxes been followed continuously since the inception of the Company, the future income tax liabilities and future income tax expense (recovery) would be:

[\$ in thousands]	2006	2005
Deferred income tax liabilities, as reported	15,430	15,430
Adjustment to reflect liability method	(4,901)	(5,246)
Unrecorded future income tax liabilities, beginning of year	9,998	10,633
Unrecorded future income tax expense (recovery)	447	(635)
<b>Future income tax liability, end of year</b>	<b>20,974</b>	<b>20,182</b>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 2. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION (cont'd)

#### Allowance for funds used during construction (AFUDC) and other capitalized costs

AFUDC is included in the cost of property, plant and equipment and is depreciated over future periods as part of the total cost of the related asset. AFUDC includes both an interest component and a cost of equity component, as approved by the Commission. In the absence of rate regulation, generally accepted accounting principles would permit the capitalization of only the interest component. Therefore, the recording of the equity component as a capitalized asset and the corresponding earnings recognized during the construction phase would not be recognized nor would the subsequent depreciation of the capitalized equity component. It is not possible to make a reasonable estimate of the carrying value of the equity component of AFUDC included in property, plant and equipment. In 2006, the Company capitalized AFUDC amounting to \$11,000 [2005 – \$258,000; 2004 – \$47,000].

As directed by its regulator, when a fixed asset is retired or otherwise disposed of, the Company does not reflect a gain or loss in income. Entities not subject to rate regulation write off the net book value of the retired asset and include any resulting gain or loss in current operating results. Since the Company does not calculate depreciation expense for individual assets, it cannot identify or quantify gains or losses on the retirement of a fixed asset in any given year which would have been recorded had the Company not been subject to rate regulation.

#### Interest capitalization

The Company is permitted to earn a short term interest return on deferrals excluded from rate base. For the years 2004 through 2006, interest was capitalized at 6 percent on all regulatory deferrals excluded from rate base. In the absence of rate regulation, generally accepted accounting principles would not permit the capitalization of interest on deferrals. Therefore, the recording of the interest component as a deferred asset or liability and the corresponding earnings adjustment would not be recognized nor would the subsequent amortization of the capitalized interest component. In 2006, this resulted in a charge to income of \$605,000 [2005 – charge of \$175,000; 2004 – charge of \$135,000].

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 2. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION (cont'd)

#### Overhead capitalization

With the approval of the Commission, the Company capitalizes a percentage of certain operating, administrative and general costs into the rate base on an ongoing basis. Such treatment is accorded in recognition of the significance of plant, property and equipment constructed by the Company. The Company is authorized to charge depreciation and earn a rate of return on the net book value of such capitalized costs in future years. In the absence of rate regulated accounting, such overhead costs would be charged to the consolidated statement of earnings in the period in which they occurred. In 2006, the Company capitalized \$1.69 million of overhead costs to plant, property and equipment [2005 – \$1.42 million; 2004 - \$1.53 million].

#### Non-Pension post retirement benefits

The Company provides for post-retirement benefits other than pensions. The cost of providing these benefits are expensed when paid. In addition, since 2004 the Company has expensed the current service cost relating to benefits earned by employees in the current year. Under generally accepted accounting principles, the Company would also expense the annual interest cost and amortize any actuarial gains and losses into income. Had these costs been accrued and their recovery not permitted in customers' rates, earnings in 2006 would have decreased by \$272,000 [2005 – \$221,000; 2004 – \$315,000] [see note 6].

#### Derivative instruments and hedging

To be recorded as a hedging instrument under GAAP for non rate-regulated entities, a derivative instrument has to be designated as such and be effective. If a derivative instrument does not meet either the designation criterion or the effectiveness criterion, it is recorded at its fair value and any resulting realized or unrealized gains and losses are included in income. In the absence of rate regulation, the Company would have had to choose whether to adopt hedge accounting as outlined in CICA Handbook Section 3865, "Hedges" and its predecessor, Accounting Guideline 13, "Hedging Relationships" and ensure its documentation and effectiveness testing met the specified criteria. Since the accounting for these derivative instruments is determined by rate regulation, the Company chose not to make the required designations nor ensure it meets all of the documentation and other criteria required to treat these instruments as hedging transactions under GAAP.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 3. MAJOR CUSTOMERS

The proportion of energy deliveries and operating revenues attributable to large industrial customers is as follows:

[Percent]	2006		2005		2004	
	Energy	Operating revenues	Energy	Operating revenues	Energy	Operating revenues
Methanex Corporation	—	5	62	7	67	9
West Fraser Mills Ltd., Alcan Inc. and British Columbia Hydro and Power Authority	24	6	9	5	8	6

At December 31, 2006, 4% [2005 – 7%; 2004 – 9%] of accounts receivable was attributable to these four customers. The Company is exposed to credit risk in the event of non-performance by customers, but does not anticipate such non-performance. The Company monitors the credit risk and credit rating of industrial customers on a regular basis. The maximum credit risk is the fair value of the accounts receivable.

On August 30, 2005, Methanex Corporation gave notice of termination of its Firm and Interruptible Gas Transportation Service Agreement with the Company. Under the terms of the agreement, Methanex made a termination payment to the Company of approximately \$23.3 million on February 28, 2006, the effective date of the termination. As approved by the British Columbia Utilities Commission, the termination payment has been recorded, net of income taxes of \$7.96 million, as an interest bearing credit deferral, and will be amortized into income over the period from March 1, 2006 to October 31, 2009. Approximately \$5.6 million of the termination payment has been amortized in 2006 and is included in other operating revenues.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 4. PLANT, PROPERTY AND EQUIPMENT

As at December 31, 2006	Average Depreciation Rate (percent)	Cost	Accumulated Depreciation	Net Book Value
[\$ in thousands]				
Transmission plant	2.7	176,689	73,307	103,382
Distribution plant	2.6	87,920	32,591	55,329
General plant	4.2	20,729	7,617	13,112
Processing plant	5.9	806	226	580
Construction in progress	—	593	—	593
	<b>2.8</b>	<b>286,737</b>	<b>113,741</b>	<b>172,996</b>

As at December 31, 2005	Average Depreciation Rate (percent)	Cost	Accumulated Depreciation	Net Book Value
[\$ in thousands]				
Transmission plant	2.8	172,212	68,618	103,594
Distribution plant	2.6	86,200	30,784	55,416
General plant	4.3	21,146	9,394	11,752
Processing plant	4.9	745	458	287
Construction in progress	—	302	—	302
	<b>2.8</b>	<b>280,605</b>	<b>109,254</b>	<b>171,351</b>

During the year, the Company received contributions in aid of construction of \$233,000 [2005 – \$278,000; 2004 – \$257,000], which have been recorded as a reduction of distribution plant.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 4. PLANT, PROPERTY AND EQUIPMENT (cont'd)

The following table provides information on the changes in the balance of plant, property and equipment cost:

[\$ in thousands]	2006	2005
Cost, beginning of year	280,605	291,141
Capital expenditures, net of contributions in aid of construction	8,211	6,847
Depreciation capitalized	217	191
Plant retirements	(2,296)	(2,235)
Deactivated assets <i>[note 2]</i>	—	(15,581)
Cost transferred from (to) deferred charges <i>[note 2]</i>	—	242
Cost, end of year	286,737	280,605

The following table provides information on the changes in the balance of accumulated depreciation:

[\$ in thousands]	2006	2005
Accumulated depreciation, beginning of year	109,254	114,361
Depreciation expense	7,687	8,011
Depreciation capitalized	217	191
Plant retirements	(2,296)	(2,235)
Salvage on plant retirements	118	94
Deactivated assets <i>[note 2]</i>	—	(10,531)
Depreciation adjustments for prior year retirements <i>[note 2]</i>	(1,239)	(637)
Accumulated depreciation, end of year	113,741	109,254

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 5. INCOME TAXES

Significant components of the Company's deferred tax liabilities are as follows:

[\$ in thousands]	2006	2005
<b>Deferred income tax liabilities</b>		
Capital cost allowance claimed for income tax purposes in excess of depreciation and amortization	14,462	14,462
Other	968	968
<b>Deferred income tax liabilities</b>	<b>15,430</b>	<b>15,430</b>

Income tax expense varies from the amount that would be expected if current rates were applied to income before income taxes for the following reasons:

[Percent]	2006	2005	2004
Combined Canadian federal and provincial statutory income tax rates, including surtaxes	34.1	34.9	35.6
Increase (decrease) in income taxes resulting from:			
Large corporations tax	—	2.2	3.1
Depreciation in excess of capital cost allowance	5.2	5.4	7.0
Amortization of intangibles	3.3	2.5	2.7
Deferred charge expenditures	(3.0)	—	—
Capitalized overhead deducted for tax purposes	(6.6)	(3.8)	(4.9)
Imputed interest on deferred charges and credits	2.6	0.5	0.5
Other items	1.7	(2.0)	(0.8)
<b>Effective rate of income taxes</b>	<b>37.3</b>	<b>39.7</b>	<b>43.2</b>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 6. EMPLOYEE FUTURE BENEFIT PLANS

The Company and its subsidiary have a number of funded and unfunded defined benefit plans, as well as defined contribution plans, that provide pension, other retirement and post-employment health and life insurance benefits for most employees. Benefits earned under the defined benefit plans are principally based on years of service and average earnings.

The measurement dates of the funded plans, as well as the effective dates of the most recent actuarial valuations and the next required actuarial valuations for the purpose of funding the funded plans are as follows:

	2006	2005
Measurement date of the plan assets and accrued benefit obligation	September 30, 2006	September 30, 2005
Effective date of the most recent actuarial valuation report for funding purposes	December 31, 2003	December 31, 2003
Effective date of the next required actuarial valuation report for funding purposes	December 31, 2006	December 31, 2006

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 6. EMPLOYEE FUTURE BENEFIT PLANS (cont'd.)

[a] Information about the defined benefit pension plans is as follows:

[\$ in thousands]	2006	2005	2004
<b>Accrued benefit obligations</b>			
Balance, beginning of year	22,577	19,235	17,224
Current service cost	830	682	595
Employees' contributions	9	7	8
Interest cost	1,186	1,148	1,028
Benefits paid	(804)	(889)	(777)
Actuarial losses (gains)	(8)	2,394	1,157
Balance, as at measurement date	<b>23,790</b>	22,577	19,235
<b>Plan assets</b>			
Fair value, beginning of year	16,106	14,038	12,720
Actual return on plan assets	1,142	1,785	1,590
Employer contributions	1,089	1,165	497
Employees' contributions	9	7	8
Benefits paid	(804)	(889)	(777)
Fair value, as at measurement date	<b>17,542</b>	16,106	14,038
Funded status - plan deficit	<b>(6,248)</b>	(6,471)	(5,197)
Unamortized net actuarial losses	5,777	6,216	4,749
Unamortized transitional asset	(30)	(28)	(26)
Accrued benefit obligation as at measurement date	<b>(501)</b>	(283)	(474)
Employer contribution between measurement date and year end	248	374	593
<b>Accrued benefit assets (liability) end of year</b>	<b>(253)</b>	91	119

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 6. EMPLOYEE FUTURE BENEFIT PLANS (cont'd.)

The following is a summary of the significant actuarial assumptions used in measuring the Company's accrued pension benefit obligations:

[Percent]	2006	2005	2004
<b>Accrued benefit obligation as of December 31, with a measurement date of September 30:</b>			
Discount rate	5.25	5.25	6.00
Rate of compensation increase	3.25	3.25	3.25
<b>Benefit costs for years ended December 31, with a measurement date of September 30:</b>			
Discount rate	6.00	6.00	6.00
Expected long-term rate of return on plan assets	7.50	7.50	7.50
Rate of compensation increase	3.25	3.25	3.25

The following table shows the allocation of the pension plan assets at the measurement dates:

[Percent]	2006	2005
<b>Asset category:</b>		
Equity securities	58	59
Debt securities	37	35
Real estate	—	—
Other	5	6
	<b>100</b>	<b>100</b>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 6. EMPLOYEE FUTURE BENEFIT PLANS (cont'd.)

The Company's pension plan expense is as follows:

[\$ in thousands]	2006	2005	2004
Current service cost	830	682	595
Interest cost	1,186	1,148	1,028
Expected return on plan assets	(1,113)	(1,069)	(930)
Amortization of past service costs	—	—	1
Amortization of net actuarial loss	402	211	214
Amortization of transitional asset	2	2	2
Net defined benefit pension plan expense	1,307	974	910
Defined contribution pension plan expense	65	58	46
Total pension expense	1,372	1,032	956

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 6. EMPLOYEE FUTURE BENEFIT PLANS (cont'd.)

[b] The following is a summary of the significant actuarial assumptions used in measuring the Company's accrued non-pension post retirement benefit obligations:

[percent]	2006	2005	2004
<b>Accrued benefit obligation as of December 31, with a measurement date of September 30:</b>			
Discount rate	5.25	5.25	6.00
Rate of compensation increase	3.25	3.25	3.25
<b>Benefit costs for years ended December 31, with a measurement date of September 30:</b>			
Discount rate	6.00	6.00	6.00
Expected long-term rate of return on plan assets	3.75	7.50	7.50
Rate of compensation increase	3.25	3.25	3.25

Information about the non-pension post-retirement benefit obligation is as follows:

[\$ in thousands]	2006	2005	2004
<b>Accrued benefit obligations</b>			
Balance, beginning of year	5,083	4,162	4,739
Current service cost	165	115	180
Interest cost	266	247	284
Benefits paid	(211)	(199)	(192)
Actuarial loss (gain)	18	758	(849)
Balance, as at measurement date	5,321	5,083	4,162
<b>Plan assets</b>			
Fair value, beginning of year	—	—	—
Employer contributions	633	199	192
Benefits paid	(211)	(199)	(192)
Fair value, as at measurement date	422	—	—
Funded status - plan deficit	(4,899)	(5,083)	(4,162)
Unamortized net actuarial losses	4,860	4,788	3,982
Accrued benefit obligation as at measurement date	(39)	(295)	(180)
Employer contribution between measurement date and year end	41	295	—
<b>Accrued benefit assets (liability) end of year</b>	<b>2</b>	<b>—</b>	<b>(180)</b>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 6. EMPLOYEE FUTURE BENEFIT PLANS (cont'd.)

Effective January 1, 2004, the Company changed the method of expensing non-pension post-retirement benefits on a prospective basis [note 1]. Prior to that date, only benefits paid were expensed. Beginning in 2004, both the current service cost and the benefits paid are expensed and recovered in customer rates. Commencing in 2005, the amounts expensed in 2004, 2005 and 2006 have been funded through contributions to a retirement compensation arrangement, as directed by the Commission.

The assumed extended health care cost trend used for measurement purpose is 10.0% per annum, grading down over 5 years to 5.0% and remaining at that level thereafter. The assumed dental premium trend used for measurement purposes is 7.0% per annum for the first 10 years and 6.0% per annum thereafter.

The Company's non-pension post-retirement benefit expense is as follows:

[\$ in thousands]	2006	2005	2004
Current service cost	165	115	180
Benefits paid	211	199	192
Non-pension post-retirement benefit expense, as reported	376	314	372
Interest cost	266	247	284
Expected return on plan assets	(8)	—	—
Amortization of transitional obligation	123	123	123
Amortization of net actuarial loss	94	50	100
Less benefits paid, expensed above	(211)	(199)	(192)
Non-pension post-retirement benefit plan expense, accrual method	640	535	687

Total cash payments for employee future benefits are \$1,518,000 in 2006 [2005 – \$1,489,000; 2004 – \$1,153,000], consisting of cash contributed to funded pension plans, cash payments in respect of non-pension post-retirement benefits, and cash contributed to defined contribution pension and non-pension post retirement benefit plans.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 7. BANK INDEBTEDNESS

[\$ in thousands]	2006	2005
Bank overdraft	5,075	10,159
Bank demand operating line of credit	—	—
<b>Bank indebtedness</b>	<b>5,075</b>	<b>10,159</b>

The Company has lines of credit that provide for a bank operating facility and hedge line of credit totalling \$35 million [2005 – \$35 million; 2004 – \$25 million]. The lines of credit have a term of 18 months, expiring July 22, 2007. The amount available under the operating facility is subject to borrowing base requirements. The lines of credit are collateralized by the pledge of a \$40 million debenture and a charge on certain accounts receivable and inventories. The operating facility bears interest at prime rate or bankers' acceptance rates [December 31, 2006 – 6.0%; December 31, 2005 – 5.0%] and provides funds for working capital requirements. At December 31, 2006, the amount available under the facility was \$20 million, \$6.9 million of which had been utilized.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 8. LONG TERM DEBT

[\$ in thousands]	2006	2005
<b>Secured Debentures [a]</b>		
RoyNat Debenture due January 15, 2011, bearing interest at a floating rate [December 31, 2006 – 7.338%], payable in monthly instalments of \$110,000, with a final instalment of \$120,000 at maturity.	5,400	6,720
RoyNat Debenture due December 15, 2012, bearing interest at a floating rate [December 31, 2006 – 7.838%], payable in monthly instalments of \$105,000, with a final instalment of \$2,505,000 at maturity.	9,960	11,220
2011 Series Debenture, 10.75% due December 13, 2011, payable in annual instalments of \$700,050, and \$799,500 in each of years 2009 and 2010 with a final instalment of \$4,999,500 at maturity.	7,999	8,700
2018 Series Debenture, 8.75% due November 15, 2018, payable in annual instalments of \$600,000 and \$1,000,000 in each of the years 2014 to 2017, with a final instalment of \$7,000,000 at maturity.	15,200	15,800
2025 Series Debenture, 9.30% due July 18, 2025, payable in annual instalments of \$500,000 with a final instalment of \$9,500,000 at maturity.	18,500	19,000
2027 Series Debenture, 6.90% due December 2, 2027, payable in annual instalments of \$500,000 2006 with a final instalment of \$9,500,000 at maturity.	19,500	20,000
	<b>76,559</b>	81,440
<b>Long term debt due within one year [b]</b>	<b>4,880</b>	4,880
	<b>71,679</b>	76,560

[a] Collateral for the Secured Debentures consists of a specific first mortgage on substantially all of the Company's plant, property and equipment and gas purchases and gas sales contracts, and a first floating charge on other property, assets and undertakings.

**NOTES TO CONSOLIDATED  
FINANCIAL STATEMENTS**

December 31, 2006, 2005 and 2004

**8. LONG TERM DEBT (cont'd.)**

[b] Payments required to meet sinking fund and retirement provisions of long term debt during the next five years and thereafter are as follows:

<b>[\$ in thousands]</b>	
2007	<b>4,880</b>
2008	<b>4,880</b>
2009	<b>4,980</b>
2010	<b>4,980</b>
2011	<b>7,980</b>
Thereafter	<b>48,859</b>
	<b>76,559</b>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 9. PREFERRED SHARES

[\$ in thousands]	2006	2005
<b>Authorized</b>		
1,400,000 cumulative redeemable junior preferred shares with a par value of \$10		
200,000 6.75% cumulative redeemable preferred shares with a par value of \$25 each		
<b>Issued</b>		
200,000 6.75% preferred shares	5,000	5,000

The 6.75% preferred shares are redeemable at the option of the Company at \$26 per share plus any accrued and unpaid dividends at the date of redemption.

### 10. COMMON SHARES AND CONTRIBUTED SURPLUS

[\$ in thousands]	2006	2005
<b>Authorized</b>		
6,020,000 Voting common shares with a par value of \$2.50 each		
<b>Issued</b>		
3,641,180 Common shares [2005 – 3,626,180]	9,103	9,065

During 2006, the Company issued 15,000 common shares [2005 – 22,600] for cash consideration of \$199,000 [2005 – \$185,000] upon the exercise of employee options. Of this amount, \$161,000 [2005 – \$129,000] has been credited to contributed surplus, representing the excess of the issue price over the par value of the shares.

The following table describes the changes in contributed surplus during the year:

[\$ in thousands]	2006	2005
Contributed surplus, beginning of year	2,828	2,567
Excess of cash consideration over par value of common shares issued	161	129
Stock option expense	179	132
Contributed surplus, end of year	3,168	2,828

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 11. STOCK OPTION PLAN

The Company has a stock option incentive plan under which share options are granted to certain of its employees. Share options are granted at an exercise price equal to the closing price of the common shares on the Toronto Stock Exchange determined as of the trading day immediately preceding the date of the option grant.

Share options generally vest in five equal stages with the first stage vesting on the date of the grant, and the remainder in four equal annual stages commencing on the first anniversary of the date of the grant. The maximum term of options awarded is ten years.

As of December 31, 2006, there are 347,618 [2005 – 307,980] shares reserved for issuance pursuant to options that may be granted under the stock option incentive plan.

In 2006, 47,600 options were issued at an average exercise price of \$18.84.

Since January 1, 2003, the Company has accounted for its grants under this plan in accordance with the fair value based method of accounting for stock-based compensation [note 1]. The compensation cost that has been charged against income (and credited to contributed surplus) in 2006 is \$179,000 [2005 – \$132,000; 2004 – \$93,000].

The fair value of each option grant is estimated on the date of the grant using the Black-Scholes option pricing model with the following assumptions:

	<b>2006</b>	<b>2005</b>	<b>2004</b>
Dividend yield	4.2%	4%	4%
Expected volatility (annualized)	28.0%	29%	44%
Risk free interest rate	4.1%	3.7%	3.0%
Expected years of option life (average)	7.5	7.5	7.5

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 11. STOCK OPTION PLAN (cont'd.)

A summary of the changes to of the Company's stock option plan during the years ended December 31, 2006, 2005 and 2004 is as follows:

	2006		2005		2004	
	Number of shares	Weighted- average exercise price \$	Number of shares	Weighted- average exercise price \$	Number of shares	Weighted- average exercise price \$
Outstanding at beginning of year	267,600	16.40	278,400	15.61	272,200	14.52
Granted	47,600	18.84	31,200	19.70	25,900	20.80
Exercised	(15,000)	13.24	(22,600)	8.20	(19,700)	7.28
Forfeited	(9,100)	20.10	—	—	—	—
Expired	(13,200)	18.75	(19,400)	20.00	—	—
Outstanding at end of year	<b>277,900</b>	<b>16.75</b>	267,600	16.40	278,400	15.61
Options exercisable at end of year	<b>208,660</b>	<b>16.04</b>	206,560	15.91	212,600	15.78
Weighted average remaining contractual life	<b>5.7 years</b>		5.8 years		5.9 years	

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 11. STOCK OPTION PLAN (cont'd.)

The following table summarizes information about the stock options outstanding and exercisable as at December 31, 2006:

Expiry Date	Options Outstanding	Options Exercisable	Exercise Price \$
March 14, 2007	12,700	12,700	20.75
March 24, 2008	11,500	11,500	30.50
March 11, 2009	13,200	13,200	24.50
March 16, 2010	22,900	22,900	15.50
March 21, 2011	18,800	18,800	7.85
April 27, 2011	11,700	11,700	6.50
March 15, 2012	28,800	28,800	13.50
July 4, 2012	30,000	30,000	13.50
March 13, 2013	30,600	24,240	14.15
March 2, 2014	23,800	14,280	20.80
August 5, 2015	28,800	11,520	19.70
March 2, 2016	33,100	6,620	18.70
October 19, 2016	12,000	2,400	19.26
	<b>277,900</b>	<b>208,660</b>	

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 12. JOINT VENTURES

In 2005 the Company commenced preliminary study and investigation of a project to loop its main line transmission system from Kitimat to Summit Lake (the "KSL Project"). On July 17, 2006, the Company announced the formation of Pacific Trail Pipelines Limited Partnership, an equal partnership between the Company and Galveston LNG Inc., the parent company of Kitimat LNG Inc., for the purpose of developing the KSL Project.

The following amounts represent the Company's proportionate interest in Pacific Trail Pipelines Limited Partnership and its general partner, Pacific Trail Pipelines Management Inc. at December 31, 2006:

[\$ in thousands]	2006
<b>Balance Sheet</b>	
Current assets	596
Non-current assets	—
Current liabilities	604
Non-current liabilities	—
	<b>For the period</b>
	<b>July 14, 2006 to</b>
	<b>December 31, 2006</b>
<b>Income Statement</b>	
Revenues	—
Expenses	2,843
Net loss	2,843
<b>Cash Flow</b>	
Cash provided by (used in):	
Operations	(1,200)
Financing	1,641
Investing	(50)
Proportional share of increase in cash of joint venture	391

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 13. RELATED PARTY TRANSACTIONS

Accounts receivable at December 31, 2006 include \$7,000 due from Pacific Trail Pipelines Limited Partnership, and relate to expenditures made by the Company which are to be reimbursed by the partnership.

### 14. FAIR VALUES OF FINANCIAL INSTRUMENTS

The fair values of short term investments and debt instruments included in the consolidated balance sheets are as follows:

[\$ in thousands]	Carrying value		Fair value	
	2006	2005	2006	2005
Short term investments	10,971	—	10,968	—
Long term debt	76,560	81,440	88,129	90,566

The fair value of the Company's short term investments and long-term debt is estimated by reference to quoted market prices for similar instruments.

The fair values of other financial instruments included in the consolidated balance sheets, including accounts receivable, bank indebtedness, and accounts payable and accrued liabilities approximate their carrying values due to their short term nature.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 15. NATURAL GAS CONTRACTS

The Company's tolls are set using a forecasted price for gas. However, most of the Company's gas supply contracts contain pricing mechanisms that reflect monthly variations in the price of gas, rather than fixed prices.

The Company had outstanding fixed price contracts, natural gas swap and collar contracts, and call options relating to natural gas supply as follows:

**As at December 31, 2006**

Financial Instrument	Notional Quantity (GJ's)	Percent of Annual Gas Purchases	Delivery Period	Price Range (per GJ)	Estimated Fair Value Receivable (Payable) [\$ in thousands]
Fixed price contracts	450 000	4.5%	Jan. – Mar. 2007	\$7.317	(542)
Natural gas swap contracts	4 308 000	43.4%	Jan. 2007 - Oct. 2008	\$6.84 to \$10.28	(5,876)
Costless Collars	500 500	5.0%	Jan. 2007 to Oct. 2008	Floors from \$6.05 to \$8.55; Caps from \$8.65 to \$10.65	250
Call options	174 500	1.8%	Jan. – Oct. 2007	Caps from \$8.40 to \$8.99	53
<b>Total</b>	<b>5 433 000</b>	<b>54.7%</b>			<b>(6,115)</b>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 15. NATURAL GAS CONTRACTS (cont'd)

As at December 31, 2005

Financial Instrument	Notional Quantity (GJ's)	Percent of Annual Gas Purchases	Delivery Period	Price Range (per GJ)	Estimated Fair Value Receivable (Payable) [\$ in thousands]
Fixed price contracts	450 000	4.6	Jan.- Mar. 2006	\$10.00	(167)
Natural gas swap contracts	1 193 000	12.1	Jan. – Oct. 2006	\$7.85 to \$10.60	1,670
Call options	1 219 500	12.3	Jan.- Mar. 2006	Caps from \$10.00 to \$15.00	633
<b>Total</b>	<b>2 862 500</b>	<b>29.0</b>			<b>2,136</b>

The difference between the price of gas used for toll purposes and the actual cost of gas purchased is deferred and refunded to or recovered from customers as directed by the Commission.

The fair values reflect the estimated amounts that the Company would receive or pay at December 31 to terminate the call options, fixed price, swap or collar contracts, based on the estimated future net cash flows under the terms of each contract.

These estimated fair market values have no impact on earnings due to the regulated nature of the Company's operations. Based on the current regulatory process, any gains or losses arising from utility related financial instruments would be treated as part of the cost of gas.

The Company's purchase commitments at December 31, 2006 under various gas supply contracts expiring through 2011 were as follows:

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 15. NATURAL GAS CONTRACTS (cont'd)

[\$ in thousands]

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2007	35,854
2008	4,791
2009	935
2010	67
2011	—
Thereafter	—

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### 16. COMMITMENTS AND GUARANTEES

Under the terms of its gas transportation and supply agreements with certain customers, the Company has provided an indemnity for all damages, claims or actions arising from any act or accident in connection with the installation, presence, maintenance and operations of the Company's property and equipment, or in connection with the presence of gas deemed to be in the possession and control of the Company, and carries insurance to cover losses in the event of any claims under these provisions. The Company has also provided an environmental indemnity to certain secured debenture holders for any losses arising from non-compliance by the Company with applicable environmental laws.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

### 17. SUPPLEMENTAL CASH FLOW INFORMATION

[\$ in thousands]	2006	2005	2004
<b>Depreciation and amortization:</b>			
Depreciation, per income statement	7,687	8,011	7,877
Amortization of deferred charges, per income statement	691	755	763
Amortization of debt issue costs, included in long term interest expense	116	139	160
<b>Total depreciation and amortization</b>	<b>8,494</b>	<b>8,905</b>	<b>8,800</b>
<b>Non-cash working capital changes:</b>			
(Increase) decrease in:			
Accounts receivable	(1,076)	(5,527)	1,796
Income taxes recoverable	375	(13)	(362)
Inventories of supplies and natural gas	85	(963)	490
Prepaid expenses	(2,534)	(1,585)	(82)
Increase (decrease) in:			
Accounts payable and accrued liabilities	973	5,075	924
Gas purchase variance payable	2,234	(1,351)	(1,047)
Income and other taxes payable	7,114	537	(11)
<b>Attributable to operating activities</b>	<b>7,171</b>	<b>(3,827)</b>	<b>1,708</b>
<b>Interest and tax payments:</b>			
Income taxes paid	2,680	2,790	2,993
Interest paid	6,790	7,181	7,269

### 18. SEGMENTED INFORMATION

The Company operates in one industry and geographic segment, the transmission and distribution of natural gas within Canada. The consolidated financial statements have therefore not been segmented.