

Consolidated Financial Statements

Pacific Northern Gas Ltd.

December 31, 2010



MANAGEMENT'S REPORT

To the Shareholders of
Pacific Northern Gas Ltd.

Management is responsible for the preparation of the accompanying consolidated financial statements and all other information contained in this Annual Report. The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles and, where appropriate, include amounts that are based on management's best estimates and judgments.

Management is also responsible for establishing and maintaining a system of internal controls and formal policies and procedures to provide reasonable assurance that transactions are authorized, assets are safeguarded, and financial records are reliable for the preparation and presentation of the consolidated financial statements.

The Board of Directors is responsible for ensuring management fulfills its responsibilities for financial reporting and internal control. The Board of Directors is assisted in exercising this responsibility through its Audit Committee. The Audit Committee meets regularly with the independent auditors, the internal auditors and management to discuss auditing and accounting matters and to review the consolidated financial statements and the independent auditor's report to satisfy itself that management's responsibilities are properly discharged. The Audit Committee reports its findings to the Board of Directors for consideration in approving the consolidated financial statements for issuance to the shareholders and for filing with the relevant securities commissions.

Deloitte & Touche LLP serves as the Company's independent auditor. Deloitte & Touche LLP's audit report on the accompanying consolidated financial statements follows. Their report outlines the scope of their examination as well as their opinion on the consolidated financial statements.

[signed] _____

Roy G. Dyce
President and Chief Executive Officer

[signed] _____

Janet P. Kennedy
Vice President Finance

March 3, 2011

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of
Pacific Northern Gas Ltd.

We have audited the accompanying consolidated financial statements of Pacific Northern Gas Ltd., which comprise the consolidated balance sheets as at December 31, 2010 and 2009 and the consolidated statements of income and comprehensive income, equity and cash flows for the years then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Pacific Northern Gas Ltd. as at December 31, 2010 and 2009, and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Emphasis of Matter

Without qualifying our opinion, we draw attention to note 2 to the consolidated financial statements which describes Pacific Northern Gas Ltd.'s early adoption of CICA Handbook Section 1582, Business Combinations, Section 1601, Consolidated Financial Statements, and Section 1602, Non-controlling Interests.

[signed]

Deloitte & Touche LLP
Chartered Accountants
March 3, 2011
Vancouver, British Columbia

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

Years ended December 31

[\$ in thousands, except per share data]	2010	2009
Revenues:		
Gas sales and transportation services	76,323	82,921
Off system sales	14,988	14,839
Other	3,853	6,371
	95,164	104,131
Cost of gas:		
Gas sales	29,125	42,400
Off system sales	14,988	14,839
	44,113	57,239
	51,051	46,892
Operating and maintenance	12,571	12,338
Administrative and general <i>[note 3]</i>	9,041	7,262
Depreciation and amortization	8,752	8,118
Municipal and other taxes	4,765	4,584
	35,129	32,302
	15,922	14,590
Interest expense <i>[note 17]</i>	6,404	5,643
Investment and other income	(3)	(34)
Project development expenditures <i>[note 16]</i>	566	181
Income before income taxes	8,955	8,800
Income taxes <i>[note 9]</i>	1,877	2,268
Net income and comprehensive income	7,078	6,532
Net loss and comprehensive loss attributable		
to non-controlling interest <i>[note 3]</i>	10	—
Net income and comprehensive income attributable to shareholders	7,088	6,532
Earnings per common share: <i>[note 18]</i>		
Basic	\$1.88	\$1.72
Diluted	\$1.83	\$1.71

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]	2010	2009
ASSETS		
Current assets:		
Cash and cash equivalents <i>[note 24]</i>	1,894	1,511
Accounts receivable <i>[note 20]</i>	23,017	21,618
Gas purchase variance recoverable <i>[note 4]</i>	4,498	1,165
Income taxes recoverable	1,305	—
Inventories of natural gas and supplies <i>[note 5]</i>	764	1,079
Prepaid expenses	1,056	940
Derivative financial instruments <i>[note 19]</i>	—	1,029
Future income taxes <i>[note 9]</i>	1,105	1,288
	33,639	28,630
Plant, property and equipment <i>[note 6]</i>	196,860	178,420
Intangible assets <i>[note 7]</i>	1,766	1,795
Regulatory and other assets <i>[notes 4 and 8]</i>	17,659	11,364
	249,924	220,209
LIABILITIES		
Current liabilities:		
Bank indebtedness <i>[note 10]</i>	4,836	2,579
Accounts payable and accrued liabilities	19,106	21,617
Income taxes payable	—	1,041
Other taxes payable	3,388	3,525
Derivative financial instruments <i>[note 19]</i>	5,696	4,298
Long-term debt, current <i>[note 11]</i>	8,192	2,800
	41,218	35,860
Long-term debt, non-current <i>[note 11]</i>	82,761	71,779
Regulatory and other liabilities <i>[notes 4 and 12]</i>	10,892	5,684
Future income taxes <i>[note 9]</i>	20,736	16,450
	155,607	129,773
EQUITY		
Preferred shares <i>[note 14a]</i>	5,000	5,000
Common shares <i>[note 14b]</i>	9,038	8,890
Contributed surplus <i>[notes 14b and 15]</i>	4,515	3,699
Retained earnings	75,490	72,847
Total shareholders' equity	94,043	90,436
Non-controlling interest	274	—
	94,317	90,436
	249,924	220,209

Commitments and guarantees *[notes 19 and 22]*
Subsequent event *[note 25]*

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 EQUITY
Years ended December 31

[\$ in thousands]	2010	2009
Preferred shares		
Balance, beginning and end of year	5,000	5,000
Common shares		
Balance, beginning of year	8,890	9,161
Share repurchase under normal course issuer bid <i>[note 14b]</i>	—	(306)
Employee stock options exercised	148	35
Balance, end of year	9,038	8,890
Contributed surplus		
Balance, beginning of year	3,699	3,610
Stock option expense <i>[note 15]</i>	96	92
Share repurchase under normal course issuer bid <i>[note 14b]</i>	—	(98)
Employee stock options exercised	720	95
Balance, end of year	4,515	3,699
Retained earnings		
Balance, beginning of year	72,847	71,502
Net income attributable to shareholders	7,088	6,532
Dividends – preferred shares	(337)	(337)
Dividends – common shares	(4,108)	(3,448)
Share repurchase under normal course issuer bid <i>[note 14b]</i>	—	(1,402)
Balance, end of year	75,490	72,847
Total shareholders' equity, end of year	94,043	90,436
Non-controlling interest		
Balance, beginning of year	—	—
Contribution from non-controlling interest	284	—
Net loss attributable to non-controlling interest	(10)	—
Balance, end of year	274	—
Total equity, end of year	94,317	90,436

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]	2010	2009
OPERATING ACTIVITIES		
Net income	7,088	6,532
Add (deduct) items not involving cash:		
Future income taxes <i>[note 9]</i>	1,629	105
Depreciation and amortization <i>[note 24]</i>	8,691	8,226
Amortization of termination payment deferral <i>[note 4]</i>	(143)	(5,466)
Share-based compensation <i>[note 15]</i>	570	311
Imputed interest on regulatory assets and liabilities	202	(91)
	18,037	9,617
Changes in operating assets and liabilities <i>[note 24]</i>	(8,179)	9,259
Net cash provided by operating activities	9,858	18,876
INVESTING ACTIVITIES		
Additions to plant, property and equipment <i>[note 6]</i>	(7,399)	(9,538)
Acquisition, net of cash acquired <i>[note 3]</i>	(8,026)	—
Additions to intangible assets <i>[note 7]</i>	(22)	(63)
Decrease in restricted cash	400	—
Other	(231)	—
Net cash used in investing activities	(15,278)	(9,601)
FINANCING ACTIVITIES		
Increase (decrease) in bank indebtedness	2,257	(419)
Debt refinancing costs	(115)	—
Issuance of long-term debt	10,000	2,939
Repayment of long-term debt	(3,046)	(5,400)
Share repurchase under normal course issuer bid <i>[note 14b]</i>	—	(1,806)
Employee stock options exercised <i>[note 15]</i>	868	130
Dividends paid <i>[notes 14a and 14b]</i>	(4,445)	(3,785)
Contribution from non-controlling interest <i>[note 3]</i>	284	—
Net cash provided by (used in) financing activities	5,803	(8,341)
Increase in cash and cash equivalents	383	934
Cash and cash equivalents, beginning of year	1,511	577
Cash and cash equivalents, end of year	1,894	1,511

Supplemental cash flow information *[note 24]*

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, 2010 and 2009

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 1 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.

In April 2010, the Company and Skookum Power Holdings Corp. acquired a 100% interest in a 9.8 megawatt ‘run of river’ hydro-electricity generation facility (“McNair Creek”) located on British Columbia’s Sunshine Coast [see note 3]. Through a series of restructuring transactions completed in December 2010, the Company and Skookum Power Holdings Corp., directly and respectively, own 97.1% and 2.9% of McNair Creek Hydro Limited Partnership and its general partner, McNair Creek Hydro Holding Corp. McNair Creek is a non-regulated business and currently operates under a long-term supply agreement with BC Hydro. The investment in McNair Creek represents the launch of the Company’s renewable power business as part of its business diversification strategy. The key elements of this strategy are to diversify the Company’s risk profile, grow its asset base and enhance its earnings and cash flows.

1. 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.), its 97.1% interest in McNair Creek [see note 3], 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 and note 25].

The results of operations, cash flows, financial position and non-controlling interest of McNair Creek have been included in these financial statements from the date of acquisition, April 19, 2010.

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

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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.

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 2010, the Company's average approved rate of return on the rate base was 8.16% after tax, and the average approved rate of return on deemed common equity was 10.09% after tax, based on a weighting of the respective rate bases of the Company and its subsidiary (2009 – 7.52% and 9.58%, 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, accounts receivable, which are recorded net of an estimated allowance for doubtful accounts and the purchase price allocation process for business acquisitions. Other significant estimates include depreciation of plant, property and equipment, amortization of intangibles, asset retirement obligations and employee future benefit plans.

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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.

Revenue recognition

The Company's gas sales and transportation services 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. Other revenues include energy sales from the McNair Creek hydroelectric facility which are recognized on the accrual basis at the time electrical energy 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 weighted-average cost. The volume of natural gas reported as line-pack 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 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].

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Development activities

The costs related to development activities are expensed up until the point in time that commercial viability of the underlying venture has been established and the Company has reasonable assurance that these costs will be recovered in the future.

Plant, property and equipment

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

The depreciation of assets used in regulated activities is taken on plant in service and is calculated on a straight-line basis at the commencement of each fiscal year at Commission-approved rates [see note 6]. Depreciation of property, plant and equipment used in non-regulated activities, including McNair Creek, is recorded when the asset enters productive use and is calculated on a straight-line basis over the asset's estimated useful life.

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].

Impairment of long-lived assets subject to amortization

The Company reviews the valuation of long-lived assets subject to amortization when events or changes in circumstances may indicate or cause its carrying value to exceed the total undiscounted cash flows expected from its use and eventual disposition. An impairment loss, if any, would be recorded as the excess of the carrying value of the asset over its fair value.

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.

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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

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.

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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].

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.

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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.

Credit risk

The determination of fair value of the Company’s financial assets, including cash, cash equivalents and derivative instruments, takes into account the Company’s own credit risk and the credit risk of the counterparty. The Company trades only with recognized, credit-worthy third parties and does not enter into derivatives to manage its credit risk. The Company’s exposure to credit risk arises from default of the counter party with a maximum exposure equal to the carrying amount of these instruments. Derivative counterparties and cash transactions are limited to high credit-quality financial institutions. The Company has policies that limit the amount of credit exposure to any one financial institution.

Disclosures

Determination of fair value requires the use of observable market data whenever available. For disclosure purposes, all financial instruments measured at fair value on the balance sheet must be categorized based into one of three hierarchy levels based on the transparency of the inputs used to measure the fair values. 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 of assets and liabilities.

The three broad levels of inputs within the hierarchy are as follows:

- 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.

The disclosures required under this framework are disclosed in note 19.

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, 2010 and 2009

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Share-based compensation

The Company has established share-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.

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.

Comprehensive income

Comprehensive income represents the change in equity of an enterprise during a period from transactions and other events arising from non-owner sources, including gains and losses arising on self-sustaining foreign operations, gains and losses from changes in fair value of available for sale financial assets and changes in fair value of the effective portion of cash flow hedging instruments. The Company has not recognized any adjustments through other comprehensive income for the years ended December 31, 2010 and 2009, and as of December 31, 2010 and 2009, has no accumulated other comprehensive income.

2. CHANGES IN ACCOUNTING POLICIES

Applied in 2010

Business combinations, consolidated financial statements and non-controlling interests

Effective January 1, 2010, the Company early adopted the pronouncements of CICA Handbook Section 1582, *Business Combinations*, Section 1601, *Consolidated Financial Statements*, and Section 1602, *Non-Controlling Interests*.

Section 1582 was introduced to replace Section 1581, *Business Combinations*, and provides the Canadian equivalent to International Financial Reporting Standard IFRS 3 (revised), *Business Combinations*. Section 1582 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 expenditures in the period incurred.

Section 1601 and Section 1602 were introduced together to 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 and 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.

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

2. CHANGES IN ACCOUNTING POLICIES (continued)

The early adoption of these standards by the Company resulted in additional disclosure related to a business acquisition that closed during 2010 [see note 3], as well as the expensing of related acquisition costs incurred of \$0.5 million, rather than the inclusion of these amounts as part of the cost of the business acquisition.

Future accounting pronouncements

International Financial Reporting Standards

The Canadian Accounting Standards Board (“AcSB”) has determined that publicly accountable enterprises are required to prepare financial statements in accordance with International Financial Reporting Standards (“IFRS”) for years beginning on or after January 1, 2011. The transition to IFRS will require the restatement for comparative purposes of amounts reported for the year prior to the transition date.

In August 2009, the International Accounting Standards Board (“IASB”) issued an exposure draft on rate-regulated activities. In September 2010, the IASB concluded that it could not resolve the rate-regulated activities matter quickly and that it would consider the development of an agenda proposal on this issue in 2011 for future consideration. Also in September 2010, the AcSB issued an amendment to Part I of the CICA Handbook allowing a one-year deferral of first-time adoption of IFRS for qualifying entities with rate-regulated activities.

The Company is a qualifying entity for purposes of this amendment and has elected to make use of the one-year deferral, with a revised IFRS conversion date for reporting under IFRS of January 1, 2012. Accordingly, the Company will present its financial statements for 2011 in accordance with Part V of the CICA Handbook.

During 2011, the Company will reassess policy choices available under IFRS, and will continue to evaluate the impacts of the transition to IFRS on the Company’s financial statements.

Comprehensive Revaluation of Assets and Liabilities

In August 2009, the CICA amended Handbook Section 1625, *Comprehensive Revaluation of Assets and Liabilities*, as a result of issuing Sections 1582, *Business Combinations*, 1601, *Consolidated Financial Statements*, and 1602, *Non-Controlling Interests*, in January 2009. The amendments require that when push-down accounting is used following the acquisition of an enterprise, the assets and liabilities are to be measured at the values used in accounting for the purchase transaction or transactions in accordance with Section 1582. The amendments also require that, when a future income tax asset that arose prior to the date of a comprehensive revaluation and that was not recognized in the comprehensive revaluation is subsequently recognized, the benefit should be recognized in accordance with Section 1582 and Section 3465, *Income Taxes*. The amendments apply prospectively to comprehensive revaluations of assets and liabilities occurring in fiscal years beginning on or after January 1, 2011. The adoption of the amendments to Section 1625 is not expected to have a material impact on the Company’s financial statements.

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

2. CHANGES IN ACCOUNTING POLICIES (continued)

Financial Instruments – Recognition and Measurement

In June 2009, the CICA provided a clarification to Handbook Section 3855, *Financial Instruments – Recognition and Measurement*, with respect to the embedded prepayment option. The Section has been amended to clarify when an embedded prepayment option is separated from its host instrument for accounting purposes. The amendment states that if the exercise price of a prepayment option compensates the lender for an amount equivalent to the present value of the lost interest for the remaining term of the host instrument, the feature is considered closely related to the host contract in which it is embedded. The amendment applies to interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. The adoption of the amendments to Section 3855 is not expected to have a material impact on the Company's financial statements.

Multiple Deliverable Revenue Arrangements

In December 2009, the CICA issued EIC-175, *Multiple Deliverable Revenue Arrangements*, replacing EIC-142, *Revenue Arrangements with Multiple Deliverables*. The changes were made in response to changes made to Accounting Standards Codification Topic 605-25, *Revenue Recognition – Multiple Element Arrangements*, under US GAAP, and more closely aligns the accounting requirements for multiple-element arrangements under Canadian GAAP and IFRS. EIC-175 addresses how to determine whether an arrangement involving multiple deliverables contains more than one accounting unit and, if so, how the consideration specified in the multiple element arrangement should be distributed between different accounting units. These recommendations are to be applied prospectively to revenue arrangements with multiple deliverables entered into or materially modified in the first annual fiscal period beginning on or after January 1, 2011. The Company is currently assessing the impact of adopting EIC-175 on its financial statements.

3. ACQUISITION

As noted under the description of business, the Company acquired a 97.1% interest in McNair Creek during 2010. Payments made for this acquisition included \$7.3 million in cash on closing (net of cash acquired) and an additional \$0.7 million in cash on finalization of post-closing adjustments. As part of the acquisition, contingent payments are required to be made to a former shareholder of McNair Creek equal to 0.75% of future revenues. Acquisition and restructuring costs of \$0.9 million have been expensed and are included in administrative and general costs for 2010.

The Company has accounted for this acquisition as a purchase business combination with the subsidiary as the acquirer. The purchase price has been allocated to the assets acquired and liabilities assumed based on the estimated fair values on the acquisition date. Estimated fair values are based on discounted cash flows, quoted market prices and estimates made by management. Management engaged a third party to review the valuation of the assets acquired and liabilities assumed. The table that follows summarizes the final fair values of the identifiable assets acquired and liabilities assumed in this acquisition.

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

3. ACQUISITION (continued)

Final Purchase Price Allocation

[\$ in thousands]

Assets	
Current assets	132
Property, plant and equipment ¹	19,467
Intangible assets	15
Restricted cash	570
	<hr/>
	20,184
<hr/>	
Liabilities	
Current liabilities	179
Long-term debt ²	9,413
Future income taxes	2,386
	<hr/>
	11,978
<hr/>	
Net assets acquired	8,206
<hr/>	
Purchase price	
Cash paid on closing, net of cash acquired	7,329
Cash paid post-closing	697
	<hr/>
	8,026
Contingent consideration	180
	<hr/>
	8,206
<hr/>	

1 – Property, plant and equipment

Prior to being acquired by the Company, McNair Creek entered into a long-term contract to sell 100% of its electricity generation to BC Hydro through to 2024, at a fixed price equal to the then prevailing market price, adjusted annually for inflation. At the acquisition date, the contract was an unfavourable operating lease as the price for electricity sold under the contract was less than the then current market price for electricity. The fair value of the unfavourable lease has been included in the determination of the acquisition-date fair value of the property, plant and equipment acquired.

2 – Long-term debt

Long-term debt assumed in this transaction is due November 1, 2024, bears interest at 7.386% and has monthly principal and interest payments of \$0.1 million. As a condition of the long-term debt, McNair Creek was required to maintain two reserve accounts held by the lender on contingency of certain events, including a hydrology cash reserve fund which will be used by the lender in the event that cash flows from the facility are insufficient to fund debt repayments and a maintenance reserve fund which will be used in the event that a major maintenance cost is incurred. In April 2010, the Company secured the release of the requirement for the hydrology cash reserve fund with the issuance of a letter of credit in the amount of \$1.4 million. The maintenance reserve fund had a balance of \$0.2 million at December 31, 2010 and is included in regulatory and other assets on the balance sheet [see note 8].

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

3. ACQUISITION (continued)

Accounting policies

Business combinations

As per note 2, early adoption of these standards has resulted in additional disclosure related to the transaction, as well as the expensing of transaction costs of \$0.5 million in administration and general expense.

Leases

The electricity purchase agreement with BC Hydro has been assessed as an operating lease for accounting purposes. Revenues from this operating lease are recognized on the same basis as energy deliveries under this agreement as this pattern is considered most representative of how benefits from the underlying assets are realized.

Segment reporting

With the acquisition of McNair Creek, the Company has entered a new business segment, the generation and sale of electricity. This change has resulted in the Company presenting segmented information as disclosed in note 23.

Operating results

The operating results of McNair Creek have been included in these consolidated financial statements from April 19, 2010, the date of acquisition, and include \$1.3 million in revenue and a net loss of \$0.5 million related to these operations [see note 23]. On a pro-forma basis, had the acquisition occurred on January 1, 2010, the Company's revenue from this operation would have been \$2.0 million and net loss for the period would have been \$0.4 million.

Non-controlling interest

The 2.9% interest in McNair Creek held by Skookum Power Holdings Corp. has been reflected as a non-controlling interest in these consolidated financial statements as a component of equity.

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.

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

4. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION (continued)

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.

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, 2010

[\$ in thousands]

Description	Note	Balance, beginning of year	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		(889)	2,418	—	1,529
Pipeline rehabilitation costs ²		1,226	483	(212)	1,497
Other ³		834	398	(253)	979
		1,171	3,299	(465)	4,005
<i>Amounts excluded from rate base</i>					
Deactivated assets ⁴		3,337	122	(625)	2,834
Other ⁵		(65)	369	213	517
		3,272	491	(412)	3,351
	8	4,443	3,790	(877)	7,356
<i>Other regulatory assets (liabilities) excluded from rate base</i>					
Gas purchase variance recoverable ⁶		1,165	3,333	—	4,498
LNG Partners option fees deferral ⁷	12	(2,385)	(214)	99	(2,500)
West Fraser termination payment deferral ⁸	12	—	(5,151)	143	(5,008)
		(1,220)	(2,032)	242	(3,010)
Sub-total		3,223	1,758	(635)	4,346
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	3,546	1,384	—	4,930
Future recovery of non-pension post-retirement benefits ¹⁰	8	2,373	124	—	2,497
		5,919	1,508	—	7,427
Total net regulatory assets		9,142	3,266	(635)	11,773

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

4. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION (continued)

Year Ended December 31, 2009

[\$ in thousands]

Description	Note	Balance, beginning of year	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		955	(1,844)	—	(889)
Pipeline rehabilitation costs ²		1,079	329	(182)	1,226
Other ³		293	635	(94)	834
		2,327	(880)	(276)	1,171
<i>Amounts excluded from rate base</i>					
Deactivated assets ⁴		3,824	134	(621)	3,337
Other ⁵		(22)	(258)	215	(65)
		3,802	(124)	(406)	3,272
	8	6,129	(1,004)	(682)	4,443
<i>Other regulatory assets (liabilities) excluded from rate base</i>					
Gas purchase variance recoverable ⁶		3,588	(2,423)	—	1,165
LNG Partners option fees deferral ⁷	12	—	(2,385)	—	(2,385)
Methanex termination payment deferral ¹¹		(5,401)	5,401	—	—
		(1,813)	593	—	(1,220)
Sub-total		4,316	(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		10,899	(1,075)	(682)	9,142

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

4. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION (continued)

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 2010, approximately \$0.4 million before income taxes of the December 31, 2010 RSAM balance was recovered in customer rates [2009 – \$0.5 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.

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.

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

4. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION (continued)

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 2010, amounts refunded and credited to cost of sales was \$2.3 million before income taxes [2009 – \$4.0 million].

7 – LNG Partners 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. In 2010, further deposits totaling \$2.0 million were paid to the Company and the agreement between the Company and Merrill Lynch was assigned and novated by Merrill Lynch to LNG Partners, LLC (“LNG Partners”). 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. Also pursuant to the negotiated settlement, the Company has drawn down \$2.0 million of the LNG Partners option fees deferral to offset the full balance of the Western system’s common equity deferral account that was set up during 2009 and 2010 following the Capital Structure and Equity Risk Premium Application.

8 – West Fraser Timber Co. Ltd. termination payment deferral

On May 31, 2010, West Fraser Timber Co. Ltd. (“West Fraser”) provided the Company with the required six months cancellation notice to terminate the transportation service agreement related to its Kitimat B.C. linerboard mill. West Fraser continued to pay the monthly demand charge due under the transportation agreement until November 30, 2010 and then made a termination payment of just over \$5 million on December 1, 2010. The Company anticipates the termination payment would be amortized over the remaining life of the agreement, consistent with the regulatory treatment accorded the Methanex termination payment. In addition, as was the case with the closure of the Methanex plant, lost future revenues from the West Fraser contract are expected to be recoverable through standard rate applications to the Commission. If this is the case, the Company anticipates limited impact on future earnings.

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.

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

4. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION (continued)

11 – Methanex Corporation 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.

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 2010 and 2009:

Year Ended December 31, 2010

[\$ in thousands]	Net deferral (recovery) of amounts	Amortization	Increase (decrease) in income before income taxes
Rate stabilization adjustment mechanism	(2,418)	—	(2,418)
Pipeline rehabilitation costs	(483)	212	(271)
Other amounts included in rate base	(398)	253	(145)
Deactivated assets	(122)	625	503
Other amounts excluded from rate base	(369)	(213)	(582)
Gas purchase variance recoverable	(3,333)	—	(3,333)
LNG Partners option fees deferral	214	(99)	115
West Fraser termination payment deferral	5,151	(143)	5,008
Future recovery of income taxes	(1,384)	—	(1,384)
Future recovery of non-pension post-retirement benefits	(124)	—	(124)
	(3,266)	635	(2,631)

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

4. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION (continued)

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

Other items affected by rate regulation

Allowance for funds used during construction (“AFUDC”)

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 2010 or 2009.

Deemed 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 2010, interest was capitalized at 3.99% [2009 – 3.78%] 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 debit to income of \$0.2 million in 2010 [2009 – credit to income of \$0.1 million].

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 Years ended December 31, 2010 and 2009

4. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION (continued)

Overhead and depreciation 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 also authorized to capitalize depreciation on equipment used in the construction of assets. The Company is allowed to earn a rate of return on the net book value of such capitalized costs in future years. In the absence of rate-regulated accounting, these costs would be charged to the consolidated statement of income in the period in which they occurred. In 2010, the Company capitalized \$1.9 million of overhead costs [2009 – \$1.9 million] and \$0.3 million of depreciation expense [2009 – \$0.3 million] to plant, property and equipment.

Gains and losses on disposal of property, plant and equipment

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.

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]	2010	2009
Natural gas (line-pack)	681	995
Materials and supplies	83	84
	764	1,079

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

6. PLANT, PROPERTY AND EQUIPMENT

As at December 31, 2010

[\$ in thousands]	Average Depreciation Rate (%)	Cost	Accumulated Depreciation	Net Book Value
Transmission plant	2.7	191,476	92,738	98,738
Distribution plant	2.5	102,346	40,737	61,609
General plant	4.4	23,282	9,509	13,773
Hydroelectric plant <i>[note 3]</i>	2.5	19,471	339	19,132
Processing plant	1.7	1,466	401	1,065
Construction in progress	—	1,440	—	1,440
Subtotal	2.9	339,481	143,724	195,757
Capital supplies inventory	—	1,103	—	1,103
	2.9	340,584	143,724	196,860

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
	2.8	314,051	135,631	178,420

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

[\$ in thousands]	2010	2009
Cost, beginning of year	312,994	304,574
Acquisition of McNair Creek <i>[note 3]</i>	19,467	—
Capital expenditures, net of contributions in aid of construction	7,788	9,682
Depreciation capitalized	321	290
Transfer to regulatory asset	(6)	(484)
Plant retirements	(1,083)	(1,068)
Cost, end of year	339,481	312,994

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

6. PLANT, PROPERTY AND EQUIPMENT (continued)

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

[\$ in thousands]	2010	2009
Accumulated depreciation, beginning of year	135,631	128,331
Depreciation expense	8,808	8,271
Depreciation capitalized	321	290
Transfer to regulatory asset	(4)	(252)
Plant retirements	(1,083)	(1,068)
Salvage on plant retirements	51	59
Accumulated depreciation, end of year	143,724	135,631

During the year, the Company received contributions in aid of construction of \$0.7 million [2009 – \$1.3 million], which have been recorded as a reduction of distribution plant.

7. INTANGIBLE ASSETS

As at December 31, 2010

[\$ in thousands]	Average Amortization Rate (%)	Cost	Accumulated Amortization	Net Book Value
Land rights	0.3	1,527	81	1,446
Computer software	7.2	847	527	320
		2,374	608	1,766

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

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

[\$ in thousands]	2010	2009
Cost, beginning of year	2,337	2,274
Purchase of intangibles	22	63
Acquisition of McNair Creek [note 3]	15	—
Cost, end of year	2,374	2,337

Amortization of these intangible assets for the year was \$66,000 [2009 – \$64,000].

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

8. REGULATORY AND OTHER ASSETS

[\$ in thousands]	2010	2009
Regulatory assets <i>[note 4]</i>	7,356	4,443
Future recovery of income taxes <i>[note 4]</i>	4,930	3,546
Future recovery of non-pension post-retirement benefits <i>[notes 4 and 12]</i>	2,497	2,373
Accrued pension benefit asset <i>[note 13]</i>	2,473	1,002
Other	403	—
	17,659	11,364

9. INCOME TAXES

[\$ in thousands]	2010	2009
Current income taxes	248	2,163
Future income taxes (recovery)	1,629	105
	1,877	2,268

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]	2010	2009
Combined Canadian federal and provincial statutory income tax rates, including surtaxes	28.5	30.0
Increase (decrease) in income taxes resulting from:		
Regulatory adjustment	(4.4)	(1.3)
Non-taxable income	(2.9)	(3.1)
Other items	(0.2)	0.2
Effective rate of income taxes	21.0	25.8

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

9. INCOME TAXES (continued)

Future income taxes

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

[\$ in thousands]	2010	2009
Future income tax asset (liability):		
Plant, property and equipment	(18,672)	(15,220)
Deactivated assets	(955)	(1,145)
Employee future benefits	(815)	(336)
Gas purchase variance account	468	801
Regulatory assets and liabilities	(1,709)	565
West Fraser termination payment deferral	1,427	—
Other	625	173
	(19,631)	(15,162)
Comprised of:		
Current future income tax assets	1,105	1,288
Non-current future income tax liabilities	(20,736)	(16,450)
	(19,631)	(15,162)

10. BANK INDEBTEDNESS

In November 2010, the Company completed a renegotiation and extension of its bank operating facility. Under the facility, \$25.0 million is available for working capital purposes [2009 – \$25.0 million] through cash draws and the issuance of letters of credit. The November 2010 amendments included deletion of the borrowing base limitation of availability under the operating facility such that the \$25.0 million is available to the Company at all times subject to a requirement that borrowings be reduced to zero for 30 days each calendar year. The Company covenants under the facility to maintain its debt leverage at 65% or less.

The bank operating facility has a term of 18 months, expiring May 28, 2012, 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, 2010 – 4.00% interest rate; December 31, 2009 – 3.75% interest rate]. At December 31, 2010, \$4.8 million (2009 – \$2.6 million) had been drawn as prime-rate advances and an additional \$3.8 million (2009 – \$5.7 million) was utilized for the issuance of letters of credit securing the Company's obligations under its Supplemental Retirement Plan and to secure certain obligations related to McNair Creek.

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

11. LONG-TERM DEBT

[\$ in thousands]	2010	2009
Secured Debentures – regulated activities ^[a]		
5-year Revolver due January 30, 2015, bearing interest at a floating rate [December 31, 2010 – 4.371%]. ^[b]	16,000	—
5-year Revolver due August 3, 2012, bearing interest at a floating rate [December 31, 2009 – 1.758%]. ^[b]	—	6,000
RoyNat Debenture due September 15, 2017, bearing interest at a floating rate [December 31, 2010 – 3.689%; December 31, 2009 – 2.896%], payable in monthly instalments of \$0.1 million, beginning on September 15, 2010, with a final instalment of \$6.6 million at maturity.	14,600	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.	5,000	5,799
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.	12,800	13,400
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.	16,500	17,000
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.	17,500	18,000
	82,400	75,199
Secured Debentures – non-regulated activities ^[c]		
2024 CFI Debenture, 7.39% due November 1, 2024, payable in monthly blended principal and interest mortgage-style instalments that total to \$1.1 million annually.	9,167	—
	91,567	75,199
Less: Debt issue costs	(614)	(620)
	90,953	74,579
Long-term debt due within one year ^[d]	8,192	2,800
	82,761	71,779

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

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. 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] Collateral for the 2024 CFI Debenture consists of first fixed specific and floating charges and a security interest over all the assets and undertakings of McNair Creek and a first security interest over all the interests of the Company and its partner in partnership interests and shares in McNair Creek.
- [d] Principal repayments of long-term debt during the next five years and thereafter are as follows:

[\$ in thousands]	
2011	8,192
2012	3,222
2013	3,254
2014	3,689
2015	19,727
Thereafter	53,483
	91,567

12. REGULATORY AND OTHER LIABILITIES

[\$ in thousands]	2010	2009
LNG Partners option fees deferral <i>[note 4]</i>	2,500	2,385
West Fraser Timber Co. Ltd. termination payment deferral <i>[note 4]</i>	5,008	—
Accrued non-pension post-retirement benefit liability <i>[note 13]</i>	2,497	2,373
Derivative financial instruments – non-current <i>[note 19]</i>	476	707
Other	411	219
	10,892	5,684

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

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]	2010	2009
Defined benefit plans	2,312	1,237
Defined contribution plans	77	68
Non-pension post-retirement plans	150	156
Non-pension post-retirement benefits paid	243	233
	2,782	1,694

[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:

	2010	2009
Measurement date of the plan assets and accrued benefit obligation	September 30, 2010	September 30, 2009
Effective date of the most recent actuarial valuation report for funding purposes	December 31, 2009	December 31, 2006
Effective date of the next required actuarial valuation report for funding purposes	December 31, 2012	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]	2010	2009
Accrued benefit obligations:		
Balance, beginning of year	23,370	22,049
Current service cost	761	752
Employees' contributions	15	15
Interest cost	1,512	1,427
Benefits paid	(1,004)	(970)
Actuarial (gains) losses	4,621	97
Balance, as at measurement date	29,275	23,370

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

13. EMPLOYEE FUTURE BENEFIT PLANS (continued)

[\$ in thousands]	2010	2009
Plan assets:		
Fair value, beginning of year	19,316	18,035
Actual return (loss) on plan assets	1,489	929
Employer contributions	2,063	1,307
Employees' contributions	15	15
Benefits paid	(1,004)	(970)
Fair value, as at measurement date	21,879	19,316
Funded status:		
Plan deficit	(7,396)	(4,054)
Unamortized net actuarial losses	9,355	4,789
Unamortized transitional asset	(38)	(36)
Accrued benefit asset, as at measurement date	1,921	699
Employer contributions between measurement date and end of year	552	303
Accrued benefit asset, end of year [note 8]	2,473	1,002

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

[Percent]	2010	2009
Accrued benefit obligation as of December 31, with a measurement date of September 30:		
Discount rate	5.30	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	6.50
Expected long-term rate of return on plan assets	7.00	7.00
Rate of compensation increase	3.25	3.25

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

[Percent]	2010	2009
Asset category:		
Equity securities	62	62
Debt securities	35	36
Other	3	2
	100	100

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

13. EMPLOYEE FUTURE BENEFIT PLANS (continued)

The Company's pension plan expense is as follows:

[\$ in thousands]	2010	2009
Current service cost	761	752
Interest cost	1,512	1,427
Expected return on plan assets	(1,481)	(1,391)
Amortization of net actuarial loss	47	26
Amortization of transitional asset	2	2
Net defined benefit pension plan expense	841	816
Defined contribution pension plan expense	77	68
Total pension expense	918	884

[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]	2010	2009
Accrued benefit obligation as of December 31, with a measurement date of September 30:		
Discount rate	5.30	6.50
Benefit cost for years ended December 31, with a measurement date of September 30:		
Discount rate	6.50	6.50
Expected long-term rate of return on plan assets	3.50	3.50

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

[\$ in thousands]	2010	2009
Accrued benefit obligations:		
Balance, beginning of year	4,930	4,891
Current service cost	150	156
Interest cost	317	315
Benefits paid	(243)	(233)
Actuarial (gain) loss	1,377	(199)
Balance, as at measurement date	6,531	4,930
Plan assets:		
Fair value, beginning of year	943	779
Actual return on plan assets	28	1
Employer contributions	394	396
Benefits paid	(243)	(233)
Fair value, as at measurement date	1,122	943

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

13. EMPLOYEE FUTURE BENEFIT PLANS (continued)

Funded status:

Plan deficit	(5,409)	(3,987)
Unamortized net actuarial losses	1,889	466
Unamortized transitional obligation	986	1,109
Benefit liability, as at measurement date	(2,534)	(2,412)
Employer contributions between measurement date and end of year	37	39
Accrued benefit liability, end of year [note 12]	(2,497)	(2,373)

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]	2010	2009
Current service cost	150	156
Interest cost	317	315
Expected return on plan assets	(36)	(30)
Amortization of transitional obligation	123	123
Amortization of net actuarial loss	1	15
Non-pension post-retirement benefit plan expense, accrual method	555	579

For 2010, \$431,000 (2009 - \$396,000) of the non-pension post-retirement benefit plan expense has been recovered in customer rates and is recognized in the Company's administration and general expense. The difference of \$124,000 (2009 - \$183,000) is recorded as an increase in the future recovery of non-pension post-retirement benefits asset [see note 8].

For 2010, 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	968	(759)
Increase (decrease) in current service and interest costs	58	(49)

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

14. SHARE CAPITAL

[a] Preferred shares

[\$ in thousands]	2010	2009
Authorized		
1,400,000		
200,000		
Issued		
200,000	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 2010 (2009 – \$1.6875).

[b] Common shares

[\$ in thousands]	2010	2009
Authorized		
Unlimited		
Issued		
3,615,144	9,038	8,890

The Company issued 59,180 common shares in 2010 upon the exercise of employee share options (2009 – 13,800).

The holders of ordinary shares are entitled to receive dividends as declared by the Company from time to time. In 2010, dividends of \$1.14 per common share were declared and paid on common shares (2009 – \$0.96).

In March 2009, the Company obtained approval from the Toronto Stock Exchange (“TSX”) to commence a normal course issuer bid which terminated on March 8, 2010. No share purchases were made under the bid during the year ended December 31, 2010. For the year ended 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 greater 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.

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

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, 2010, 361,514 [2009 – 355,596] shares were available to be reserved for issuance pursuant to options granted under the stock option incentive plan.

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:

	2010	2009
Dividend yield	4.9%	7.5%
Expected volatility (annualized)	20.2%	22.3%
Risk-free interest rate	3.2%	2.2%
Expected life (years)	7.5	7.5

Options granted in 2010 had an individual fair value of \$2.66 per option [2009 – \$0.80 per option]. The Company recognized a stock-based compensation expense of \$0.1 million for the year ended December 31, 2010 [2009 – \$0.1 million].

A summary of the changes to the Company's stock option plan during the years ended December 31, 2010 and 2009 is as follows:

	2010		2009	
	Number of options	Weighted- average exercise price [\$]	Number of options	Weighted- average exercise price [\$]
Outstanding, beginning of year	332,240	15.85	296,720	16.70
Granted	38,300	22.72	62,800	12.24
Exercised	(59,180)	14.66	(13,800)	9.43
Forfeited	—	—	(280)	18.10
Expired	—	—	(13,200)	24.50
Outstanding, end of year	311,360	16.90	332,240	15.85
Options exercisable, end of year	228,934	16.79	237,500	16.16
Weighted-average remaining contractual life of outstanding options	5.6 years		5.7 years	

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

15. SHARE-BASED COMPENSATION (continued)

The following table summarizes information about stock options outstanding and exercisable as at December 31, 2010:

Exercise price [\$]	Number of options outstanding	Weighted-average remaining exercise price [\$]	Weighted-average remaining contractual life [years]	Number of options exercisable
10.00 – 14.99	129,400	13.05	4.7	93,880
15.00 – 19.99	125,360	18.57	5.9	109,094
20.00 – 24.50	56,600	22.10	7.2	25,960
	311,360	16.90	5.6	228,934

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]	2010	2009
Outstanding, beginning of year	24,545	17,824
Issued during year	6,601	9,116
Redemptions	—	(2,395)
Outstanding, end of year	31,146	24,545

Liability [\$ in thousands]	2010	2009
Balance, beginning of year	460	241
Expensed	474	249
Redemptions	—	(30)
Balance, end of year	934	460

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

16. JOINT VENTURES

In 2006, the Company formed Pacific Trail Pipelines Limited Partnership (“PTP”), 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”). During 2010, Apache Canada Inc. acquired a 25.5% interest in PTP from Galveston LNG Inc. The Company continued to hold a 50% interest in the partnership and Galveston LNG Inc. retained a 24.5% interest throughout the year ended December 31, 2010.

In the third quarter of 2010, the Company commenced the detailed design phase of the KSL Project and commenced capitalization of expenditures including \$0.7 million relating to engineering and technical studies.

The following amounts represent the Company’s proportionate interest in PTP and its general partner, Pacific Trail Pipelines Management Inc. at December 31, 2010 and 2009:

[\$ in thousands]	2010	2009
Balance Sheet		
Current assets	595	32
Non-current assets	684	—
Current liabilities	197	9
Non-current liabilities	—	—
Income Statement		
Revenues	—	—
Expenses	566	181
Net loss	566	181
Cash Flow		
Cash provided by (used in):		
Operations	(551)	(181)
Investing	(499)	—
Financing	1,614	100
Proportionate share of increase (decrease) in cash of the joint venture	564	(81)

As described in note 25, subsequent to December 31, 2010, the Company entered into an agreement to sell its 50% interest in PTP to Apache Canada Ltd. and EOG Resources Canada Inc., the Company’s partners in the KSL Project.

17. INTEREST EXPENSE

[\$ in thousands]	2010	2009
Interest on long-term debt	6,100	5,653
Interest on short-term debt	102	81
	6,202	5,734
Imputed interest on regulatory assets and liabilities	202	(91)
	6,404	5,643

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

18. EARNINGS PER COMMON SHARE

[\$ in thousands, except share and per share amounts]	2010	2009
Net income attributable to shareholders	7,088	6,532
Dividends on preferred shares	(337)	(337)
Net income attributable to common shares	6,751	6,195
Basic weighted-average number of shares outstanding	3,598,335	3,594,522
Effect of dilutive securities:		
Stock options	98,786	31,346
Diluted weighted-average number of shares outstanding	3,697,121	3,625,868
Net income per common share		
Basic	\$ 1.88	\$ 1.72
Diluted	\$ 1.83	\$ 1.71

For the year ended December 31, 2010, no stock options were excluded from the computation of diluted securities because the exercise prices of these options were lower than the average market price of the Company's common shares during the year. For the year ended December 31, 2009, 163,240 stock options were excluded from the computation of diluted securities because the options' exercise prices were greater than the average market price of the common shares.

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, 2010		December 31, 2009	
	Carrying value	Estimated fair value	Carrying value	Estimated fair value
Held for trading				
Cash and cash equivalents	1,894	1,894	1,511	1,511
Loans and receivables				
Accounts receivable	23,017	23,017	21,618	21,618
Other financial liabilities				
Bank indebtedness	4,836	4,836	2,579	2,579
Accounts payable and accrued liabilities	19,106	19,106	21,617	21,617
Long-term debt, including current portion	90,953	100,735	74,579	82,674

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

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 two hedge lines of credit, each is secured by the pledge of a \$20.0 million debenture. One line is with the provider of the Company's bank operating line and the other is with another Canadian bank. Under either hedge line if the credit exposure of the provider exceeds \$20.0 million, the Company is required to provide cash collateral to the extent of the excess credit exposure.

The facility with the Company's operating line provider has one financial covenant which requires the Company's debt leverage not to exceed 65 percent. The second 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 a minimum interest coverage of 1.5 times 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 risk management plan and to enter into interest rate hedging transactions.

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, 2010					
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	9.4	Jan 2011 – Mar 2011	\$4.23	(678)
Natural gas swap contracts	3 846 600	40.2	Jan 2011 – Oct 2012	\$4.16 to \$7.26	(5,453)
Collar contracts	53 500	0.6	Apr 2012 – Oct 2012	\$3.80 (floor) - \$5.81 (cap)	(8)
	4 800 100	50.2			(6,139)

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

19. FINANCIAL INSTRUMENTS (continued)

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)

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, 2010 reflects a decrease of \$6.1 million (decreased by \$4.0 million at December 31, 2009) in accordance with specific regulatory treatment.

Fair value hierarchy

The classification within the fair value hierarchy of the Company's financial is summarized in the following table:

December 31, 2010

[\$ in thousands]	Level 1	Level 2	Level 3	Total
Assets				
Cash and cash equivalents	1,894	—	—	1,894
Derivative financial instruments	—	33	—	33
	1,894	33	—	1,927
Liabilities				
Derivative financial instruments – current	—	5,696	—	5,696
Derivative financial instruments – non-current <i>[note 12]</i>	—	476	—	476
	—	6,172	—	6,172

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

19. FINANCIAL INSTRUMENTS (continued)

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 <i>[note 12]</i>	—	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 with respect to its regulated operations 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.

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.

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

20. RISK MANAGEMENT (continued)

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

[\$ in thousands]	2010	2009
Core market – residential and commercial	19,581	18,746
Industrial customers	779	948
Off-system sales customers	3,167	3,831
Other	339	137
	23,866	23,662
Less: Allowance for doubtful accounts	(849)	(2,044)
	23,017	21,618

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

[\$ in thousands]	2010	2009
Unbilled revenues	11,991	10,729
Past due 0 to 30 days (current)	11,119	10,747
Past due 31 to 90 days	303	384
Past due over 91 days	453	1,802
	23,866	23,662
Less: Allowance for doubtful accounts	(849)	(2,044)
	23,017	21,618

Changes in the allowance for doubtful accounts are as follows:

[\$ in thousands]	2010	2009
Balance, beginning of year	2,044	1,735
Provision for doubtful accounts	265	313
Write-off of bad debts, net of recoveries, and other	(1,460)	(4)
Balance, end of year	849	2,044

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, 2009, with the increase in the availability of credit under its risk management facilities, 5-year term revolving debt facility and its operating line.

As at December 31, 2010, the Company had utilized \$8.6 million of its \$25 million operating line facility [see note 10] and \$16.0 million of the \$35.0 million available under its revolving term facility [see note 11].

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

20. RISK MANAGEMENT (continued)

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, 2010 and as at December 31, 2009 include its bank indebtedness, accounts payable and accrued liabilities, natural gas derivatives and long-term debt. The tables below summarize the Company’s financial liabilities in relevant maturity groupings based on the remaining period from the balance sheet dates to the contractual maturity date. As the amounts disclosed in the tables are contractual undiscounted cash flows (including interest payments where applicable), these balances may not necessarily agree with the amounts disclosed in the balance sheets.

Expected payments by period, as at December 31, 2010						
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	4,836	—	—	—	4,836	4,836
Accounts payable and accrued liabilities	19,106	—	—	—	19,106	19,106
Long-term debt, including current portion	14,502	17,392	32,812	79,682	144,388	90,953
Derivative financial liabilities						
Fixed-price contracts	678	—	—	—	678	678
Natural gas swap contracts	5,018	468	—	—	5,486	5,486
Collar contracts	—	8	—	—	8	8
	44,140	17,868	32,812	79,682	174,502	121,067

Expected payments by period, as at December 31, 2009						
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	3,869	707	—	—	4,576	4,576
Collar contracts	429	—	—	—	429	429
	36,451	26,410	13,729	77,012	153,602	103,780

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

20. RISK MANAGEMENT (continued)

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, 2010, 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 \$6.1 million to \$10.9 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 \$6.1 million to a payable of \$1.4 million and a decrease in the gas purchase variance recoverable account.

At December 31, 2009, a one dollar per gigajoule decrease in the underlying forecast price of natural gas 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].

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

21. CAPITAL MANAGEMENT

The Company's objective in managing capital remains largely unchanged from December 31, 2009. The capital structure consisted of the following components at December 31, 2010: bank indebtedness, long-term debt and shareholders' equity, totaling \$189.9 million [2009 – \$167.6 million].

The Company's objectives with its capital structure are:

- to maintain the amount of common equity in its capital structure at the level approved by the Commission for the purpose of determining rates for the Company's regulated operations plus sufficient equity to support investments in the Company's non-regulated businesses; 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.

Prior to the second quarter of 2010, the Company was not able to meet both objectives as the proportion of common equity approved by the Commission was not sufficient to allow the Company to maintain a satisfactory credit rating. The Company was carrying approximately \$20 million (22%) more common equity on its balance sheet than was allowed by the Commission for the purpose of determining rates ("excess equity") in order to maintain a minimum investment grade credit rating. In 2009 the Company filed a Capital Structure and Equity Risk Premium Application (the "CAP/ROE Application") with the Commission to, among other things, increase its deemed common equity.

In the second quarter of 2010, the Commission approved the CAP/ROE Application negotiated settlement agreement resulting in the common equity used for the purpose of determining rates for the Company's regulated operations increasing by approximately \$8 million. In addition, the Company reduced its excess equity by another \$8 million through acquisition of the McNair Creek facility. The Company is now closer to meeting its capital structure objectives and further positive movement is possible through additional renewable power investments provided that the Company is able to maintain its credit rating.

During the fiscal year ending December 31, 2010 the Company added a second hedge facility, extended and increased the amount available under its revolving term facility and extended and amended its operating line. The hedge 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 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 \$35.0 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 May 17, 2010 Dominion Bond Rating Services ("DBRS") confirmed the Company's secured debt ratings at BBB (low). The Company is in compliance with its debt covenants as at December 31, 2010.

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

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, 2010 under various gas supply contracts expiring through 2015 were as follows:

[\$ in thousands]

2011	19,837
2012	4,893
2013	52
2014	52
2015	44
Total	24,878

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, 2010.

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.

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

23. SEGMENTED INFORMATION

Historically, the Company has operated in one business and in one geographic segment, the transmission and distribution of natural gas within Canada, and the consolidated financial statements have not been segmented. In the second quarter of 2010, the Company acquired an interest in McNair Creek hydroelectric facility [see note 3], and with this acquisition has entered into a new business segment, the generation and sale of electricity from renewable resources. The Company continues to operate in a single geographic segment.

Segmented results

The following tables provide segmented financial information for the year ended December 31, 2010. Comparative information has not been presented as the Company operated in a single business segment during the prior year.

Year ended December 31, 2010

[\$ in thousands]	Gas Transmission and Distribution	Renewable Energy	Consolidated
Revenues	93,848	1,316	95,164
Cost of gas	44,113	—	44,113
	49,735	1,316	51,051
Operating and maintenance	12,388	183	12,571
Administrative and general	8,064	977	9,041
Depreciation and amortization	8,413	339	8,752
Municipal and other taxes	4,691	74	4,765
	33,556	1,573	35,129
Finance fees	5,889	512	6,401
Project development expenditures	566	—	566
Income (loss) before income taxes and non-controlling interest	9,724	(769)	8,955
Income tax expense (recovery)	2,084	(207)	1,877
Net income (loss) and comprehensive income (loss)	7,640	(562)	7,078
Net loss attributable to non-controlling interest	—	10	10
Net income (loss) and comprehensive income (loss) attributable to shareholders	7,640	(552)	7,088

Other segment information regarding capital expenditures, assets and liabilities is as follows:

As at and for the year ended December 31, 2010

[\$ in thousands]	Gas Transmission and Distribution	Renewable Energy	Consolidated
Capital expenditures	7,395	4	7,399
Plant, property & equipment	177,728	19,132	196,860
Assets	228,753	21,171	249,924
Liabilities	143,231	12,376	155,607

Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

24. SUPPLEMENTAL CASH FLOW INFORMATION

[\$ in thousands]	2010	2009
Cash and cash equivalents:		
Cash	1,894	503
Cash equivalents	—	1,008
	1,894	1,511

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

[\$ in thousands]	2010	2009
Depreciation and amortization:		
Depreciation and amortization, per income statement	8,752	8,118
Amortization of debt issue costs included in long-term interest expense	(61)	108
Total depreciation and amortization	8,691	8,226

Changes in operating assets and liabilities:

(Increase) decrease in:		
Accounts receivable	(1,268)	6,429
Gas purchase variance recoverable	—	935
Income taxes recoverable	(1,305)	555
Inventories of supplies and natural gas	315	1,148
Prepaid expenses	(115)	18
Increase (decrease) in:		
Accounts payable and accrued liabilities	(3,523)	(2,629)
Gas purchase variance payable	(1,332)	—
Income taxes payable	(1,041)	—
Other taxes payable	(157)	(539)
Changes in regulatory assets and liabilities	1,718	3,763
Contributions to defined benefit plans in excess of expense	(1,471)	(421)
Attributable to operating activities	(8,179)	9,259

Interest and tax payments:

Income taxes paid	2,594	1,746
Interest paid	6,176	5,529

Non-cash transactions:

Plant, property and equipment purchases included in accounts payable and accrued liabilities	382	133
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Pacific Northern Gas Ltd.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2010 and 2009

25. SUBSEQUENT EVENT

On February 7, 2011, the Company announced it had entered into an agreement to sell its 50% interest in PTP to Apache Canada Ltd. and EOG Resources Canada Inc., the Company's partners in the KSL Project [see note 16], for payments of up to \$50 million.

The sale transaction has two elements, including an initial payment of \$30 million to be paid on closing and a second payment of \$20 million to be paid contingent on the purchasers making a decision to proceed with construction of a liquefied natural gas facility in Kitimat, B.C. The transaction was subject to standard industry conditions and consents and closed on March 2, 2011.

The Company has recorded \$7.3 million of KSL Project expenditures from its inception to December 31, 2010, of which \$6.6 million has been expensed and \$0.7 million has been capitalized.

26. COMPARATIVE FIGURES

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