

Consolidated Financial Statements

Pacific Northern Gas Ltd.

December 31, 2009



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 judgments 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 2009 to 2008 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] _____

Janet P. Kennedy
Vice President Finance

February 8, 2010

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, 2009 and 2008 and the consolidated statements of income and comprehensive income, shareholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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, 2009 and 2008 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

[signed]

Deloitte & Touche LLP

Chartered Accountants
Vancouver, British Columbia
February 8, 2010

Pacific Northern Gas Ltd.
CONSOLIDATED STATEMENTS OF INCOME AND
COMPREHENSIVE INCOME

Years ended December 31

[\$ in thousands, except per share data]	2009	2008
Revenues:		
Gas sales and transportation services	82,921	93,316
Off system sales	14,839	32,508
Other	6,371	7,015
	104,131	132,839
Cost of gas:		
Gas sales	42,400	53,616
Off system sales	14,839	32,508
	57,239	86,124
	46,892	46,715
Operating and maintenance	12,338	12,010
Administrative and general	7,262	6,514
Depreciation and amortization	8,335	8,050
Amortization of regulatory assets and liabilities	(217)	571
Municipal and other taxes	4,584	4,709
	32,302	31,854
	14,590	14,861
Interest expense [note 17]	5,643	6,988
Investment and other income	(34)	(101)
Project development expenditures [note 16]	181	845
Income before income taxes	8,800	7,129
Income taxes [note 9]	2,268	1,192
Net income and comprehensive income	6,532	5,937
Earnings per common share: [note 18]		
Basic	\$1.72	\$1.53
Diluted	\$1.71	\$1.52

The accompanying notes to the consolidated financial statements are an integral part of these financial statements.

Pacific Northern Gas Ltd.
CONSOLIDATED BALANCE SHEETS
As at December 31

[\$ in thousands]	2009	2008
ASSETS		
Current assets:		
Cash and cash equivalents <i>[note 23]</i>	1,511	577
Accounts receivable <i>[note 20]</i>	21,618	28,047
Gas purchase variance recoverable <i>[note 4]</i>	1,165	4,171
Inventories of natural gas and supplies <i>[note 5]</i>	1,079	2,227
Prepaid expenses	940	958
Derivative financial instruments <i>[note 19]</i>	1,029	1,843
Future income taxes <i>[note 9]</i>	1,288	—
	28,630	37,823
Plant, property and equipment <i>[note 6]</i>	178,420	175,977
Intangible assets <i>[note 7]</i>	1,795	1,796
Regulatory and other assets <i>[notes 4 and 8]</i>	11,364	6,169
Future income taxes <i>[note 9]</i>	—	284
	220,209	222,049
LIABILITIES		
Current liabilities:		
Bank indebtedness <i>[note 10]</i>	2,579	2,998
Accounts payable and accrued liabilities	21,617	23,897
Income taxes payable	1,041	486
Other taxes payable	3,525	4,064
Methanex termination payment deferral <i>[note 4]</i>	—	3,781
Derivative financial instruments <i>[note 19]</i>	4,298	7,319
Long-term debt due within one year <i>[note 11]</i>	2,800	2,400
	35,860	44,945
Long-term debt, non-current portion <i>[note 11]</i>	71,779	74,533
Regulatory and other liabilities <i>[notes 4 and 12]</i>	5,684	217
Future income taxes <i>[note 9]</i>	16,450	—
Deferred income taxes <i>[note 9]</i>	—	13,630
	129,773	133,325
SHAREHOLDERS' EQUITY		
Preferred shares <i>[note 14a]</i>	5,000	5,000
Common shares <i>[note 14b]</i>	8,890	9,161
Contributed surplus <i>[notes 14b and 15]</i>	3,699	3,610
Retained earnings	72,847	70,953
	90,436	88,724
	220,209	222,049

Commitments and guarantees *[notes 19 and 22]*

The accompanying notes to the consolidated financial statements are an integral part of these financial statements.

On behalf of the Board:

“signed”

Roy G. Dyce, Director

“signed”

Robert F. Chase, Director

Pacific Northern Gas Ltd.
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
Years ended December 31

[\$ in thousands]	2009	2008
Preferred shares		
Balance, beginning and end of year	5,000	5,000
Common shares		
Balance, beginning of year	9,161	9,161
Share repurchase under normal course issuer bid <i>[note 14b]</i>	(306)	—
Employee stock options exercised	35	—
Balance, end of year	8,890	9,161
Contributed surplus		
Balance, beginning of year	3,610	3,490
Stock option expense <i>[note 15]</i>	92	120
Share repurchase under normal course issuer bid <i>[note 14b]</i>	(98)	—
Employee stock options exercised	95	—
Balance, end of year	3,699	3,610
Retained earnings		
Balance, beginning of year	70,953	68,578
Adjustment to retained earnings <i>[note 3]</i>	549	—
Adjusted balance, beginning of year	71,502	68,578
Net income	6,532	5,937
Dividends – Preferred shares	(337)	(337)
Dividends – Common shares	(3,448)	(3,225)
Share repurchase under normal course issuer bid <i>[note 14b]</i>	(1,402)	—
Balance, end of year	72,847	70,953
Total Shareholders' Equity	90,436	88,724

The accompanying notes to the consolidated financial statements are an integral part of these financial statements.

Pacific Northern Gas Ltd.
CONSOLIDATED STATEMENTS OF CASH FLOWS
Years ended December 31

[\$ in thousands]	2009	2008
OPERATING ACTIVITIES		
Net income	6,532	5,937
Add (deduct) items not involving cash:		
Future income taxes <i>[note 9]</i>	105	(129)
Deferred income taxes	—	399
Depreciation and amortization <i>[note 23]</i>	8,226	8,733
Amortization of Methanex termination payment deferral <i>[note 4]</i>	(5,466)	(6,592)
Stock option expense <i>[note 15]</i>	92	120
Imputed interest on regulatory assets and liabilities	(91)	113
Deferred income taxes on regulatory assets and liabilities	—	632
Other	(199)	(522)
	9,199	8,691
Changes in operating assets and liabilities <i>[note 23]</i>	9,677	9,268
Net cash provided by operating activities	18,876	17,959
INVESTING ACTIVITIES		
Additions to plant, property and equipment <i>[note 6]</i>	(9,538)	(10,361)
Additions to intangible assets <i>[note 7]</i>	(63)	(12)
Net cash used in investing activities	(9,601)	(10,373)
FINANCING ACTIVITIES		
Repayment of bank indebtedness	(419)	(5,949)
Issue of long-term debt	2,939	4,000
Repayment of long-term debt	(5,400)	(2,300)
Share repurchase under normal course issuer bid <i>[note 14b]</i>	(1,806)	—
Employee stock options exercised <i>[note 15]</i>	130	—
Dividends paid <i>[notes 14a and 14b]</i>	(3,785)	(3,562)
Net cash used in financing activities	(8,341)	(7,811)
Increase (decrease) in cash and cash equivalents	934	(225)
Cash and cash equivalents, beginning of year	577	802
Cash and cash equivalents, end of year	1,511	577

Supplemental cash flow information *[note 23]*

The accompanying notes to the consolidated financial statements are an integral part of these financial statements.

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2009 and 2008

1. DESCRIPTION OF THE BUSINESS

Pacific Northern Gas Ltd. (the “Company”) and its wholly-owned subsidiary, Pacific Northern Gas (N.E.) Ltd. (“PNG (N.E.)”), are engaged in the transportation and distribution of natural gas in northern British Columbia, Canada. The Company and PNG (N.E.) are subject to regulation [see note 2 and note 4] by the British Columbia Utilities Commission (the “Commission”) which, among other things, approves rates charged to customers.

The Company operates a transmission and distribution system in the west-central portion of northern British Columbia (“Western system”) and PNG (N.E.) operates a distribution system in northeastern British Columbia (“Northeast system”). Together, the Company and PNG (N.E.) operate over 3,500 kilometres of transmission and distribution pipeline and serve a base of more than 39,000 residential, commercial and industrial customers.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of presentation

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles (“GAAP”), including selected accounting treatments that differ from those used by entities not subject to rate regulation. The timing of the recognition of certain assets, liabilities, revenue and expenses may be different as a result of regulation from what might be anticipated using GAAP by entities not subject to rate regulation. These differences are described in this note under the headings “Regulation”, “Use of estimates”, “Revenue recognition”, “Inventories of natural gas and supplies”, “Regulatory assets and liabilities”, “Plant, property and equipment” and “Financial instruments”, and in note 4.

All financial figures are presented in Canadian dollars unless otherwise stated.

Principles of consolidation

These consolidated financial statements include the accounts of the Company, its wholly-owned subsidiary PNG (N.E.), as well as the Company’s proportionate share of its 50% interest in the assets, liabilities, revenue and expenses of both Pacific Trail Pipelines Limited Partnership and its general partner, Pacific Trail Pipelines Management Inc. [see note 16].

All intercompany transactions and balances are eliminated, including on a pro rata basis for those related to the entities which have been proportionately consolidated.

Regulation

The regulated activities of the Company and its subsidiary, PNG (N.E.) are subject to the authority of the Commission. The Commission administers acts and regulations pursuant to the *Utilities Commission Act* (British Columbia), covering 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.

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2009 and 2008

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

The Company and its subsidiary operate under a cost-of-service regulatory model whereby customer rates are set based on revenues that allow for the recovery of forecast costs plus an established rate of return on deemed common equity. 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. 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.

Applications for changes to rates are made annually and are submitted to the Commission for their review and approval. For 2009, the Company's average approved rate of return on the rate base was 7.52% after tax, and the average approved rate of return on deemed common equity was 9.58% after tax, based on a weighting of the respective rate bases of the Company and its subsidiary (2008 – 8.36% and 9.22%, respectively).

Accounting records and practices related to regulated activities are maintained and conform to the requirements of the Commission. As noted previously, in order to comply with these requirements, the timing of recognition of certain assets, liabilities, revenues and expenses may differ from that which would otherwise be required under GAAP for non rate-regulated entities. The financial effects of rate regulation relate principally to balances and accounting policies related to:

- Regulatory assets and liabilities;
- Plant, property and equipment and related depreciation rates; and
- Hedges, derivatives and other financial instruments.

Disclosure of the impact of rate regulation on these balances and policies are included in note 4.

Use of estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses and disclosure of contingent assets and liabilities. Estimates are based on historical experience, current conditions and various other assumptions believed to be reasonable under the circumstances, and are subject to review on a periodic basis and adjusted as necessary. Significant balances impacted by estimates include revenues, which incorporate 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. Other significant estimates include depreciation of plant, property and equipment, amortization of intangibles, asset retirement obligations and employee future benefit plans.

The regulatory environment in which the Company operates also requires that certain estimates be made and amounts recorded pending finalization of the regulatory approval process. Accordingly, regulatory assets and liabilities also involve significant estimates. As the estimation process is inherently uncertain, actual future outcomes could differ from current estimates and assumptions, potentially having material effects on future financial statements.

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2009 and 2008

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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. Differences between amounts billed and rates approved 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 reporting period. Operating revenues also include transportation services revenues that are recorded as service is provided, as well as the sale of gas surplus to the needs of the Company's sales customers ("off system sales") that are recognized when the gas is delivered.

Cash and cash equivalents

Cash and cash equivalents include cash and term deposits with original maturities of less than three months and are presented at fair value.

Accounts receivable

Accounts receivable are recorded at amortized cost, net of a provision for doubtful accounts that is based on expected collectibility.

Inventories of natural gas and supplies

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. 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.

Inventories of supplies are valued at the lower of cost determined on a first-in, first-out basis and net realizable value.

Regulatory assets and liabilities

The Company defers certain charges and credits which the Commission or contractual arrangements may require or permit to be recovered or refunded through future customer rates. These regulatory assets and liabilities are amortized over various periods as approved by the Commission, depending on the nature of the charges or credits [see note 4].

Development activities

The costs related to development activities are presently being expensed. Future costs meeting the definition of an asset will be capitalized at the time commercial viability of the underlying ventures has been established and the Company has reasonable assurance that these costs will be recovered in the future.

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2009 and 2008

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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 and may include an allocation of depreciation expense when the Company's own assets are used in the construction of new assets. 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.

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 [see note 6].

Intangible assets

Intangible assets mainly include land rights and computer software not directly attributable to the operation of plant, property and equipment and are recorded at cost less accumulated amortization. These assets are amortized on a straight-line basis at rates approved by the Commission [see note 7].

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 Company's natural gas transmission and distribution long-lived assets are comprised principally of mains, service lines, compressors, and measuring and regulating equipment. The fair value of asset retirement obligations, 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.

No amount has been recorded for asset retirement obligations relating to the Company's long-lived 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 that all retirement costs associated with the regulated assets will be recovered through tolls in future periods.

Income taxes

The Company records future income tax assets and liabilities where temporary differences exist between the carrying amounts of assets and liabilities on the balance sheet and their tax bases. Future tax assets and liabilities are measured using substantively enacted tax rates expected to apply when the temporary differences reverse. The effect on future tax assets and liabilities of a change in tax rates is recognized in the period in which the change is substantively enacted.

A regulatory asset or liability is recognized for future taxes on temporary differences not included in current customer rates, but for which management expects to recover from or return to customers in future rates.

The income tax provision includes current and future income tax portions. The current income tax expense represents the estimated income taxes payable for the current reporting period. Future income tax expense is recognized for the change in future income tax assets and liabilities related to non-regulated assets and

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2009 and 2008

liabilities and the changes in temporary differences on regulated assets and liabilities that are recovered through current customer rates as prescribed by the Commission.

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2009 and 2008

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Employee future benefit plans

The Company accrues its obligations under employee pension benefit plans and the related costs, net of plan assets. The actuarial determination of the accrued benefit obligation for these plans uses the projected benefit method prorated on service and management's best estimate of future salary levels, other cost escalations, retirement ages of employees and other actuarial factors. 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 treasury bills plus 2.5%.

Actuarial gains or losses arise from the difference between the actual long-term rate of return on plan assets for the 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% of the greater of the benefit obligation and the market 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 13 years.

For the defined contribution plan maintained by the Company, contributions payable by the Company are expensed as pension costs in the period to which they relate.

The non-pension post-retirement benefit plans include non-contributory health care and life insurance plans. The Company accrues its 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 and management's best estimate of future salary levels, other cost escalations, retirement ages of employees and other actuarial factors. 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 current service costs and the benefits paid are expensed and recovered in customer rates. The accrued benefit obligation for the non-pension post-retirement benefit plan is included on the balance sheet under regulatory and other liabilities, with a corresponding and offsetting regulatory asset for amounts expected to be recovered from customers in future rates [see note 4].

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2009 and 2008

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Financial instruments

Financial assets and liabilities

The Company has classified its cash, cash equivalents and derivative financial instruments as held-for-trading assets and liabilities and has recorded them at their fair value, with gains and losses arising on the revaluation at the end of each reporting period included in net income subject to regulatory deferral treatment.

Accounts receivable from customers are classified as loans and receivables and are recorded at amortized cost.

Bank indebtedness, accounts payable and accrued liabilities, other taxes payable and long-term debt have been classified as other financial liabilities. Other financial liabilities are initially presented at their fair value, with subsequent measurements at amortized cost.

Transaction costs directly attributable to the issuance of short-term debt instruments are expensed in the period in which the instrument is issued, subject to regulatory deferral treatment, if applicable. Transaction costs that are directly attributable to the issuance of a long-term debt instrument are deducted from the obligation's initial carrying amount and are amortized using the effective interest rate method.

Derivative financial instruments

The Company uses derivative and other financial instruments in connection with the management of gas supply prices. 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 indices of market prices which vary on a daily or monthly basis. 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.

Embedded derivatives

Derivatives may be embedded in other financial and non-financial instruments (the "host instrument"). Embedded derivatives are treated as separate derivatives when: their economic characteristics and risks are not clearly and closely related to those of the host instrument; the terms of the embedded derivative are the same as those of a stand-alone derivative; and the combined contract is not held-for-trading or designated at fair value. These embedded derivatives are measured at fair value with subsequent changes recognized in the consolidated statement of income as an element of administrative and general expenses. The Company currently has no contracts with embedded derivatives that are required to be separated from the host instrument.

Earnings per share

Basic earnings per common share amounts are calculated using the weighted-average number of common shares outstanding during the reporting period. Diluted earnings per common 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.

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2009 and 2008

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Stock-based compensation

The Company has established stock-based compensation plans for eligible directors, officers and employees as described in note 15. The compensation expense for stock options granted under the Company's stock option plan is measured at fair value at the grant date computed using the Black-Scholes option pricing model and amortized over the vesting period of the underlying options, with an offsetting credit to contributed surplus. Consideration paid by plan participants on the exercise of stock options is credited to common share capital for an amount up to the \$2.50 par value per common share, with any excess credited to contributed surplus. In addition, the fair value of the options, as previously recorded, is reclassified from contributed surplus to common share capital.

The Company also has a deferred share unit plan for non-employee directors whereby such directors may elect to allocate all or a portion of their annual compensation as deferred share units. This plan makes use of notional common share units that are valued based on the Company's common share price on the Toronto Stock Exchange and are marked-to-market at the end of each reporting period. Changes in the value of the units as a result of fluctuations in the Company's share price and new issues are recognized in administrative and general expenses with the corresponding liability recorded in accounts payable and accrued liabilities in the consolidated balance sheet.

3. ACCOUNTING CHANGES

Applied in 2009

Accounting for rate-regulated operations

In December 2007, the Canadian Institute of Chartered Accountants ("CICA") issued the following new guidance in accounting for rate-regulated operations which applies to fiscal years beginning on or after January 1, 2009:

- the removal of the temporary exemption in CICA Handbook Section 1100, Generally Accepted Accounting Principles, providing relief to entities subject to rate regulation from the requirement to apply the Section to the recognition and measurement of assets and liabilities arising from rate regulation;
- the amendment to Handbook Section 3465, Income Taxes, to remove the exemption for entities subject to rate regulation so they are required to recognize future income tax liabilities and assets as well as a regulatory asset or liability for the amount of future income taxes expected to be recovered or refunded to customers in future rates; and
- minor amendments to Accounting Guideline AcG-19, Disclosures by Entities Subject to Rate Regulation, to reflect the above changes.

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2009 and 2008

3. ACCOUNTING CHANGES (continued)

On January 1, 2009, the Company adopted these new standards retrospectively without restating prior years' figures with the following results:

- With the removal of the temporary exemption in CICA Handbook Section 1100 for rate-regulated entities, the Company must now apply Handbook Section 1100 to the recognition of assets and liabilities arising from rate regulation. Certain assets and liabilities arising from rate regulation continue to have specific guidance under a primary source of Canadian GAAP that applies only to the particular circumstances described therein, including those arising under Handbook Section 1600, Consolidated Financial Statements, Handbook Section 3061, Property, Plant and Equipment, Handbook Section 3465, Income Taxes, and Handbook Section 3475, Disposal of Long-Lived Assets and Discontinued Operations.

There is no specific guidance provided under primary sources of Canadian GAAP regarding the recognition of regulatory assets and liabilities as described in note 4. In accordance with Handbook Section 1100, the Company has consulted other sources including pronouncements issued by accounting standard setting bodies in other jurisdictions. As there is no definitive guidance on this matter under current International Financial Reporting Standards ("IFRS"), the Company has consulted US GAAP and has determined that the continued recognition of its regulatory assets and liabilities under Canadian GAAP is consistent with US Financial Accounting Standards Board Accounting Standard Codification 980: Regulated Operations.

As a result of this change, the Company recognized, on a prospective basis, \$2.2 million of post-retirement benefits liabilities composed of non-contributory healthcare and life insurance plans and a corresponding and offsetting regulatory asset for the same amount for the cost of non-pension post-retirement benefits expected to be included in future rates and recovered from customers. Previously, the Company followed a cash basis method of accounting for its non-pension post-retirement benefits as directed by the Commission.

Other than the adjustment for post-retirement benefits, there was no material effect on the Company's consolidated financial statements as at January 1, 2009 due to the removal of the temporary exemption in Handbook Section 1100.

- As a result of applying CICA Handbook Section 3465, Income Taxes, the Company now recognizes future income tax assets and liabilities on all temporary differences and to the extent that such future taxes are expected to be recovered or returned to customers in future rates, the Company recognizes a corresponding and offsetting regulatory asset or liability. Prior to January 1, 2009, as prescribed by the Commission, the Company accounted for taxes on the taxes payable method and certain deferral accounts on a net of realized tax basis. This resulted in the recognition of \$16.1 million in future income tax liabilities; a reduction of \$12.7 million to deferred income tax liabilities; the recognition of a \$4.4 million regulatory asset; a net reduction of \$1.8 million to regulated assets and liabilities previously accounted for on a net of realized tax basis; an adjustment increasing plant, property and equipment by \$1.3 million; and an adjustment increasing opening retained earnings by \$0.5 million.

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2009 and 2008

3. ACCOUNTING CHANGES (continued)

Goodwill and intangible assets

On January 1, 2009, the Company adopted CICA Handbook Section 3064, Goodwill and Intangible Assets, which replaced Section 3062, Goodwill and Other Intangible Assets, and Section 3450, Research and Development Costs. The new standard is aligned with IFRS and provides more comprehensive guidance on the recognition, measurement, presentation and disclosure of goodwill and intangible assets in accordance with the definition of an asset and the criteria for asset recognition, in particular for internally generated intangible assets.

This change in accounting standard has been adopted retrospectively and resulted in the reclassification of \$1.8 million related to land rights and computer software previously included in plant, property and equipment to intangible assets on the balance sheet at December 31, 2008.

Fair value of financial assets and liabilities

Credit risk

On January 20, 2009, the CICA published Emerging Issues Committee (“EIC”) Abstract 173, Credit Risk and the Fair Value of Financial Assets and Liabilities. The EIC abstract states that an entity’s own credit risk and the credit risk of the counterparty should be taken into account in determining the fair value of financial assets and liabilities, including derivative instruments. This recommendation is to be applied retrospectively without restatement of prior periods to all financial assets and liabilities measured at fair value in interim and annual financial statements ending on or after the date of issuance of the abstract. The Company has adopted this standard and determined that it had no material impact on the Company’s consolidated financial statements.

Disclosures

In June 2009, amendments to CICA Handbook Section 3862, Financial Instruments – Disclosures, were issued that included additional disclosure requirements about the fair value measurement of financial instruments and enhanced liquidity risk disclosures. The amendments are effective for annual financial statements relating to fiscal years ending after September 30, 2009. These amendments only impact the Company’s disclosures and are reflected in notes 19 and 20.

Section 3862 now requires that all financial instruments measured at fair value on the balance sheet be categorized into one of three hierarchy levels, described below, for disclosure purposes. Each level is based on the transparency of the inputs used to measure the fair values of assets and liabilities:

- Level 1 Inputs are unadjusted quoted prices of identical instruments in active markets;
- Level 2 Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly; and
- Level 3 One or more significant inputs used in a valuation technique are unobservable in determining fair values of the instruments.

Determination of fair value and the resulting hierarchy requires the use of observable market data whenever available. The classification of a financial instrument in the hierarchy is based upon the lowest level of input that is significant to the measurement of fair value.

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2009 and 2008

3. ACCOUNTING CHANGES (continued)

Future accounting pronouncements

Business combinations

In January 2009, the CICA issued new recommendations for Handbook Section 1582, Business Combinations, to replace Section 1581, Business Combinations. Section 1582 provides the Canadian equivalent to IFRS 3 (revised), Business Combinations, and specifies a number of changes, including: an expanded definition of a business, a requirement to measure all business acquisitions at fair value, a requirement to measure non-controlling interests at fair value, and a requirement to recognize acquisition related costs as expenses. The section applies prospectively to business combinations for which the acquisition date is on or after January 1, 2011, however, early adoption is permitted as long as the new recommendations for consolidated financial statements and non-controlling interests described below are adopted concurrently. The Company is currently assessing the impact of this new standard on its consolidated financial statements.

Consolidated financial statements and non-controlling interests

In January 2009, the CICA also issued new recommendations for Handbook Section 1601, Consolidated Financial Statements, and Section 1602, Non-Controlling Interests, which together replace Section 1600, Consolidated Financial Statements, and provide the Canadian equivalent to the corresponding provisions of International Accounting Standard IAS 27 (revised), Consolidated and Separate Financial Statements. Section 1601 establishes standards for the preparation of consolidated financial statements. Section 1602 specifies that non-controlling interests be treated as a separate component of equity, instead of a liability or other item outside of equity. These new standards are effective for interim and annual consolidated financial statements relating to fiscal years beginning on or after January 1, 2011 however, early adoption is permitted as of the beginning of a fiscal year as long as the new recommendations for business combinations described above are adopted concurrently. The Company is currently assessing the impact of these new standards on its consolidated financial statements.

International Financial Reporting Standards

In February 2008, the Canadian Accounting Standards Board confirmed that publicly accountable enterprises are required to prepare financial statements in accordance with IFRS for interim and annual reporting periods beginning on or after January 1, 2011, including comparative figures. The adoption date of January 1, 2011 will require the restatement, for comparative purposes, of amounts reported by the Company for its year ended December 31, 2010, and of the opening balance sheet as at January 1, 2010.

The Company is continuing to assess the financial reporting impacts of the adoption of IFRS and, at this time, the impact on future financial position and results of operations is not reasonably determinable or estimable. The Company does anticipate a significant increase in disclosure resulting from the adoption of IFRS and is continuing to assess the level of disclosure required.

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2009 and 2008

4. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION

Regulatory assets and liabilities

Regulatory assets and liabilities arise as a result of the rate-setting process. 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 GAAP for non rate-regulated entities. All amounts deferred as regulatory assets and liabilities are subject to future regulatory approval. As such, the regulator could alter amounts subject to deferral, at which time the change would be reflected in the financial statements. Certain remaining recovery and settlement periods are those expected by management and may differ from the actual recovery or settlement periods ultimately approved by the regulator. In the absence of rate-regulated accounting, GAAP would not permit the recognition of regulatory assets and liabilities and therefore the earnings impact would be recorded in the period in which the related event occurs.

Regulatory assets represent future revenues associated with certain costs incurred that will be or are expected to be recovered from customers in future periods through the rate setting process. Regulatory liabilities represent future reductions or limitations on future increase in revenues associated with amounts that will be or are expected to be refunded to customers through the rate-setting process.

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2009 and 2008

4. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION (continued)

The following table summarizes the continuity of regulatory assets and liabilities expected to be recovered from or refunded to customers in future periods:

Year Ended December 31, 2009

[\$ in thousands]

Description	Note	Balance, beginning of year	Adjust for future income taxes and opening balances [note 3]	Net (deferral) recovery of amounts	Amortization	Balance, end of year
Subject to rate regulation and approval for recovery in rates						
<i>Amounts included in rate base</i>						
Rate stabilization adjustment mechanism ¹		684	271	(1,844)	—	(889)
Pipeline rehabilitation costs ²		793	286	329	(182)	1,226
Other ³		211	82	635	(94)	834
		1,688	639	(880)	(276)	1,171
<i>Amounts excluded from rate base</i>						
Deactivated assets ⁴		3,824	—	134	(621)	3,337
Other ⁵		76	(98)	(258)	215	(65)
		3,900	(98)	(124)	(406)	3,222
	8	5,588	541	(1,004)	(682)	4,443
<i>Other regulatory assets (liabilities) excluded from rate base</i>						
Gas purchase variance recoverable ⁶		4,171	(583)	(2,423)	—	1,165
Merrill Lynch option fees deferral ⁷	12	—	—	(2,385)	—	(2,385)
Methanex termination payment deferral ⁸		(3,781)	(1,620)	5,401	—	—
		390	(2,203)	593	—	(1,220)
Sub-total		5,978	(1,662)	(411)	(682)	3,223
Subject to rate regulation but not yet approved for recovery in rates						
<i>Other regulatory assets excluded from rate base</i>						
Future recovery of income taxes ⁹	8	—	4,393	(847)	—	3,546
Future recovery of non-pension post-retirement benefits ¹⁰	8	—	2,190	183	—	2,373
		—	6,583	(664)	—	5,919
Total net regulatory assets		5,978	4,921	(1,075)	(682)	9,142

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2009 and 2008

4. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION (continued)

Year Ended December 31, 2008

[\$ in thousands]

Description	Note	Balance, beginning of year	Net (deferral) recovery of amounts	Taxes	Amortization	Balance, end of year
<i>Amounts included in rate base</i>						
Rate stabilization adjustment mechanism ¹		1,853	(1,694)	525	—	684
Pipeline rehabilitation costs ²		924	—	—	(131)	793
Other ³		(191)	489	(151)	64	211
		2,586	(1,205)	374	(67)	1,688
<i>Amounts excluded from rate base</i>						
Deactivated assets ⁴		4,253	240	—	(669)	3,824
Other ⁵		212	(434)	134	164	76
		4,465	(194)	134	(505)	3,900
	8	7,051	(1,399)	508	(572)	5,588
<i>Other regulatory assets (liabilities) excluded from rate base</i>						
Gas purchase variance recoverable ⁶		3,862	184	125	—	4,171
Methanex Termination Payment deferral ⁸		(8,079)	6,229	(1,931)	—	(3,781)
		(4,217)	6,413	(1,806)	—	390
Total net regulatory assets		2,834	5,014	(1,298)	(572)	5,978

1 – Rate stabilization adjustment mechanism

The Company is authorized by the Commission to maintain a rate stabilization adjustment mechanism (“RSAM”) regulatory account to mitigate the effect on its earnings of volatility in deliveries to certain customers caused principally by volatility in weather and in the cost of natural gas. The RSAM account accumulates the margin impact of variations in the actual versus forecast use for residential and small commercial customers. Balances in the RSAM account are recovered in customer rates over a three-year period based on forecast deliveries. During 2009, approximately \$0.5 million before income taxes of the December 31, 2008 RSAM balance was recovered in customer rates [2008 – \$1.2 million].

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, are recorded in regulatory 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. Amounts added to the pipeline rehabilitation cost regulatory account are recovered in customer rates over a ten-year period.

3 – Other amounts included in rate base

The balance of other amounts included in rate base is comprised of various items, each less than \$0.5 million, that are approved for recovery from customers in future rates and are subject to a regulatory return. Items making up this balance include a regulatory account for the recovery of lost margin from certain industrial customers whose actual deliveries varied from deliveries forecast for rate-setting purposes, and a regulatory account to recover the difference between actual and forecast property taxes. Amounts added to these accounts are recovered in customer rates over varying periods, from one to ten years.

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2009 and 2008

4. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION (continued)

4 – Deactivated assets

Subsequent to the closure of Methanex Corporation's Kitimat methanol plant in January 2006, the Company identified certain plant, property and equipment as no longer required on an ongoing basis to provide service to its customers. 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 \$5.0 million. This amount was transferred to a non-rate-base, interest-bearing regulatory account effective December 31, 2005, and is being amortized on a straight-line basis over a ten year period commencing 2006.

5 – Other amounts excluded from rate base

The balance of other amounts excluded from rate base is comprised of various items, each less than \$0.5 million, that are approved for recovery from customers in future rates, but are not subject to a regulatory return. Items making up this balance include an interest deferral mechanism approved by the Commission to mitigate exposure to fluctuations in floating interest rates on short- and long-term debt, and provisions for recovery of the net book value of assets no longer in service. Amounts added to these regulatory accounts are recovered in customer rates over varying periods, from one to ten years.

6 – Gas purchase variance recoverable

Gas purchase variance recoverable 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 amounts are recovered from or refunded to customers on a straight-line basis generally over a one year period. This balance also includes the fair value of derivative financial instruments used in hedging future gas costs. For 2009, amounts refunded and credited to cost of sales was \$4.0 million before income taxes [2008 – \$0.7 million].

7 – Merrill Lynch option fees deferral

In 2009, Merrill Lynch paid \$2.5 million in option and extension fees to the Company to secure excess firm pipeline capacity. Pursuant to the Commission approved negotiated settlement agreement for the Western system 2009 revenue requirements application, the Company has recorded these amounts as an interest bearing, non-rate base regulatory liability to be credited to cost of service in future years.

8 – Methanex termination payment deferral

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. As approved by the Commission, the termination payment was recorded as an interest-bearing regulatory liability and was amortized into income over the period from March 1, 2006 to October 31, 2009. During 2009, the remaining \$5.5 million of this termination payment was amortized and credited to other operating revenues [2008 – \$6.6 million].

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2009 and 2008

4. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION (continued)

9 – Future recovery of income taxes

This balance represents future income taxes that are not recovered through the current rate-making methodology as prescribed by the Commission. This regulatory asset is adjusted to reflect changes in the underlying temporary differences and for changes in future income tax rates. Management expects that this regulatory asset will be recovered through future rates.

10 – Future recovery of non-pension post-retirement benefits

This balance represents the non-pension post-retirement liability that is not recovered through the current rate-making methodology as prescribed by the Commission. Management expects that this regulatory asset will be recovered through future rates.

Financial statement effect of rate regulation

In order to comply with the regulatory requirements of the Commission, the timing of recognition of certain revenues and expenses may differ from that which would otherwise be required under GAAP for non rate-regulated entities. The following table illustrates the effect of the deferral treatment allowed under rate-regulated accounting as compared to the corresponding treatment under GAAP for non rate-regulated entities on income before income taxes for both 2009 and 2008:

Year Ended December 31, 2009

[\$ in thousands]	Net deferral (recovery) of amounts	Amortization	Increase (decrease) in income before income taxes
Rate stabilization adjustment mechanism	1,844	—	1,844
Pipeline rehabilitation costs	(329)	182	(147)
Other amounts included in rate base	(635)	94	(541)
Deactivated assets	(134)	621	487
Other amounts excluded from rate base	258	(215)	43
Gas purchase variance recoverable	2,423	—	2,423
Merrill Lynch option fees deferral	2,385	—	2,385
Methanex termination payment deferral	(5,401)	—	(5,401)
Future recovery of income taxes	847	—	847
Future recovery of non-pension post-retirement benefits	(183)	—	(183)
	1,075	682	1,757

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2009 and 2008

4. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION (continued)

Year Ended December 31, 2008

[\$ in thousands]	Net deferral (recovery) of amounts	Amortization	Increase (decrease) in income before income taxes
Rate stabilization adjustment mechanism	1,694	—	1,694
Pipeline rehabilitation costs	—	131	131
Other amounts included in rate base	(489)	(64)	(553)
Deactivated assets	(240)	669	429
Other amounts excluded from rate base	434	(164)	270
Gas purchase variance recoverable	(184)	—	(184)
Methanex termination payment deferral	(6,229)	—	(6,229)
	(5,014)	572	(4,442)

Other items affected by rate regulation

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

AFUDC is included in the cost of plant, property 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 cost of 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 cost of equity component. It is not possible to make a reasonable estimate of the carrying value of the cost of equity component of AFUDC included in plant, property and equipment. The Company did not capitalize any AFUDC in 2009 or 2008.

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 or charge a short-term interest return on regulatory assets and liabilities excluded from rate base. For 2009, interest was capitalized at 3.78% [2008 – 6.09%] on these amounts. In the absence of rate regulation, GAAP would not permit the capitalization of interest on deferrals. Therefore, the recording of capitalized interest as a component of regulatory assets or liabilities and the corresponding earnings adjustment would not be recognized nor would the subsequent amortization of the capitalized interest component. The amortization of capitalized interest resulted in a credit to income of \$0.1 million in 2009 [2008 – charge to income of \$0.1 million].

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2009 and 2008

4. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION (continued)

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 2009, the Company capitalized \$1.9 million of overhead costs to plant, property and equipment [2008 – \$2.1 million].

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 meet certain criteria for effectiveness. If a derivative instrument does not meet the designation criterion, the effectiveness criterion or the documentation requirements necessary for designation as a hedging instrument, 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 consider whether to adopt hedge accounting as outlined in CICA Handbook Section 3865, Hedges, 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 has chosen not to pursue the required designations, nor to fulfill the documentation and effectiveness criteria required to account for these instruments as hedging instruments under GAAP for non rate-regulated entities.

5. INVENTORIES OF NATURAL GAS AND SUPPLIES

[\$ in thousands]	2009	2008
Natural gas (line-pack)	995	2,151
Materials and supplies	84	76
	1,079	2,227

6. PLANT, PROPERTY AND EQUIPMENT

As at December 31, 2009

[\$ in thousands]	Average Depreciation Rate (%)	Cost	Accumulated Depreciation	Net Book Value
Transmission plant	2.7	189,852	87,634	102,218
Distribution plant	2.6	98,342	38,746	59,596
General plant	4.6	22,941	8,886	14,055
Processing plant	1.4	1,218	365	853
Construction in progress	—	641	—	641
Subtotal	2.8	312,994	135,631	177,363
Capital supplies inventory	—	1,057	—	1,057

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2009 and 2008

2.8	314,051	135,631	178,420
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Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2009 and 2008

6. PLANT, PROPERTY AND EQUIPMENT (continued)

As at December 31, 2008

[\$ in thousands]	Average Depreciation Rate (%)	Cost	Accumulated Depreciation	Net Book Value
Transmission plant	2.7	185,574	82,955	102,619
Distribution plant	2.6	94,043	36,699	57,344
General plant	4.7	22,024	8,365	13,659
Processing plant	1.4	1,014	312	702
Construction in progress	—	642	—	642
Subtotal	2.8	303,297	128,331	174,966
Capital supplies inventory	—	1,011	—	1,011
	2.8	304,308	128,331	175,977

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

[\$ in thousands]	2009	2008
Cost, beginning of year	303,297	293,269
Capital expenditures, net of contributions in aid of construction	9,682	10,535
Accounting change adjustment [note 3]	1,277	—
Depreciation capitalized	290	284
Transfer to regulatory asset	(484)	—
Plant retirements	(1,068)	(791)
Cost, end of year	312,994	303,297

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

[\$ in thousands]	2009	2008
Accumulated depreciation, beginning of year	128,331	120,777
Depreciation expense	8,271	7,993
Depreciation capitalized	290	284
Transfer to regulatory asset	(252)	—
Plant retirements	(1,068)	(791)
Salvage on plant retirements	59	68
Accumulated depreciation, end of year	135,631	128,331

During the year, the Company received contributions in aid of construction of \$1.3 million [2008 – \$0.3 million], which have been recorded as a reduction of distribution plant.

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2009 and 2008

7. INTANGIBLES

As at December 31, 2009

[\$ in thousands]	Average Amortization Rate (%)	Cost	Accumulated Amortization	Net Book Value
Land rights	0.3	1,512	76	1,436
Computer software	7.8	825	466	359
		2,337	542	1,795

As at December 31, 2008

[\$ in thousands]	Average Amortization Rate (%)	Cost	Accumulated Amortization	Net Book Value
Land rights	0.3	1,512	72	1,440
Computer software	7.0	762	406	356
		2,274	478	1,796

The following table provides information on the changes in the balance of the cost of intangibles:

[\$ in thousands]	2009	2008
Cost, beginning of year	2,274	2,262
Purchase of intangibles	63	12
Cost, end of year	2,337	2,274

Amortization of these intangible assets for the year was \$64,000 [2008 – \$57,000].

8. REGULATORY AND OTHER ASSETS

[\$ in thousands]	2009	2008
Regulatory assets <i>[note 4]</i>	4,443	5,588
Future recovery of income taxes <i>[note 4]</i>	3,546	—
Future recovery of non-pension post-retirement benefits <i>[notes 4 and 12]</i>	2,373	—
Accrued pension benefit asset <i>[note 13]</i>	1,002	581
	11,364	6,169

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2009 and 2008

9. INCOME TAXES

[\$ in thousands]	2009	2008
Current income taxes	2,163	922
Future income taxes (recovery)	105	(129)
Deferred income taxes	—	399
	2,268	1,192

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

[Percent]	2009	2008
Combined Canadian federal and provincial statutory income tax rates, including surtaxes	30.0	31.0
Increase (decrease) in income taxes resulting from:		
Regulatory adjustment	(1.3)	(2.7)
Non-taxable income	(3.1)	(12.6)
Other items	0.2	1.0
Effective rate of income taxes	25.8	16.7

Future income taxes

Future income tax assets and liabilities are comprised of the following:

[\$ in thousands]	2009	2008
Future income tax asset (liability):		
Plant, property and equipment	(15,220)	—
Employee future benefits	(336)	—
Gas purchase variance account	801	—
Regulatory assets and liabilities	(580)	—
Other	173	284
	(15,162)	284
Comprised of:		
Current future income tax assets	1,288	—
Long-term future income tax assets (liabilities)	(16,450)	284
	(15,162)	284

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2009 and 2008

10. BANK INDEBTEDNESS

In July 2009, the Company completed the renegotiation of its bank operating facility. Under the facility, \$25.0 million is available for working capital purposes [2008 – \$20.0 million]. The amount available under the operating facility is subject to borrowing base requirements and a financial covenant requiring the Company's debt leverage not to exceed 65%, or approximately the same level currently approved by the Commission.

The facility has a term of 18 months, expiring January 7, 2011 and is collateralized by a charge on the Company's accounts receivable and inventories. Draws on the operating facility bear interest at prime rate or bankers' acceptance rates plus an applicable credit spread [December 31, 2009 – 3.75%; December 31, 2008 – 3.75%]. The Company may also issue letters of credit under the operating facility. At December 31, 2009, \$2.6 million (2008 – \$3.0 million) had been drawn as prime-rate advances and an additional \$5.7 million (2008 – \$12.9 million) was utilized for the issuance of letters of credit securing the Company's obligations under its Supplemental Retirement Plan and certain gas purchases.

11. LONG-TERM DEBT

[\$ in thousands]	2009	2008
Secured Debentures ^[a]		
5-year Revolver due August 3, 2012, bearing interest at a floating rate [December 31, 2009 – 1.758%; December 31, 2008 – 2.971%]. ^[b]	6,000	6,000
RoyNat Debenture due September 15, 2017, bearing interest at a floating rate [December 31, 2009 – 2.896%; December 31, 2008 – 4.169%], payable in monthly instalments of \$0.1 million, beginning on September 15, 2010, with a final instalment of \$6.6 million at maturity.	15,000	15,000
2011 Series Debenture, 10.75% due December 13, 2011, payable with an instalment of \$0.8 million in 2010, with a final instalment of \$5.0 million at maturity.	5,799	6,599
2018 Series Debenture, 8.75% due November 15, 2018, payable in annual instalments of \$0.6 million through to 2013 and \$1.0 million in each of the years 2014 to 2017, with a final instalment of \$7.0 million at maturity.	13,400	14,000
2025 Series Debenture, 9.30% due July 18, 2025, payable in annual instalments of \$0.5 million, with a final instalment of \$9.5 million at maturity.	17,000	17,500
2027 Series Debenture, 6.90% due December 2, 2027, payable in annual instalments of \$0.5 million, with a final instalment of \$9.5 million at maturity.	18,000	18,500
Less: Debt issue costs	(621)	(666)
	74,579	76,933
Long-term debt due within one year ^[c]	2,800	2,400
	71,779	74,533

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2009 and 2008

11. LONG-TERM DEBT (continued)

- [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 purchase and gas sales contracts, and a first floating charge on other property, assets and undertakings.
- [b] At December 31, 2009, the Company had a \$20.0 million, 5-year revolving term facility arranged through Canadian Western Bank and RoyNat Inc. Subsequent to year end, on February 2, 2010, this facility was amended to make \$35.0 million available under the facility and to extend the maturity date to January 30, 2015.
- [c] Principal repayments of long-term debt during the next five years and thereafter are as follows:

[\$ in thousands]	
2010	2,800
2011	7,800
2012	8,800
2013	2,800
2014	3,200
Thereafter	49,800
	75,200

12. REGULATORY AND OTHER LIABILITIES

[\$ in thousands]	2009	2008
Merrill Lynch option fees deferral <i>[note 4]</i>	2,385	—
Accrued non-pension post-retirement benefit liability <i>[note 13]</i>	2,373	—
Derivative financial instruments – non-current <i>[note 19]</i>	707	—
Other	219	217
	5,684	217

13. 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.

Total cash payments for employee future benefits included the following:

[\$ in thousands]	2009	2008
Defined benefit plans	1,237	1,599
Defined contribution plans	106	84
Non-pension post-retirement plans	156	184
Non-pension post-retirement benefits paid	233	211
	1,732	2,078

Pacific Northern Gas Ltd.
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13. EMPLOYEE FUTURE BENEFIT PLANS (continued)

[a] Defined benefit pension plans

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:

	2009	2008
Measurement date of the plan assets and accrued benefit obligation	September 30, 2009	September 30, 2008
Effective date of the most recent actuarial valuation report for funding purposes	December 31, 2006	December 31, 2006
Effective date of the next required actuarial valuation report for funding purposes	December 31, 2009	December 31, 2009

Benefits earned under the defined benefit plans are principally based on years of service and average earnings. Information about the Company's defined benefit pension plans is as follows:

[\$ in thousands]	2009	2008
Accrued benefit obligations:		
Balance, beginning of year	22,049	24,056
Current service cost	752	875
Employees' contributions	15	17
Interest cost	1,427	1,320
Benefits paid	(970)	(984)
Actuarial (gains) losses	97	(3,235)
Balance, as at measurement date	23,370	22,049
Plan assets:		
Fair value, beginning of year	18,035	19,378
Actual return (loss) on plan assets	929	(1,976)
Employer contributions	1,307	1,600
Employees' contributions	15	17
Benefits paid	(970)	(984)
Fair value, as at measurement date	19,316	18,035
Funded status:		
Plan deficit	(4,054)	(4,014)
Unamortized net actuarial losses	4,789	4,256
Unamortized transitional asset	(36)	(34)
Accrued benefit asset, as at measurement date	699	208
Employer contributions between measurement date and end of year	303	373
Accrued benefit asset, end of year [note 8]	1,002	581

Pacific Northern Gas Ltd.
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13. EMPLOYEE FUTURE BENEFIT PLANS (continued)

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

[Percent]	2009	2008
Accrued benefit obligation as of December 31, with a measurement date of September 30:		
Discount rate	6.50	6.50
Rate of compensation increase	3.25	3.25
Benefit cost for years ended December 31, with a measurement date of September 30:		
Discount rate	6.50	5.50
Expected long-term rate of return on plan assets	7.00	7.25
Rate of compensation increase	3.25	3.25

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

[Percent]	2009	2008
Asset category:		
Equity securities	62	58
Debt securities	36	34
Other	2	8
	100	100

The Company's pension plan expense is as follows:

[\$ in thousands]	2009	2008
Current service cost	752	875
Interest cost	1,427	1,320
Expected return on plan assets	(1,391)	(1,387)
Amortization of net actuarial loss	26	195
Amortization of transitional asset	2	2
Net defined benefit pension plan expense	816	1,005
Defined contribution pension plan expense	106	84
Total pension expense	922	1,089

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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13. EMPLOYEE FUTURE BENEFIT PLANS (continued)

[b] Non-pension post-retirement benefits

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

[Percent]	2009	2008
Accrued benefit obligation as of December 31, with a measurement date of September 30:		
Discount rate	6.50	6.50
Benefit cost for years ended December 31, with a measurement date of September 30:		
Discount rate	6.50	5.50
Expected long-term rate of return on plan assets	3.50	3.63

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

[\$ in thousands]	2009	2008
Accrued benefit obligations:		
Balance, beginning of year	4,891	5,377
Current service cost	156	184
Interest cost	315	295
Benefits paid	(233)	(211)
Actuarial gain	(199)	(754)
Balance, as at measurement date	4,930	4,891
Plan assets:		
Fair value, beginning of year	779	596
Actual return on plan assets	1	1
Employer contributions	396	393
Benefits paid	(233)	(211)
Fair value, as at measurement date	943	779
Funded status:		
Plan deficit	(3,987)	(4,112)
Unamortized net actuarial losses	466	690
Unamortized transitional obligation	1,109	1,232
Benefit liability, as at measurement date	(2,412)	(2,190)
Employer contributions between measurement date and end of year	39	46
Unrecognized benefit liability, end of year	—	2,144
Accrued benefit liability, end of year [note 12]	(2,373)	—

Pacific Northern Gas Ltd.
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13. EMPLOYEE FUTURE BENEFIT PLANS (continued)

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]	2009	2008
Current service cost	156	184
Benefits paid	233	211
Non-pension post-retirement benefit expense (as reported in 2008)	389	395
Interest cost	315	295
Expected return on plan assets	(30)	(25)
Amortization of transitional obligation	123	123
Amortization of net actuarial loss	15	73
Less benefits paid, expensed above	(233)	(211)
Non-pension post-retirement benefit plan expense, accrual method	579	650

For 2009, the effects of a one percentage point change in assumed health-care cost trend rates would have the following effects:

[\$ in thousands]	1% increase in rate	1% decrease in rate
Increase (decrease) in accrued benefit obligation	549	(444)
Increase (decrease) in current service and interest costs	68	(54)

14. SHARE CAPITAL

[a] Preferred shares

[\$ in thousands]	2009	2008
Authorized		
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		
Issued		
200,000 6.75% preferred shares	5,000	5,000

The 6.75% preferred shares are entitled to the payment of fixed cumulative preferential cash dividends. These shares are non-voting and are redeemable at the option of the Company at \$26.00 per share plus any accrued and unpaid dividends at the date of redemption. Dividends of \$1.6875 per preferred share were declared and paid on preferred shares in 2009 (2008 – \$1.6875).

Pacific Northern Gas Ltd.
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14. SHARE CAPITAL (continued)

[b] Common shares

[\$ in thousands]	2009	2008
Authorized		
6,020,000 Voting common shares with a par value of \$2.50 each		
Issued		
3,555,964 Common shares [2008 – 3,664,580]	8,890	9,161

In March 2009, the Company obtained approval from the Toronto Stock Exchange (“TSX”) to commence a normal course issuer bid. Under the bid, the Company may purchase a maximum of 300,000 common shares through the facilities of the TSX at the then current market price for cancellation. The bid, subject to renewal, will terminate on the earlier of March 8, 2010 and the date on which the Company has acquired 300,000 common shares.

As at December 31, 2009, the Company had purchased and cancelled an aggregate of 122,416 common shares. When the cost of common shares repurchased by the Company is less than their assigned value, the cost is allocated first to share capital in an amount equal to the stated or assigned value of the shares and any difference is allocated to contributed surplus and retained earnings. In connection with the common shares repurchased in 2009, \$0.3 million was allocated to common share capital, \$0.1 million was allocated to contributed surplus and \$1.4 million was allocated to retained earnings.

The Company issued 13,800 common shares in 2009 upon the exercise of employee share options. The Company did not issue any common shares in 2008.

The holders of ordinary shares are entitled to receive dividends as declared by the Company from time to time. In 2009, dividends of \$0.96 per common share were declared and paid on common shares (2008 – \$0.88).

15. SHARE-BASED COMPENSATION

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, 2009, 355,596 [2008 – 366,458] shares were available to be reserved for issuance pursuant to options granted under the stock option incentive plan.

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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15. SHARE-BASED COMPENSATION (continued)

The Company uses the fair-value method of accounting for stock-based compensation. The fair value of each option grant is estimated on the date of the grant using the Black-Scholes option pricing model. The following weighted-average assumptions were used in computing the fair value of stock options granted for the periods noted:

	2009	2008
Dividend yield	7.5%	4.9%
Expected volatility (annualized)	22.3%	24.9%
Risk-free interest rate	2.2%	3.3%
Expected life (years)	7.5	7.5

Options granted in 2009 had an individual fair value of \$0.80 per option [2008 – \$2.83 per option]. The Company recognized a stock-based compensation expense of \$0.1 million for the year ended December 31, 2009 [2008 – \$0.1 million].

A summary of the changes to the Company's stock option plan during the years ended December 31, 2009 and 2008 is as follows:

	2009		2008	
	Number of options	Weighted-average exercise price [\$]	Number of options	Weighted-average exercise price [\$]
Outstanding, beginning of year	296,720	16.70	267,800	17.01
Granted	62,800	12.24	40,400	18.10
Exercised	(13,800)	9.43	—	—
Forfeited	(280)	18.10	(1,380)	18.03
Expired	(13,200)	24.50	(10,100)	30.50
Outstanding, end of year	332,240	15.85	296,720	16.70
Options exercisable, end of year	237,500	16.16	222,660	16.16
Weighted-average remaining contractual life of outstanding options	5.7 years		5.4 years	

The following table summarizes information about stock options outstanding and exercisable as at December 31, 2009:

Exercise price [\$]	Number of options outstanding	Weighted-average remaining exercise price [\$]	Weighted-average remaining contractual life [years]	Number of options exercisable
6.50 – 9.99	11,500	7.40	0.1	11,500
10.00 – 14.99	139,900	13.07	2.3	90,220
15.00 – 19.99	159,540	18.23	3.0	114,480
20.00 – 24.50	21,300	20.80	0.3	21,300
	332,240	15.85	5.7	237,500

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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15. SHARE-BASED COMPENSATION (continued)

Deferred share unit plan

Effective January 1, 2007, the Company initiated a deferred share unit (“DSU”) plan for non-employee directors whereby such directors may elect to allocate all or a portion of their annual compensation as deferred share units. The units vest upon issuance and the number of units to be issued is based on the participant’s compensation payable on that date divided by the fair market value of a common share of the Company. These units accumulate dividend equivalents in the form of additional units based upon the dividends paid on the Company’s common shares. Units are redeemable for cash or shares only following termination of service on the Board of Directors. The value of the deferred share units when converted to cash will be equivalent to the market value of the Company’s common shares at the time the conversion takes place.

DSU is a term used to describe a method of paying an incentive to participants. DSU’s are not securities and do not entitle participants to the exercise of voting rights, the receipt of dividends or the exercise of any other rights attached to ownership of shares. Shares delivered under the DSU plan to departing participants are purchased in the open market by a trustee on behalf of the participant.

Details of the DSU Plan are as follows:

Continuity		
[Units]	2009	2008
Outstanding, beginning of year	17,824	8,273
Issued during year	9,116	9,551
Redemptions	(2,395)	—
Outstanding, end of year	24,545	17,824

Liability		
[\$ in thousands]	2009	2008
Balance, beginning of year	241	155
Expensed	249	86
Redemptions	(30)	—
Balance, end of year	460	241

Pacific Northern Gas Ltd.
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16. JOINT VENTURES

In 2006, the Company formed 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 a project to loop its main line transmission system from Kitimat to Summit Lake (the “KSL Project”).

Subsequent to December 31, 2009, Apache Canada Inc. acquired a 25.5% interest in the Pacific Trail Pipelines Limited Partnership from Galveston LNG Inc. The Company continues to hold a 50% interest in the partnership and Galveston LNG Inc. has retained a 24.5% interest.

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, 2009 and 2008:

[\$ in thousands]	2009	2008
Balance Sheet		
Current assets	32	110
Non-current assets	—	—
Current liabilities	9	6
Non-current liabilities	—	—
Income Statement		
Revenues	—	—
Expenses	181	845
Net loss	181	845
Cash Flow		
Cash provided by (used in):		
Operations	(181)	(924)
Financing	100	625
Investing	—	—
Proportionate share of decrease in cash of the joint venture	(81)	(299)

17. INTEREST EXPENSE

[\$ in thousands]	2009	2008
Interest on long-term debt	5,653	6,525
Interest on short-term debt	81	350
	5,734	6,875
Imputed interest on regulatory assets and liabilities	(91)	113
	5,643	6,988

Pacific Northern Gas Ltd.
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18. EARNINGS PER COMMON SHARE

[\$ in thousands, except share and per share amounts]	2009	2008
Net income	6,532	5,937
Less: Dividends on preferred shares	337	337
Net income attributable to common shares	6,195	5,600
Basic weighted-average number of shares outstanding	3,594,522	3,664,580
Effect of dilutive securities:		
Stock options	31,346	29,131
Diluted weighted-average number of shares outstanding	3,625,868	3,693,711
Net income per common share		
Basic	\$ 1.72	\$ 1.53
Diluted	\$ 1.71	\$ 1.52

For the year ended December 31, 2009, 163,240 stock options [2008 – 176,720] have been excluded from the computation of diluted securities as the effect would be anti-dilutive.

19. FINANCIAL INSTRUMENTS

Financial instruments by category

The fair value of the Company's financial instruments, including derivatives, reflects a point in time estimate based on information about the instruments as at the balance sheet dates. The estimates involve uncertainties and judgment and may not be relevant in predicting future earnings or cash flows.

Non-derivative financial instruments

The Company has designated its non-derivative financial instruments as follows:

[\$ in thousands]	December 31, 2009		December 31, 2008	
	Carrying value	Estimated fair value	Carrying value	Estimated fair value
Held for trading				
Cash and cash equivalents	1,511	1,511	577	577
Loans and receivables				
Accounts receivable	21,618	21,618	28,047	28,047
Other financial liabilities				
Bank indebtedness	2,579	2,579	2,998	2,998
Accounts payable and accrued liabilities	21,617	21,617	23,897	23,897
Long-term debt, including current portion	74,579	82,674	76,933	79,298

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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19. FINANCIAL INSTRUMENTS (continued)

The fair values of financial instruments included in current assets and current liabilities in the Company's consolidated balance sheets approximate their fair value, reflecting the short-term maturity of these instruments. The fair value of the Company's long-term debt is estimated by reference to quoted market prices for similar instruments, taking into account credit risk.

Derivative financial instruments

The Company hedges exposures to fluctuations in natural gas prices through the use of derivative financial instruments. The Company has a hedge line of credit for \$15.0 million [2008 – \$15.0 million] with its bank operating line provider [see note 10] that allows it to transact its natural gas swaps and collars and is secured by the pledge of a \$20.0 million debenture.

Subsequent to December 31, 2009, the Company added a second risk management facility with another provider. This facility, arranged in January 2010, has two financial covenants, one which requires the Company's debt leverage not to exceed 65 percent, and the second which requires the Company to maintain an interest coverage of 1.5 times or higher using earnings before interest, income taxes and expenditures on the KSL Project to a maximum of \$10.0 million. Further, if the Company's secured debt rating is less than BBB (low) or the Company has no debt rating, the interest coverage requirement is 2.0 times or higher. The risk management facilities allow the Company to hedge natural gas purchases in accordance with its annual gas contracting and gas supply price management plan and to enter into interest rate hedging transactions to the extent of a total maximum exposure of \$15.0 million under each of the facilities.

The following table summarizes the valuation of the Company's derivative financial instruments related to natural gas supply as at December 31:

As at December 31, 2009

Financial instrument	Notional quantity (gigajoules)	Percent of annual gas purchases (%)	Delivery period	Price range (per gigajoule)	Estimated net fair value receivable (payable) ((\$000's))
Fixed-price contracts	900 000	9.2	Jan 2010 – Mar 2010	\$4.03	1,021
Natural gas swap contracts	3 954 850	40.6	Jan 2010 – Oct 2011	\$4.96 to \$10.87	(4,568)
Collar contracts	308 650	3.2	Jan 2010 – Oct 2010	\$5.26 to \$8.38 (floors) \$6.76 to \$11.46 (caps)	(429)
	5 163 500	53.0			(3,976)

As at December 31, 2008

Financial instrument	Notional quantity (gigajoules)	Percent of annual gas purchases (%)	Delivery period	Price range (per gigajoule)	Estimated net fair value receivable (payable) ((\$000's))
Call options	66 300	0.7	Jan 2009 – Oct 2009	\$10.08 to \$11.79	4
Fixed-price contracts	900 000	9.1	Jan 2009 – Mar 2009	\$9.31	(2,885)
Natural gas swap contracts	3 453 800	35.1	Jan 2009 – Oct 2010	\$6.25 to \$10.87	(2,228)
Collar contracts	406 600	4.1	Jan 2009 – Oct 2010	\$6.24 to \$8.38 (floors) \$8.40 to \$11.46 (caps)	(367)
	4 826 700	49.0			(5,476)

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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19. FINANCIAL INSTRUMENTS (continued)

The fair values reflect the estimated amounts that the Company would receive or pay at December 31 to terminate the fixed-price, swap or collar contracts and call options 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.

As a result of the recognition of these derivative assets and liabilities, the gas cost variance payable account at December 31, 2009 was decreased by \$4.0 million (decreased by \$5.5 million at December 31, 2008) in accordance with specific regulatory treatment.

Fair value hierarchy

The classification within the fair value hierarchy [see note 3] of the Company's financial instruments as at December 31, 2009 is summarized in the following table:

December 31, 2009

[\$ in thousands]	Level 1	Level 2	Level 3	Total
Assets				
Cash and cash equivalents	503	1,008	—	1,511
Derivative financial instruments	—	1,029	—	1,029
	503	2,037	—	2,540
Liabilities				
Derivative financial instruments – current	—	4,298	—	4,298
Derivative financial instruments – non-current	—	707	—	707
	—	5,005	—	5,005

The Company uses valuation models to determine the fair value of its derivative instruments. The inputs to these models are primarily external observable inputs such as natural gas forward prices.

20. RISK MANAGEMENT

Credit risk

The Company is exposed to credit risk in the event that a customer or counterparty to a financial instrument fails to meet its contractual obligations and arises mainly from its accounts receivable and derivative financial instruments. In accordance with established credit approval practices, the Company deals only with recognized high credit quality institutions as counterparties to its derivative instruments and physical off system gas sales and does not expect any counterparties to fail to meet its obligations. Should the Company incur a financial loss as a result of the failure of counterparty to meet its obligations, the Company would require regulatory approval to recover related costs through future rate adjustments.

Pacific Northern Gas Ltd.
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20. RISK MANAGEMENT (continued)

The Company's credit policy requires a review of each customer for creditworthiness and often will require residential and commercial customers to pay a customer deposit based on two times the highest estimated monthly gas consumption prior to the installation of service. For industrial customers, the Company has the right to require securities such as letters of credit should a customer fail to pay its bills. No letters of credit or alternate security are currently in place with any individual industrial customer.

The Company establishes an allowance for doubtful accounts that represents its estimate of accounts receivable which may not be recoverable. The main components of this allowance are a specific provision that relates to individual significant exposures and a general provision for the core market (residential and commercial) customers based on past experience. The Company actively reviews the adequacy of its allowance for doubtful accounts.

The following table shows the breakdown of accounts receivables by major customer class:

[\$ in thousands]	2009	2008
Core market – residential and commercial	18,746	21,513
Industrial customers	948	1,347
Off-system sales customers	3,831	6,580
Other	137	342
	23,662	29,782
Less: Allowance for doubtful accounts	(2,044)	(1,735)
	21,618	28,047

The following table sets forth details of the aging of accounts receivables:

[\$ in thousands]	2009	2008
Unbilled revenues	10,729	12,551
Past due 0 to 30 days (current)	10,747	15,431
Past due 31 to 90 days	384	212
Past due over 91 days	1,802	1,588
	23,662	29,782
Less: Allowance for doubtful accounts	(2,044)	(1,735)
	21,618	28,047

Changes in the allowance for doubtful accounts are as follows:

[\$ in thousands]	2009	2008
Balance, beginning of year	1,735	1,694
Provision for doubtful accounts	313	307
Write-off of bad debts, net of recoveries, and other	(4)	(266)
Balance, end of year	2,044	1,735

Pacific Northern Gas Ltd.
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20. RISK MANAGEMENT (continued)

Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet obligations associated with financial liabilities and commitments as they become due. The Company manages liquidity risk through the management of its capital structure and financial leverage. It also regularly monitors actual and projected cash flows. The Company believes that future cash flows generated from operations and access to additional liquidity through capital and banking markets will be adequate to meet its financial obligations in the foreseeable future. The Company's overall liquidity risk has improved slightly from December 31, 2008, with the increase in the availability of credit under its operating line, risk management facilities and 5-year term revolving credit facility.

The Company's credit facilities include a \$25 million operating line, a \$15 million risk management facility and a \$20 million committed 5-year term revolving debt facility. The operating line is subject to borrowing base requirements which may restrict the amount that the Company can borrow under the line at any point in time. As of December 31, 2009, the calculated borrowing base of the operating line was approximately \$13.8 million and actual utilization was \$8.3 million [see note 10]. \$6.0 million was outstanding under the \$20.0 million revolving term facility at December 31, 2009 via Banker Acceptance equivalent loans [see note 11].

The Company's operating line and risk management facilities are subject to renewal after 18 months with the operating line and the risk management facility maturing on January 7, 2011.

Subsequent to the end of the reporting period, on January 19, 2010, the Company arranged a second \$15.0 million risk management facility which matures on July 18, 2011, and on February 2, 2010 the Company amended its committed 5-year term revolving debt facility by increasing the credit available under the facility to \$35.0 million and extending the maturity date to January 30, 2015.

The Company maintains regular dialogue with the financial institution that provides these facilities and has no reason to believe the facilities will not be renewed upon maturity. See "Market Risk – Interest Rates" below for additional information on how this may impact the Company's future results.

Repayments of financial liabilities

The Company's financial liabilities as at December 31, 2009 include its bank indebtedness, accounts payable and accrued liabilities, natural gas derivatives and long-term debt. The table below summarizes the Company's financial liabilities in relevant maturity groupings based on the remaining period from the balance sheet date to the contractual maturity date. As the amounts disclosed in the table are contractual undiscounted cash flows (including interest payments where applicable), these balances may not necessarily agree with the amounts disclosed in the balance sheet.

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20. RISK MANAGEMENT (continued)

Expected payments by period, as at December 31, 2009						
[\$ in thousands]						
Description	Within 1 year	2 to 3 years	4 to 5 years	More than 5 years	Total contractual cash flows	Carrying amount
Non-derivative financial liabilities						
Bank indebtedness	2,579	—	—	—	2,579	2,579
Accounts payable and accrued liabilities	21,617	—	—	—	21,617	21,617
Long-term debt, including current portion	7,957	25,703	13,729	77,012	124,401	74,579
Derivative financial liabilities						
Natural gas swap contracts	3,871	705	—	—	4,576	4,576
Collar contracts	429	—	—	—	429	429
	36,453	26,408	13,729	77,012	153,602	103,780

Market risk

Market risk is the risk that changes in market prices, including foreign exchange, interest rates and commodity prices will affect the fair value of the Company's financial instruments. The Company is not exposed to any foreign exchange risks on its earnings. The Company's overall market risk has not changed significantly from the prior year.

Market risk – commodity prices

The commodity cost of natural gas can be highly volatile. The Company utilizes derivative and other financial instruments in connection with the management of gas supply. The Company enters into forward, future, swap, fixed-price and option contracts to manage the impact of market fluctuations on assets, liabilities or other contractual commitments. Based on the current regulatory process, any gains or losses arising from utility related derivative financial instruments are treated as part of the flow through of gas supply costs in customer rates.

For illustrative purposes, a one dollar per gigajoule decrease in the underlying forecast price of natural gas at December 31, 2009, with all other variables remaining constant, would result in the estimated net fair value payable related to natural gas commodity derivatives [see note 19] increasing from \$4.0 million to \$9.2 million and an increase in the gas purchase variance recoverable account. Conversely, a one dollar per gigajoule increase in the underlying forecast price of natural gas would result in the estimated net fair value payable decreasing from \$4.0 million to a receivable of \$1.1 million and a decrease in the gas purchase variance recoverable account.

Market risk – interest rates

While underlying interest rates, such as prime and bankers' acceptances rates are subject to changes in the future, as are interest rate spreads on borrowings by the Company, the Company does not expect these changes to have a material impact on its financial results. As directed by the Commission, the Company has an interest deferral mechanism that mitigates exposure to fluctuations in floating rates on both short-term and long-term debt instruments [see note 4].

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21. CAPITAL MANAGEMENT

The Company's objective in managing capital remains unchanged from December 31, 2008. The capital structure consisted of the following components at December 31, 2009 and December 31, 2008: bank indebtedness, long-term debt and shareholders' equity, totaling \$167.6 million at the end of 2009 [2008 – \$168.7 million].

The Company's objectives with its capital structure are:

- to maintain the proportion of common equity in its capital structure at the level approved by the Commission for the purpose of determining rates which is necessary to ensure that the Company has the opportunity to earn the rate of return on common equity allowed by the Commission; and
- to maintain a credit rating at which the Company has sufficient access to capital and to natural gas and other supplies on reasonable terms to be able to provide safe, secure and reliable service to its customers, which in turn is critical to the Company's ongoing prosperity.

However, the Company is not currently able to meet both objectives as it believes that the proportion of common equity approved by the Commission is not sufficient to allow the Company to maintain a satisfactory credit rating. The Company currently carries approximately \$20.0 million more common equity on its balance sheet than is allowed by the Commission for the purpose of determining rates. To address this situation the Company has filed a Capital Structure and Equity Risk Premium Application with the Commission to increase its deemed common equity and to increase its risk premium relative to the benchmark utility return on equity.

The financial terms and conditions of the Company's debentures and credit facilities remain unchanged since December 31, 2008 except for amendments to the Company's operating line in July 2009. The amendment to the operating line included an increase to \$25.0 million of the credit available to the Company as well as increases in stand-by fees and interest rate spreads to reflect then current market conditions. No changes were made to the financial covenant under the operating line.

The \$25.0 million operating line and \$20.0 million 5-year revolving term facility are subject to a financial covenant requiring the Company's debt leverage not to exceed 65%. The 5-year revolving term facility contains an additional covenant which states that if the Company's secured debt rating is less than BBB (low) or the Company has no debt rating, the Company must maintain an interest coverage of 2.0 times or higher using earnings before interest, income taxes and expenditures on the KSL Project to a cumulative maximum of \$10.0 million. On August 11, 2009 Dominion Bond Rating Services ("DBRS") confirmed the Company's secured debt ratings at BBB (low) and changed the trend to Stable from Negative. The Company is in compliance with its debt covenants as at December 31, 2009.

Subsequent to year end, on February 2, 2010, the \$20.0 million 5-year revolving term facility was amended. The amount of the facility was increased to \$35.0 million and the maturity date extended to January 30, 2015 [see note 20].

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22. COMMITMENTS AND GUARANTEES

Gas purchase commitments

The Company has long-term natural gas purchase arrangements all of which are transacted at market prices and in the normal course of business. The Company's purchase commitments as at December 31, 2009 under various gas supply contracts expiring through 2013 were as follows:

[\$ in thousands]

2010	26,784
2011	8,504
2012	3,762
2013	60
2014	60
Thereafter	50
Total	39,220

These obligations are based on market prices that vary with gas commodity indices. The amounts disclosed reflect index prices that were in effect as at December 31, 2009.

Indemnifications

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 plant, 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.

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23. SUPPLEMENTAL CASH FLOW INFORMATION

[\$ in thousands]	2009	2008
Cash and cash equivalents:		
Cash	503	577
Cash equivalents	1,008	—
	1,511	577

Cash equivalents are comprised of highly-liquid term investments with original maturities of 90 days or less.

[\$ in thousands]	2009	2008
Depreciation and amortization:		
Depreciation and amortization, per income statement	8,335	8,050
Amortization of deferred charges, per income statement	(217)	571
Amortization of debt issue costs included in long-term interest expense	107	112
Total depreciation and amortization	8,226	8,733

Changes in operating assets and liabilities:

(Increase) decrease in:		
Accounts receivable	6,429	(685)
Gas purchase variance recoverable	935	—
Income taxes recoverable	555	2,210
Inventories of supplies and natural gas	1,148	(1,065)
Prepaid expenses	18	605
Increase (decrease) in:		
Accounts payable and accrued liabilities	(2,632)	5,374
Gas purchase variance payable	—	266
Income taxes payable	—	486
Other taxes payable	(539)	936
Changes in regulatory assets and liabilities	3,763	1,141
Attributable to operating activities	9,677	9,268

Interest and tax payments:

Income taxes paid	1,746	150
Interest paid	5,529	6,358

Non-cash transactions:

Plant, property and equipment purchases included in accounts payable and accrued liabilities	133	216
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24. 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.

25. COMPARATIVE FIGURES

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