



# Interim Report

**For the Three and Nine Months Ended September  
30, 2008**

**November 3, 2008**

Pacific Northern Gas Ltd.  
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## **Pacific Northern Gas Ltd.**

### **MANAGEMENT'S DISCUSSION AND ANALYSIS**

**for the Three and Nine Months Ended September 30, 2008**

**Dated November 3, 2008**

#### **FORWARD-LOOKING STATEMENTS**

This Management Discussion and Analysis ("MD&A") includes forward-looking statements. Forward-looking statements relate to, among other things, anticipated financial performance, business prospects, strategies, regulatory developments, new services, market forces, commitments and technological developments. Many of these statements can be identified by words such as "believe", "expects", "expected", "will", "intends", "projects", "anticipates", "estimates", "continues" or similar words. Pacific Northern Gas Ltd. ("the Company") believes the expectations reflected in such statements are reasonable but no assurance is given that such expectations will be correct. All forward-looking statements are based on management's beliefs and assumptions based on information available at the time the assumption was made and on its experience and perception of historical trends, current conditions and expected further developments as well as other factors deemed appropriate in the circumstances. In addition to other assumptions made in this MD&A, assumptions have been made in respect of:

- gas commodity prices;
- forecasted gas deliveries;
- regulatory conditions, including decisions by the British Columbia Utilities Commission (the "Commission");
- the Company's ability to access capital;
- capital expenditure estimates, plans, schedules and activities and the development, construction, operations and cost of facilities and infrastructure;
- income tax considerations;
- operating risks and related insurance coverage and inspection and integrity systems; and
- competitive conditions.

By its nature, such forward-looking information is subject to various risks and uncertainties that are known and unknown, including those material risks discussed in this MD&A and in the Company's Annual Information Form for the year ended December 31, 2007 under "Risk Factors" which could cause the Company's actual results and experience to differ materially from the anticipated results or other expectations expressed. Such risks and uncertainties include but are not limited to: general economic conditions and markets; gas supply and availability; gas commodity price volatility; competition; decisions by regulators; seasonal weather patterns; federal and provincial climate change initiatives; financing of investments as well as the value of such investments; the cost and availability of capital; and the ability of the Company to attract and retain quality employees. Readers are cautioned not to place undue reliance on this forward-looking information, which is given as of the date it is expressed in this MD&A or otherwise, and the Company undertakes no obligation to update publicly or revise any forward-looking information, whether as a result of new information, future events or otherwise, except as required by applicable securities laws.

#### **Business of the Company**

The Company continues to monitor the competitiveness of its natural gas retail rates relative to alternative heating sources in its service area. The Company's current residential rate in the Western system service area is slightly less than the comparable residential conservation electricity rate that became effective October 1, 2008. The Province of British Columbia's Energy Plan,

released in early 2007, calls for the Province to become self-sufficient in electricity by 2016 with all new generation capacity being carbon neutral and to use demand side management to curtail growing electricity consumption. These policy objectives are expected to result in higher electricity rates with a corresponding impact on the competitiveness of gas relative to electricity. The Province of B.C. implemented a carbon tax on fossil fuel consumption effective July 1, 2008. The carbon tax on natural gas is just under \$0.50 per Gigajoule ("GJ") effective July 1, 2008, rising annually to just under \$1.50 per GJ effective July 1, 2012. The Company's gas rates are expected to maintain their relative competitiveness with electricity rates as electricity rate increases are expected to be higher than the carbon tax on natural gas to encourage electricity conservation.

High natural gas prices and weak economic conditions faced by the Company's customer base in the Western system service area have reduced the quantity of gas sold and delivered to the Company's customers in that area over the last several years. In particular, lower demand and lower prices for forest products in North America have resulted in deliveries to the forest sector continuing to decline in 2008. The economy in the Northeast system service area continues to grow as a result of activity in the oil and gas exploration sector, which is reflected in customer additions in that area.

The Company continues to pursue a project to loop its mainline transmission system from Kitimat to Summit Lake (the "KSL Project") through its 50 percent ownership of Pacific Trail Pipelines Limited Partnership ("PTP"). On June 27, 2008, PTP received its Environmental Assessment Certificate from the B.C. Environmental Assessment Office ("BCEAO") for the KSL Project. Approvals from the Canadian Environmental Assessment Agency ("CEAA") are expected to be granted before the end of 2008.

The KSL Project would provide gas transportation services for up to 1.0 billion cubic feet per day, primarily for Kitimat LNG Inc.'s proposed liquefied natural gas ("LNG") export terminal to be located approximately 15 kilometers southwest of Kitimat, the same location as their originally proposed LNG import and regasification terminal. Strong natural gas demand in Asia and increases in gas supply throughout North America have led to higher natural gas prices in Asia than North America. On this basis, Kitimat LNG has determined that the exporting of LNG is more viable than the earlier proposal to import LNG. The KSL Project entails the construction of approximately 463 kilometers of a 36 inch diameter pipeline and associated compression facilities, at a cost of \$1.2 billion based on estimates made in 2006. Subject to a number of conditions, construction of the KSL Project by PTP is planned to commence in 2010 for completion in early 2013 when the LNG export terminal is planned to begin operation. Conditions to construction include the securing of contracts for use of PTP's transportation capacity, financing for construction of the KSL Project, and additional regulatory approvals for the KSL Project, including approvals under the Canadian Environmental Assessment Act, a Certificate of Public Convenience and Necessity from the Commission and other permits from the B.C. Oil and Gas Commission. The Company can give no assurances that these conditions will be satisfied or that construction of the KSL Project by PTP will proceed.

PNG filed an application with the Commission on September 25, 2008 for approval to provide LNG Partners, LLC ("LNG Partners") with an option to contract for a minimum 75 MMcf per day of firm gas transportation service using existing capacity on PNG's Western pipeline system. If LNG Partners exercises its option it would utilize the transportation service to deliver natural gas to a floating natural gas liquefaction vessel to be owned and operated by an LNG Partners affiliate on the Douglas Channel near Kitimat, B.C. The LNG would then be transferred to other LNG carriers for export.

Following Commission approval of the arrangement, LNG Partners will pay a \$1.5 million non-refundable fee to PNG which will give LNG Partners an exclusive 6 month option to contract firm gas transportation capacity for a 3 to 5 year primary term, with a right to renew for an additional 3 to 5 year term. Alternatively, LNG Partners may extend the initial option period for another six months on payment of an additional no-refundable option fee of \$1.5 million. PNG has applied for Commission approval to apply approximately two-thirds of the initial option fee to reduce customer rates in 2009

with the remaining one-third to compensate PNG for the reduced return it has earned since the Methanex closure at the end of 2005. If LNG Partners exercises its option, the PNG pipeline system would be at full capacity utilization, generating almost \$15 million per year of incremental revenue for the benefit of PNG and its customers, compared to approximately \$12 million previously received annually from Methanex. The commencement date for the transportation service is expected to be at the beginning of 2011.

The Commission is expected to render a decision on the PNG/LNG Partners arrangements prior to the end of 2008. The Company can give no assurances that the Commission will approve the arrangements or that LNG Partners will proceed with its floating natural gas liquefaction project.

## **Overall Performance**

Net loss for the three months ended September 30, 2008 was \$1.5 million, compared to a net loss of \$1.4 million for same period in 2007. After providing for preferred share dividends, the loss per common share in the three months ended September 30, 2008 was \$0.44 compared with a loss per common share of \$0.40 for the same period in 2007.

The net loss for the quarter was slightly higher by \$0.1 million in 2008 compared to 2007 due mainly to lower than anticipated deliveries to small industrial customers due to the downturn in the forestry sector, lower net residential additions than anticipated for this quarter and higher operating expenses in 2008 compared to 2007. This was partially offset by lower PTP project development expenses and the higher allowed return on equity ("ROE") rate of 9.27% in 2008 compared to 9.02% in 2007 in the Western system and the Tumbler Ridge division of the Northeast system and the higher ROE of 9.02% in 2008 compared to 8.77% in 2007 in the Fort St. John/Dawson Creek division of the Northeast system.

Included in the net losses for the three month periods ended September 30, 2008 and 2007 are charges, net of income taxes, of \$0.1 million and \$0.4 million, respectively for the Company's share of KSL Project development expenditures incurred by PTP. The Company will continue to expense its share of these expenditures until suitable commercial arrangements for firm gas transportation services are put in place by PTP.

Net income for the nine months ended September 30, 2008 was \$2.8 million, compared to \$1.7 million for the corresponding period in 2007. After providing for preferred share dividends, earnings per common share in the nine months ended September 30, 2008 were \$0.69 compared with \$0.41 for the same period in 2007. Net income for the nine months ended September 30, 2008 was higher by \$1.1 million compared to 2007 due mainly to the lower expenditures incurred on the KSL Project and the higher ROE rates in 2008 compared to 2007. Included in net income for the nine months ended September 30, 2008 and 2007 are charges, net of income taxes of \$0.4 million and \$1.1 million, respectively for the Company's share of KSL Project development expenditures.

The rate stabilization adjustment mechanism approved by the Commission continues to contribute to the stability of the Company's earnings. This mechanism allows the Company to record the after-tax revenue variances arising from differences between actual and forecast sales volumes for residential and small commercial customers in a deferral account for collection or refund in future rates. As a result of this account, the Company's net income was increased by \$0.1 million for the three month period ended September 30, 2008 and decreased by \$0.1 million for the nine month period ended September 30, 2008.

Residential deliveries were lower by approximately 12 percent in the three month period ended September 30, 2008 compared to the same period in 2007 and unchanged in the nine month period ended September 30, 2008 compared to deliveries over the same period in 2007. Total commercial deliveries were lower by 2 percent and were higher by 5 percent in the three month and nine month periods ended September 30, 2008, respectively, relative to deliveries over the same periods in

2007. Management believes that overall weather was a minor factor in the change in residential deliveries because, based on a degree day analysis, it was approximately only 2 percent colder, in the three month period ended September 30, 2008 and just 3 percent colder for the nine month period ended September 30, 2008 compared to the same periods in 2007. The lower residential deliveries in the third quarter were mainly due to a reduced customer use per account in all service areas and a lower number of customers in the Western system, offset by a higher number of customers in the Northeast system in 2008 compared to 2007. Commercial deliveries were higher primarily due to a greater number of commercial customers consuming gas in the Northeast system in 2008 compared to 2007.

Total industrial deliveries were lower by 16 percent and 13 percent for the three month and nine month periods ended September 30, 2008 compared to the same periods in 2007. Deliveries to small industrial customers were lower by 9 percent and by 8 percent for the three and nine month periods ended September 30, 2008 compared to the same periods in 2007. The reductions in small industrial customer deliveries relate primarily to customers in the forest industry. Deliveries to large industrial customers were lower by 23 percent and by 17 percent for the three and nine month periods ended September 30, 2008 compared to the same periods in 2007, mainly due to lower deliveries to the pulp mill owned by West Fraser Mills Ltd. in Kitimat. Deferral accounts are in place that recover or refund margin differences resulting from deliveries to large industrial customers and to some small industrial customers for variances from the forecast approved for ratemaking purposes.

## **Results of Operations**

Operating revenues in the three months ended September 30, 2008 increased to \$13.8 million, as compared with \$12.0 million in the corresponding period in 2007. The increase in operating revenues was primarily due to an increase in residential, commercial, and small industrial sales revenue of \$1.4 million due mainly to a higher cost of service in 2008 and higher gas cost recoveries from sales customers and an increase of \$0.4 million in revenues from the sale of gas surplus to the needs of the Company's sales customers ("off system gas sales"). Any profit or loss realized on off system gas sales is deferred for future recovery from, or refund to, the Company's sales customers. The increase in off system gas sales revenue in the third quarter of 2008 reflects the impact of higher gas prices in 2008 compared to 2007 and lower deliveries in 2008 to sales customers resulting in a higher volume of surplus gas in the third quarter of 2008 compared to the corresponding period in 2007. Natural gas commodity prices, which are passed through to the Company's sales customers without mark-up, are very volatile and result in significant variability of the Company's reported operating revenues, but do not affect net income.

Operating revenues in the nine months ended September 30, 2008 increased to \$91.7 million as compared with \$88.9 million in the first nine months of 2007. The increase in operating revenues was primarily due to an increase in residential gas sales of \$1.9 million, an increase of \$1.6 million in commercial gas sales and transportation revenues, and an increase in off system gas sales of \$0.2 million offset by a reduction of \$1.1 million from industrial gas sales and transportation revenues, compared with the corresponding period in 2007. The higher gas sales revenues from residential and commercial customers reflect the higher cost of service in 2008 compared to 2007 and higher gas cost recoveries in the second and third quarters of 2008 to reflect higher forecast gas prices embedded in rates. The reduction in revenues from industrial customers is due to the lower than anticipated deliveries to customers in the forestry industry.

Operating margin in the three months ended September 30, 2008 increased slightly to \$7.1 million compared to \$7.0 million in the same period in 2007. The higher operating margin in the third quarter is primarily the result of the higher cost of service in 2008 compared to 2007 offset by lower than anticipated deliveries to all the customer classes during the third quarter.

Operating margin in the nine months ended September 30, 2008 increased slightly to \$32.4 million, as compared with \$31.5 million in the same period in 2007. The higher operating margin during the

nine months ended September 30, 2008 is primarily the result of the increase in the regulated cost of service mainly due to the higher ROEs in 2008 compared to 2007 and higher than anticipated deliveries to commercial transportation customers for the nine month period, offset by lower than anticipated deliveries to small industrial customers in the forestry industry.

Included in project development expenditures and other income deductions for the three month and nine month periods ended September 30, 2008 are the Company's pre-tax share of KSL Project development expenditures expensed by PTP amounting to \$0.1 million (2007: \$0.6 million) and \$0.6 million (2007: \$1.7 million), respectively.

The Company filed quarterly gas cost reports with the Commission in March 2008, June 2008 and September 2008 on past and projected gas supply costs compared to gas cost recoveries from customers. On the basis of these reports the Commission issued orders accepting the Company's recommendation to increase gas cost rates in all of the Company's service areas effective April 1, 2008 and July 1, 2008 and to decrease gas cost rates in all of the Company's service areas effective October 1, 2008. The increases ranged from \$0.48 to \$2.21 per GJ effective April 1 and from \$0.90 to \$3.27 per GJ effective July 1, while the decreases ranged from \$1.09 to \$3.183 per GJ effective October 1.

### Summary of Quarterly Results for Eight Quarters Ending September 30, 2008

<i>Thousands of dollars except per share amounts</i>	Sept 30, 2008	June 30, 2008	Mar. 31 2008	Dec. 31 2007	Sept 30, 2007	June 30, 2007	Mar. 31 2007	Dec. 31 2006
Operating Revenues	\$13,834	\$20,332	\$57,529	\$40,568	\$12,002	\$17,934	\$58,960	\$46,190
KSL expenditures, net of income taxes	(84)	(79)	(246)	(266)	(428)	(367)	(345)	(556)
Net income (loss) <sup>1</sup>	(1,528)	(205)	4,511	2,636	(1,391)	(799)	3,927	2,319
Earnings per share <sup>2</sup>	(\$0.44)	(\$0.08)	\$1.21	\$0.70	(\$0.40)	(\$0.24)	\$1.06	\$0.61
- per share diluted <sup>2</sup>	(\$0.44)	(\$0.08)	\$1.20	\$0.70	(\$0.40)	(\$0.24)	\$1.04	\$0.60

<sup>1</sup> The Company did not have any extraordinary items which impacted net income over the most recently completed eight quarters.

<sup>2</sup> Per share amounts are after provision for preferred share dividends of approximately \$84,000 per quarter.

The Company's natural gas distribution business is very seasonal, with higher sales in the colder winter months and lower sales in warmer months. Deliveries to residential and commercial customers tend to be more temperature sensitive than deliveries to industrial customers, with deliveries in the first and fourth quarters accounting for more than 75 percent of annual deliveries. Given that a substantial portion of its gas sales are used for space heating purposes, the Company earns in excess of its annual net income in the first and fourth quarters of its fiscal year and generally realizes losses in the other two quarters.

### Liquidity

The Company has credit facilities which include a \$20 million operating line, a \$20 million 5-year revolving term facility and a \$15 million risk management facility. The operating line is subject to borrowing base requirements and a financial covenant requiring the Company's debt leverage not to exceed 65 percent, or approximately the same level currently approved by the Commission for rate making purposes. At September 30, 2008 the Company's actual debt leverage was under 50 percent. The operating line is collateralized by a pledge of the Company's accounts receivables and inventories.

As of September 30, 2008, the calculated borrowing base of the operating line was approximately \$11.9 million and actual utilization was \$6.4 million. The Company was in compliance with the financial covenant under its operating line through September 30, 2008.

The \$20 million 5-year revolving term facility, available for general corporate purposes, is repayable at maturity and is secured by the pledge of a \$20 million debenture issued by the Company. Draws under the facility are made via prime rate advances or Bankers' Acceptance equivalent loans at the Canadian Deposit Offering Rate ("CDOR") plus 1.325 percent. The 5-year revolving term facility contains a financial covenant requiring the Company's debt leverage not to exceed 65 percent and, 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 million. The Company's current interest coverage is greater than 2.0 times and its secured debt is currently rated at BBB (low).

\$2 million was outstanding under the revolving term facility at September 30, 2008 via Bankers' Acceptance equivalent loans. Additional funds available under the facility will be used for general corporate purposes including the Company's capital program and for expenditures on the KSL Project.

The Company's risk management facility allows it to hedge natural gas purchases in accordance with its annual gas contracting and gas price risk management plan and to enter into interest rate hedging transactions to a total maximum exposure of \$15 million, with exposure calculated by the facility provider using its standard methodology. The risk management facility is secured by the pledge of a \$20 million debenture issued by the Company.

Accounts receivable at September 30, 2008 were \$20.5 million lower than at December 31, 2007 due to a reduction in accounts receivable related to off system sales of \$7.6 million as well as the seasonal nature of natural gas deliveries to residential and commercial customers.

Accounts payable and accrued liabilities at September 30, 2008 were \$8.2 million lower due to lower volumes of natural gas purchases in September 2008 compared to December 2007. The gas purchase variance account has changed from a \$3.9 million recoverable at December 31, 2007 to a \$0.3 million payable at September 30, 2008 due to the net asset value of the Company's derivative financial instruments recorded in the gas purchase variance account changing from a net liability position of \$4.9 million to a net asset position of \$0.1 million at September 30, 2008. Also during the same period, gas commodity costs paid by the Company were greater than the gas commodity cost rates paid by customers by approximately \$0.8 million after taxes.

The Company purchases gas for resale to its gas sales customers and passes through the commodity cost of gas to those customers without mark-up. The rates charged to gas sales customers are based, in part, on projected gas supply prices. The Company's liquidity requirements can be affected by delays between increases or decreases in the cost of gas purchased by the Company and regulatory approval of rate adjustments to reflect the cost increases or decreases.

## **Capital Resources**

The Company does not have material commitments for capital expenditures at this time. Planned capital expenditures in the last quarter of 2008 are approximately \$0.9 million in order to maintain the transmission and distribution system and to provide for minor expansions of its distribution system to service new customers. In addition, the Company's share of funding of the development expenditures for the KSL Project through PTP is expected to be approximately \$0.4 million (\$0.3 million after income taxes) in the fourth quarter of 2008. The Company expects to finance these expenditures from cash flow from operations and draws on the Company's debt facilities as required.

### **Off-Balance Sheet Arrangements**

As of September 30, 2008, the Company had no off-balance sheet arrangements.

### **Transactions with Related Parties**

There were no transactions with related parties during the three month and nine month periods ended September 30, 2008.

### **Critical Accounting Estimates**

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 for such operating revenues. These estimates are made assuming normal consumption patterns, adjusted for weather variations, which may differ from actual consumption patterns. The estimates of unbilled operating revenue at September 30, 2008 comprise 6.3 percent of the Company's operating revenues for the nine month period ended September 30, 2008. Through future meter readings, the usage estimates are replaced with actual delivered volumes which will be reflected in the Company's financial results at that time.

### **Financial and Other Instruments**

The Company utilizes natural gas commodity hedging contracts in order to manage the volatility inherent in the prices of its natural gas purchases. It may also utilize interest rate hedging contracts to reduce the volatility of the interest expense associated with its floating rate debt instruments. As of September 30, 2008 the Company had no interest rate hedging contracts outstanding.

The Company's annual gas contracting and gas price risk management plan was filed with and accepted by the Commission during the second quarter of 2008. The plan calls for gas price hedging, covering purchases over the November 1, 2008 through October 31, 2010 period, to be completed in stages beginning in May 2008. Each hedging transaction is subject to approval by the Company's price risk management plan committee.

At September 30, 2008, the Company had outstanding natural gas swap contracts, natural gas collar contracts and natural gas call options relating to natural gas supply as follows:

<b>Financial instrument</b>	<b>Notional Quantity (GJ's)</b>	<b>Percent of Annual Gas Purchases (%)</b>	<b>Delivery period</b>	<b>Price Range (per GJ)</b>	<b>Derivative Asset (\$000's)</b>	<b>Derivative Liability (\$000's)</b>
Natural gas swap contracts	4,176,300	42.38	Oct. 2008 – Oct. 2010	\$6.25 to \$10.87	\$2,791	<b>\$2,510</b>
Natural gas collar contracts	418,400	4.25	Oct. 2008 – Oct. 2010	Floors from \$6.24 to \$8.38; Caps from \$8.40 to \$11.46	-	214
Natural gas call options	81,800	0.83	Dec. 2008 – Oct. 2009	Caps at \$10.08 to \$11.79	8	-
<b>Total</b>	<b>4,676,500</b>	<b>47.46</b>			<b>\$ 2,799</b>	<b>\$2,724</b>

The fair value amounts used to determine the derivative asset and liability balances reflect the estimated amounts that the Company would receive or pay at September 30, 2008 to terminate the natural gas swap contracts, natural gas collar contracts, or call options based on the estimated 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 flow through of gas supply costs in customer rates. As a result of the recognition of the net derivative asset, the gas cost variance payable account was increased by \$0.1 million, in accordance with specific regulatory treatment. At December 31, 2007, the estimated fair value of these derivative instruments was a net liability of \$4.9 million.

### **Dividends**

The Board of Directors declared a semi-annual dividend of 84.375 cents per share on the Company's 6-3/4 percent cumulative, redeemable, preferred shares, payable January 1, 2009 to the shareholders of record at the close of business on December 15, 2008.

The Board of Directors declared a quarterly dividend of 22 cents per share on the Company's Common Shares, payable December 23, 2008 to shareholders of record at the close of business on December 8, 2008.

Pacific Northern Gas Ltd., for purposes of the Income Tax Act (Canada), and any similar provincial or territorial legislation, designates all dividends paid by Pacific Northern Gas Ltd. after December 31, 2005 to be "eligible dividends" unless otherwise notified by the Company. An eligible dividend paid to a Canadian resident is entitled to the enhanced dividend tax credit.

### **Changes in Accounting Policies**

Effective January 1, 2008, the Company adopted the following new accounting standards issued by the Canadian Institute of Chartered Accountants ("CICA"):

## Financial instruments – Disclosures and Presentation

The Company adopted Section 3862, Financial Instruments – Disclosures and Section 3863 Financial Instruments – Presentation of the Canadian Institute of the CICA Handbook. These two sections require enhanced disclosure and compliance with presentation standards for financial instruments to enable users to better their understanding and evaluate the significance and the nature and extent of risks associated with them. The adoption of these standards did not have any impact on the classification and valuation of the Company's financial instruments. The new disclosures are included in the Notes to the unaudited Interim Consolidated Financial Statements.

## Capital Disclosures

The Company adopted Section 1535 of the CICA Handbook, "Capital Disclosures". This Section establishes standards for disclosing information about an entity's capital and how it is managed, requiring disclosure of information about an entity's objectives, policies and processes for managing capital. These new disclosures are included in the Notes to the unaudited Interim Consolidated Financial Statements.

## Inventories

The Company adopted Section 3031 of the CICA Handbook, "Inventories" which replaces Section 3030. This Section requires inventories to be measured at the lower of cost or net realizable value and provides guidance on the determination of cost and its subsequent recognition as an expense, including any write-down to net realizable value. The adoption of this standard did not have an impact on net income.

## **Transition to International Financial Reporting Standards (IFRS)**

In February 2008, the Accounting Standards Board confirmed that publicly accountable enterprises are required to prepare financial statements in accordance with IFRS for years beginning on or after January 1, 2011, with comparative figures for the previous year. The Company expects the transition to IFRS to impact accounting, financial reporting, business processes and information systems.

PNG started its IFRS conversion project during the third quarter of 2008 and has established a formal project team. Regular reporting to the Audit Committee will take place throughout the project.

The IFRS conversion project is composed of three phases: project planning, scoping and preliminary impact analysis; detailed diagnostics and evaluation of financial impacts, selection of accounting policies, and design of operational and business processes; and implementation and review. The Company is in the process of completing the initial review to identify the differences between IFRS and current Canadian GAAP, preparing the detailed convergence plan and training of key personnel. This first phase of the IFRS conversion project is expected to be completed by the end of 2008.

## **Management's responsibility for financial reporting**

Internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with Canadian generally accepted accounting principles. Management is responsible for establishing and maintaining adequate internal control over financial reporting for the Company.

The Company's Chief Executive Officer and Vice President, Finance (as chief financial officer) certified the appropriateness of the financial disclosures in the interim MD&A and unaudited interim

consolidated financial statements for the period ended September 30, 2008. These executives also certified that they are responsible for the design of disclosure controls and procedures and internal control over financial reporting. There have been no changes in internal control over financial reporting during the quarter ended September 30, 2008 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting. As in prior quarters, the Company's Audit Committee reviewed this MD&A and the attached unaudited interim consolidated financial statements and the Board of Directors approved the documents prior to their release.

#### **Other**

The Company files an Annual Information Form on SEDAR which can be accessed at [www.sedar.com](http://www.sedar.com).

Pacific Northern Gas Ltd. had 3,664,580 common shares and 200,000 preferred shares outstanding as of November 3, 2008. These are the only issued securities of the Company and it has no securities outstanding which may be converted into voting or equity securities. As at November 3, 2008 there were 298,100 options granted and outstanding (representing 8 percent of issued and outstanding common shares). Each option is exercisable for one common share.

"Roy G. Dyce"

President and Chief Executive Officer

November 3, 2008

# **PACIFIC NORTHERN GAS LTD.**

## Interim Consolidated Financial Statements

*(Unaudited)*

For the Three and Nine Months Ended September 30, 2008

**PACIFIC NORTHERN GAS LTD**  
**CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME**  
(in thousands, except shares and per share data)

<b>(UNAUDITED)</b>	<b>For the nine months ended September 30</b>		<b>For the three months ended September 30</b>	
	<b><u>2008</u></b>	<b><u>2007</u></b>	<b><u>2008</u></b>	<b><u>2007</u></b>
<b>Operating revenues:</b>				
Gas sales and transportation services	\$61,228	\$58,506	\$11,213	\$9,773
Off system gas sales	25,208	24,985	876	429
Other [note 7]	5,259	5,405	1,745	1,800
	<u>91,695</u>	<u>88,896</u>	<u>13,834</u>	<u>12,002</u>
<b>Cost of sales:</b>				
Gas sales	34,057	32,446	5,822	4,614
Off system sales	25,208	24,985	876	429
	<u>59,265</u>	<u>57,431</u>	<u>6,698</u>	<u>5,043</u>
	<u>32,430</u>	<u>31,465</u>	<u>7,136</u>	<u>6,959</u>
<b>Operating and maintenance</b>	<b>8,542</b>	8,551	<b>2,763</b>	2,786
<b>Administrative and general</b>	<b>5,016</b>	4,958	<b>1,717</b>	1,460
<b>Amortization of deferred charges</b>	<b>428</b>	181	<b>143</b>	66
<b>Municipal and other taxes</b>	<b>3,532</b>	3,426	<b>1,178</b>	1,142
<b>Depreciation</b>	<b>6,040</b>	5,881	<b>2,020</b>	1,960
	<u>23,558</u>	<u>22,997</u>	<u>7,821</u>	<u>7,414</u>
<b>Operating income (loss)</b>	<b>8,872</b>	8,468	<b>(685)</b>	(455)
<b>Investment and other income</b>	<b>51</b>	470	<b>2</b>	321
	<u>8,923</u>	<u>8,938</u>	<u>(683)</u>	<u>(134)</u>
<b>Income deductions:</b>				
Interest on long term debt	4,875	4,831	1,656	1,627
Interest on short term debt	367	520	101	145
Project development expenditures and other income deductions	589	1,867	117	647
	<u>5,831</u>	<u>7,218</u>	<u>1,874</u>	<u>2,419</u>
<b>Income (loss) before income taxes</b>	<b>3,092</b>	1,720	<b>(2,557)</b>	(2,553)
<b>Income taxes: [note 11]</b>				
Currently recoverable	(437)	(1,093)	(1,028)	(1,611)
Deferred income taxes	885	1,277	2	453
Future income taxes	(134)	(201)	(3)	(4)
	<u>314</u>	<u>(17)</u>	<u>(1,029)</u>	<u>(1,162)</u>
<b>Net income (loss) for the period</b>	<b>\$2,778</b>	\$1,737	<b>(\$1,528)</b>	(\$1,391)
<b>Total comprehensive income (loss) for the period</b>	<b>\$2,778</b>	\$1,737	<b>(\$1,528)</b>	(\$1,391)
<b>For common shares:</b>				
Net income (loss) for the period	\$2,778	\$1,737	(\$1,528)	(\$1,391)
Dividends on preferred shares	253	253	84	84
<b>Net income (loss) applicable to common shares</b>	<b>\$2,525</b>	\$1,484	<b>(\$1,612)</b>	(\$1,475)
<b>Per common share:</b>				
Basic	\$0.69	\$0.41	(\$0.44)	(\$0.40)
Diluted	\$0.68	\$0.40	(\$0.44)	(\$0.40)
<b>Weighted average number of common shares outstanding:</b>				
Basic	3,664,580	3,643,690	3,664,580	3,648,712
Diluted	3,697,298	3,678,244	3,664,580	3,648,712

See accompanying notes

**PACIFIC NORTHERN GAS LTD.  
CONSOLIDATED BALANCE SHEETS**

(UNAUDITED)	(in thousands)	September 30, <u>2008</u>	December 31, <u>2007</u>
<b>ASSETS</b>			
<b>Current assets:</b>			
Cash		\$ 532	\$802
Accounts receivable <i>[note 13]</i>		6,855	27,362
Income taxes recoverable		2,805	2,210
Gas purchase variance recoverable		—	3,862
Inventory of supplies and natural gas		2,257	2,063
Prepaid expenses		1,451	1,563
Derivative financial instruments <i>[note 13]</i>		2,799	416
		<b>16,699</b>	<b>38,278</b>
<b>Plant, property and equipment</b>		<b>176,058</b>	<b>174,333</b>
<b>Other Items:</b>			
Rate stabilization adjustment mechanism		1,233	1,853
Pipeline rehabilitation costs		825	924
Deactivated assets		3,934	4,253
Other		655	21
Future income taxes <i>[note 11]</i>		289	155
		<b>6,936</b>	<b>7,206</b>
		<b>\$ 199,693</b>	<b>\$219,817</b>
<b>LIABILITIES</b> <i>Commitments [note 8]</i>			
<b>Current liabilities:</b>			
Bank indebtedness		\$ 4,469	\$ 8,947
Accounts payable and accrued liabilities		10,009	18,221
Gas purchase variance payable		325	—
Other taxes payable		1,980	3,128
Methanex Termination Payment deferral, current portion		4,493	4,308
Long term debt due within one year		2,300	2,300
Derivative financial instruments <i>[note 13]</i>		2,724	5,317
		<b>26,300</b>	<b>42,221</b>
<b>Non-current liabilities</b>		<b>224</b>	<b>245</b>
<b>Methanex Termination Payment deferral non-current portion</b> <i>[note 7]</i>		<b>387</b>	<b>3,771</b>
<b>Long term debt, non-current portion</b>		<b>72,405</b>	<b>72,821</b>
<b>Deferred income taxes</b> <i>[note 11]</i>		<b>13,855</b>	<b>14,530</b>
		<b>86,871</b>	<b>91,367</b>
		<b>113,171</b>	<b>133,588</b>
<b>SHAREHOLDERS' EQUITY</b>			
Preferred shares <i>[note 5]</i>		5,000	5,000
Common shares <i>[notes 3 and 6]</i>		9,161	9,161
Share capital		14,161	14,161
Contributed surplus <i>[note 3]</i>		3,592	3,490
Retained earnings		68,769	68,578
		<b>86,522</b>	<b>86,229</b>
		<b>\$ 199,693</b>	<b>\$219,817</b>

ON BEHALF OF THE BOARD

"Robert F. Chase"  
Director

"Roy G. Dyce"  
Director

See accompanying notes

**PACIFIC NORTHERN GAS LTD.**  
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**  
(in thousands)

<b>(UNAUDITED)</b>	<b>For the nine months ended September 30</b>		<b>For the three months ended September 30</b>	
	<b><u>2008</u></b>	<b><u>2007</u></b>	<b><u>2008</u></b>	<b><u>2007</u></b>
<b>Preferred shares</b>	<b>\$5,000</b>	\$5,000	<b>\$5,000</b>	\$5,000
<b>Common shares</b>				
Balance at beginning of period	<b>\$9,161</b>	\$9,103	<b>\$9,161</b>	\$9,103
Issued during the period	—	58	—	58
Balance at end of period	<b>\$9,161</b>	\$9,161	<b>\$9,161</b>	\$9,161
<b>Contributed surplus</b>				
Balance at beginning of period	<b>\$3,490</b>	\$3,168	<b>\$3,571</b>	\$3,264
Stock option expense [note 3]	<b>102</b>	115	<b>21</b>	19
Excess of cash consideration over par value of common shares issued	—	210	—	210
Balance at end of period	<b>\$3,592</b>	\$3,493	<b>\$3,592</b>	\$3,493
<b>Retained earnings</b>				
Balance at beginning of period	<b>\$68,578</b>	\$67,506	<b>\$71,103</b>	\$68,968
Cumulative impact of adopting new accounting requirements for financial instruments, net of income taxes	—	(41)	—	—
Adjusted balance at beginning of period	<b>68,578</b>	67,465	<b>71,103</b>	68,968
Net income (loss) for the period	<b>2,778</b>	1,737	<b>(1,528)</b>	(1,391)
Dividends — Preferred shares	<b>(169)</b>	(169)	—	—
Dividends — Common shares	<b>(2,418)</b>	(2,189)	<b>(806)</b>	(733)
Balance at end of period	<b>\$68,769</b>	\$66,844	<b>\$68,769</b>	\$66,844
<b>Total Shareholders' equity</b>	<b>\$86,522</b>	\$84,498	<b>\$86,522</b>	\$84,498

See accompanying notes

**PACIFIC NORTHERN GAS LTD**  
**CONSOLIDATED STATEMENTS OF CASH FLOW**  
(in thousands)

<b>(UNAUDITED)</b>	<b>For the nine months ended September 30</b>		<b>For the three months ended September 30</b>	
	<b><u>2008</u></b>	<b><u>2007</u></b>	<b><u>2008</u></b>	<b><u>2007</u></b>
<b>Operating activities:</b>				
<b>Net income (loss) for the period</b>	<b>\$2,778</b>	<b>\$1,737</b>	<b>(\$1,528)</b>	<b>(\$1,391)</b>
<b>Add (deduct) items not involving cash:</b>				
Deferred income taxes	885	1,277	2	453
Future income taxes	(134)	(201)	(3)	(4)
Depreciation and amortization <i>[note 12]</i>	6,553	6,142	2,192	2,062
Amortization of Methanex Termination Payment deferral, net of income taxes <i>[note 7]</i>	(3,496)	(3,478)	(1,166)	(1,159)
Stock option expense <i>[note 3]</i>	102	115	21	19
Deferred income taxes on deferred charges	(1,560)	(1,952)	(227)	(678)
Imputed interest on deferred charges	97	279	19	77
Other	(440)	(331)	(143)	(580)
<b>Operating cash flow</b>	<b>4,785</b>	<b>3,588</b>	<b>(833)</b>	<b>(1,201)</b>
<b>Non-cash working capital changes <i>[note 12]</i></b>	<b>9,681</b>	<b>(579)</b>	<b>2,727</b>	<b>(2,242)</b>
<b>Net cash provided by (used in) operating activities</b>	<b>14,466</b>	<b>3,009</b>	<b>1,894</b>	<b>(3,443)</b>
<b>Investing activities:</b>				
Additions to plant, property and equipment	(7,765)	(6,145)	(3,299)	(1,358)
(Increase) decrease in deferred charges and credits	594	403	(143)	(178)
<b>Net cash used in investing activities</b>	<b>(7,171)</b>	<b>(5,742)</b>	<b>(3,442)</b>	<b>(1,536)</b>
<b>Financing activities:</b>				
Increase (decrease) in bank indebtedness	(4,478)	(5,075)	2,992	—
Issuance of long term debt, net of transaction costs	—	14,622	—	14,622
Repayment of long term debt	(500)	(15,860)	(500)	(14,570)
Issue of common shares	—	268	—	268
Dividends paid	(2,587)	(2,358)	(806)	(733)
<b>Net cash provided by (used in) financing activities</b>	<b>(7,565)</b>	<b>(8,403)</b>	<b>1,686</b>	<b>(413)</b>
<b>Increase (decrease) in cash during the period</b>	<b>(270)</b>	<b>(11,136)</b>	<b>138</b>	<b>(5,392)</b>
<b>Cash, beginning of period</b>	<b>802</b>	<b>11,574</b>	<b>394</b>	<b>5,830</b>
<b>Cash, end of period</b>	<b>\$532</b>	<b>\$438</b>	<b>\$532</b>	<b>\$438</b>

*Supplemental cash flow information [note 12]*

*See accompanying notes*

## **NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

These unaudited interim consolidated financial statements are prepared, from the records of Pacific Northern Gas Ltd (“the Company”), in accordance with Canadian generally accepted accounting principles (“GAAP”), except that disclosures do not conform, in all respects, to the requirements for annual consolidated financial statements. While management believes that the disclosures presented are adequate to make the information not misleading, these unaudited interim consolidated financial statements and notes should be read in conjunction with the Company’s most recent annual consolidated financial statements.

These unaudited interim consolidated financial statements follow the same accounting policies and methods of their application as the Company’s most recent annual consolidated financial statements, except as described in note 1 below.

Earnings for the interim periods may not be indicative of results for the fiscal year due to weather variations and other factors.

### **1. CHANGES IN ACCOUNTING POLICY**

#### Financial instruments – Disclosures and Presentation

On January 1, 2008, the Company adopted Section 3862, Financial Instruments – Disclosures and Section 3863 Financial Instruments – Presentation of the Canadian Institute of Chartered Accountants (“CICA”) Handbook. These two sections require enhanced disclosure and compliance with presentation standards for financial instruments to enable users to better their understanding and evaluate the significance and the nature and extent of risks associated with them. The adoption of these standards did not have any impact on the classification and valuation of the Company’s financial instruments. The new disclosures are included in Note 13.

#### Capital Disclosures

On January 1, 2008, the Company adopted Section 1535 of the CICA Handbook, “Capital Disclosures”. This Section establishes standards for disclosing information about an entity’s capital and how it is managed, requiring disclosure of information about an entity’s objectives, policies and processes for managing capital. These new disclosures are included in Note 14.

#### Inventories

On January 1, 2008, the Company adopted Section 3031 of the CICA Handbook, “Inventories” which replaces Section 3030. This Section requires inventories to be measured at the lower of cost or net realizable value and provides guidance on the determination of cost and its subsequent recognition as an expense, including any write-down to net realizable value. The adoption of this standard did not have an impact on net income.

### **2. PRINCIPLES OF CONSOLIDATION**

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

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

### 2. PRINCIPLES OF CONSOLIDATION (cont'd)

Significant subsidiaries and joint ventures are as follows, as at September 30:

	Direct and Indirect Interest Held by the Company (percent)	
	2008	2007
<b>Subsidiaries:</b>		
Pacific Northern Gas (N.E.) Ltd.	100	100
<b>Joint Ventures and Non-Controlled Partnerships [note 9]:</b>		
Pacific Trail Pipelines Limited Partnership	50	50
Pacific Trail Pipelines Management Inc.	50	50

### 3. STOCK-BASED COMPENSATION

The Company does not have any plans which result in the direct award of stock, stock appreciation rights and awards that call for settlement in cash or other assets, except as described below.

#### Stock Option Plan

The Company has one stock option plan. During the three and nine months ended September 30, 2008, zero and 40,400 (2007: zero and 35,200) stock options were issued respectively. The compensation cost that has been charged against income (and credited to contributed surplus) in the quarter and nine months ended September 30, 2008 is \$21,000 and \$102,000 (2007 - \$19,000 and 115,000), respectively, and represents expense for options issued in the current and previous periods which are being amortized over their vesting period. The fair value of each option grant is estimated on the date of the grant using the Black-Scholes option pricing model with the following assumptions:

	Nine months ended September 30, 2008	Three months ended September 30, 2008
Risk free interest rate	3.28%	—
Expected volatility (annualized)	24.9%	—
Expected years of option life (average)	7.5	—
Expected annual rate of dividends	4.9%	—

#### Deferred Share Unit Plan

The Company has a deferred share unit plan for outside directors of the Company. Under this plan, an outside director may elect to defer all or a portion of total compensation as stock units of the Company's common shares. Director compensation expense is recorded in the period in which the compensation is earned. Changes in the amount of the compensation as a result of dividends and share price movement are recorded as director compensation expense in the period of the change.

There were 2,288 and 14,866 (2007: 1,816 and 6,188) deferred share units granted for the three and nine months ended September 30, 2008, respectively, and all units granted under the plan remained outstanding at that date. Liabilities related to this plan are recorded in accounts payable and accrued liabilities on the balance sheet and amounted to \$255,000 (2007: \$112,300) at September 30, 2008. Directors' compensation related to this plan for the three month and nine month periods ended September 30, 2008 amounted to \$34,600 and \$99,400 (2007: \$33,800 and \$112,300), respectively.

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

### 4. SEASONALITY

Due to the seasonal nature of natural gas sales, the Company generally reports net income in the first and fourth quarters of the year, and losses in the second and third quarters, reflecting the typical timing of the heating season.

### 5. PREFERRED SHARES

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

### 6. COMMON SHARES

The Company has outstanding stock options for 298,100 common shares, of which 220,260 are exercisable at September 30, 2008. There were 178,100 stock options outstanding at September 30, 2008 (117,250 stock options at September 30, 2007) that could potentially dilute basic earnings per share in the future for the nine months ended September 30, 2008 but were not included in the computation of diluted earnings per share because the options' exercise prices were greater than the average market price of the common shares. There were 298,100 stock options outstanding at September 30, 2008 (272,800 outstanding at September 30, 2007) that could potentially dilute basic earnings per share in the future for the three months ended September 30, 2008 but were not included in the computation of diluted earnings per share because for the three months ended September 30, 2008 the Company reported a net loss and therefore including these shares would have an anti-dilutive effect on earnings per share.

During the nine month period ended September 30, 2008, no common shares were issued by the Company (2007: 23,400).

### 7. METHANEX TERMINATION PAYMENT DEFERRAL

On August 30, 2005, Methanex Corporation gave notice of termination of its Firm and Interruptible Gas Transportation Service Agreement with the Company. Under the terms of the agreement, Methanex made a termination payment to the Company of approximately \$23.3 million on February 28, 2006, the effective date of the termination. As approved by the British Columbia Utilities Commission (the "Commission"), the termination payment was recorded in 2006, net of income taxes of \$7.96 million, as an interest bearing credit deferral, and is being amortized into income over the period from March 1, 2006 to October 31, 2009. For the three month and nine month periods ended September 30, 2008, \$1.7 million (2007: \$1.7 million) and \$5.0 million (2007: \$5.1 million) of the termination payment was included in other operating revenues, respectively.

### 8. COMMITMENTS

The Company's estimated purchase commitments based on forward gas prices at September 30, 2008 under various gas supply and transportation service contracts expiring through 2012 were as follows:

<b>(in thousands)</b>	
2008	\$23,136
2009	34,480
2010	13,486
2011	13,726
2012	8,397
Thereafter	-
Total	\$93,225

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

### 9. JOINT VENTURES

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

The following amounts represent the Company's proportionate interest in Pacific Trail Pipelines Limited Partnership and its general partner, Pacific Trail Pipelines Management Inc. at September 30, 2008 and December 31, 2007:

(in thousands)	At September 30, 2008	At December 31, 2007
<b>Balance Sheet</b>		
Current assets	\$269	\$416
Non-current assets	—	—
Current liabilities	34	94
Non-current liabilities	—	—

Income Statement	For the nine months ended September 30		For the three months ended September 30	
	2008	2007	2008	2007
Revenues	\$ —	\$ —	\$ —	\$ —
Expenses	589	1,697	117	646
Net loss	(589)	(1,697)	(117)	(646)
<b>Cash Flow</b>				
Cash Provided by (Used In):				
Operations	(\$639)	(\$1,945)	(\$102)	(\$702)
Financing	500	1,835	250	650
Investments	—	—	—	—
Proportionate share of increase (decrease) in cash of joint ventures	(\$139)	(\$110)	\$148	(\$52)

### 10. RELATED PARTY TRANSACTIONS

There were no transactions with related parties during the nine month periods ended September 30, 2008 and 2007.

### 11. FUTURE AND DEFERRED INCOME TAXES

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

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

### 11. FUTURE AND DEFERRED INCOME TAXES (cont'd)

accepted accounting principles require the recognition of future income tax liabilities and future income tax assets in the absence of rate regulation.

From July 1, 1978 until its suspension on November 1, 1986, the deferral method was followed by the Company. In its 2008 revenue requirement application for the Western system, the Company requested approval to draw down \$900,000 of these previously recorded deferred income taxes, with a credit being applied to the cost of service. The \$900,000 drawdown was accepted under the 2008 negotiated settlement and was also approved by the Commission under the 2007 revenue requirement application. During the three month and nine month periods ended September 30, 2008 and 2007, deferred income taxes recorded on the balance sheet were drawn down by \$225,000 and \$675,000, respectively, resulting in a deferred income tax recovery included in the consolidated income statement for each period.

### 12. SUPPLEMENTAL CASH FLOW INFORMATION

(in thousands)	For the nine months ended September 30		For the three months ended September 30	
	2008	2007	2008	2007
<b>Depreciation and amortization:</b>				
Depreciation, per income statement	\$6,040	\$5,881	\$2,020	\$1,960
Amortization of deferred charges, per income statement	428	181	143	66
Amortization of debt issue costs, included in long term interest expense	85	80	29	36
<b>Total depreciation and amortization</b>	<b>\$6,552</b>	<b>\$6,142</b>	<b>\$2,192</b>	<b>\$2,062</b>
<b>Non-cash working capital changes:</b>				
<b>(Increase) decrease in:</b>				
Accounts receivable	\$20,507	\$23,427	\$2,062	\$2,098
Income taxes recoverable	(595)	(2,538)	(1,036)	(1,809)
Inventories of supplies and natural gas	(194)	751	(428)	(56)
Prepaid expenses	112	1,759	(644)	(1,095)
<b>Increase (decrease) in:</b>				
Accounts payable and accrued liabilities	(8,212)	(14,165)	4,151	994
Gas purchase variance payable	(789)	(1,056)	738	(85)
Other taxes payable	(1,148)	(8,757)	(2,116)	(2,289)
<b>Attributable to operating activities</b>	<b>(\$9,681)</b>	<b>(\$579)</b>	<b>\$2,727</b>	<b>(\$2,242)</b>
<b>Interest and tax payments:</b>				
<b>Income taxes paid</b>	<b>\$150</b>	<b>\$8,474</b>	<b>\$ -</b>	<b>\$231</b>
<b>Interest paid</b>	<b>\$4,381</b>	<b>\$4,361</b>	<b>\$1,114</b>	<b>\$1,105</b>

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

### 13. FINANCIAL INSTRUMENTS

#### Fair Values

Due to the short term nature of cash, accounts receivable, bank indebtedness, and accounts payable and accrued liabilities, their respective carrying amounts in the consolidated balance sheet approximate their fair value.

The fair value of the Company's floating rate long term debt instruments is estimated to be equal to their carrying amounts in the consolidated balance sheet due to the regular resetting of interest rates applicable to the instruments in relation to current market rates. The fair value of the Company's fixed rate long term debt instruments is estimated by reference to quoted market prices for instruments of similar credit quality and term. As of September 30, 2008, the estimated fair value of the long term debt is \$75.4 million.

At September 30, 2008, the Company had outstanding natural gas swap contracts, natural gas collar contracts and natural gas call options relating to natural gas supply as follows:

Financial instrument	Notional Quantity (GJ's)	Percent of Annual Gas Purchases	Delivery period	Price Range (per GJ)	Estimated Fair Value Derivative Asset (\$000's)	Estimated Fair Value Derivative Liability (\$000's)
Natural gas swap contracts	4,176,300	42.38	Oct. 2008 – Oct. 2010	\$6.25 to \$10.87	\$2,791	\$2,510
Natural gas collar contracts	418,400	4.25	Oct. 2008 – Oct. 2010	Floors from \$6.24 to \$8.38; Caps from \$8.40 to \$11.46	-	214
Natural gas call options	81,800	0.83	Dec. 2008 – Oct. 2009	Caps at \$10.08 to \$11.79	8	-
<b>Total</b>	<b>4,676,500</b>	<b>47.46</b>			<b>\$ 2,799</b>	<b>\$2,724</b>

The fair value reflects the estimated amounts that the Company would receive or pay at September 30, 2008 to terminate the natural gas swap contracts and natural gas collar contracts based on the estimated 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 gas hedging instruments would be treated as part of the flow through of gas supply costs in customer rates. As a result of the recognition of the net derivative asset, the gas cost variance payable account was increased by \$75,000 in accordance with specific regulatory treatment.

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

### 13. FINANCIAL INSTRUMENTS (cont'd)

At December 31, 2007, the estimated fair value of these derivative instruments was a net liability of \$4.9 million as follows:

Financial instrument	Notional Quantity (GJ's)	Percent of Annual Gas Purchases	Delivery period	Price Range (per GJ)	Estimated Fair Value Derivative Asset (\$000's)	Estimated Fair Value Derivative Liability (\$000's)
Natural gas fixed price contracts	455,000	5.1%	Jan '08 to Mar '08	\$7.268	—	\$355
Natural gas swap contracts	4,630,650	52.2%	Jan '08 to Oct '09	\$6.25 to \$9.75	\$416	\$4,579
Natural gas collar contracts	456,100	5.1%	Jan '08 to Oct '09	Floors from \$6.24 to \$8.47; Caps from \$8.40 to \$10.02	—	\$383
Total	5,541,750	62.4%			\$416	\$5,317

#### 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. There has been no change to the Company's credit risk from the prior year. In accordance with established credit approval practices, the Company deals only with recognized high credit quality institutions as counterparties to its derivative instruments and physical off system gas sales and does not expect any counterparties to fail to meet its obligations. Should the Company incur a financial loss as a result of the failure of a 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.

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

### 13. FINANCIAL INSTRUMENTS (cont'd)

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

(in thousands)

	<b>September 30, 2008</b>	December 31, 2007
Core Market – Residential and Commercial	<b>\$7,190</b>	\$19,797
Industrial customers	<b>772</b>	1,220
Off-system sales customers	<b>284</b>	7,844
Other	<b>283</b>	195
Accounts Receivable	<b>\$8,529</b>	29,056

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

(in thousands)

	<b>September 30, 2008</b>	December 31, 2007
Unbilled revenues	<b>\$2,346</b>	\$9,623
Past due 0 to 30 days (current)	<b>4,407</b>	17,432
Past due 31 to 90 days	<b>124</b>	245
Past due over 91 days	<b>1,652</b>	1,756
Sub-total accounts receivables	<b>8,529</b>	29,056
Less: Allowance for doubtful accounts	<b>(1,674)</b>	(1,694)
Total accounts receivables	<b>\$6,855</b>	\$27,362

Changes in the allowance for doubtful accounts are as follows:

(in thousands)

	<b>Nine month period ended September 30, 2008</b>
Balance at January 1, 2008	<b>\$1,694</b>
Provision for doubtful accounts	<b>230</b>
Write-off of bad debts, net of recoveries, and other	<b>(250)</b>
Balance at September 30, 2008	<b>\$1,674</b>

#### 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 has credit facilities which include a \$20 million operating line, a \$20 million 5-year revolving term facility and a \$15 million risk management facility. As of September 30, 2008, the calculated borrowing base of the operating line was approximately \$11.9 million and actual utilization was \$6.4 million. \$2 million was outstanding under the \$20 million revolving term facility at

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

### 13. FINANCIAL INSTRUMENTS (cont'd)

September 30, 2008 via Bankers' Acceptance equivalent loans. The Company's overall liquidity risk has not changed significantly from December 31, 2007.

#### Overall 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. 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.

#### Market Risk - Interest Rates

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.

### 14. CAPITAL MANAGEMENT

The Company's objective in managing capital remains unchanged from December 31, 2007. The capital structure consisted of the following components at September 30, 2008 and December 31, 2007: bank indebtedness, long term debt, preferred shares and common shareholders' equity.

The Company's objectives with its capital structure are:

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

However, the Company is not currently able to meet both objectives as it believes that the proportion of common equity approved by the Commission is not sufficient to allow the Company to maintain a satisfactory credit rating. The Company currently carries approximately \$16 million more common equity on its balance sheet than is allowed by the Commission for the purpose of determining rates. To address this situation the Company has sought and will continue to seek relief from the Commission.

The financial terms and conditions of the Company's debentures and credit facilities remain unchanged since December 31, 2007. The \$20 million operating line and \$20 million 5-year revolving term facility are subject to a financial covenant requiring the Company's debt leverage not to exceed 65 percent. 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

## **NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

### **14. CAPITAL MANAGEMENT (cont'd)**

interest, income taxes and expenditures on the KSL Project to a cumulative maximum of \$10 million. The Company is in compliance with its debt covenants.

### **15. COMPARATIVE FIGURES**

Certain items in the unaudited interim consolidated financial statements have been reclassified to conform to the 2008 presentation.

**PACIFIC NORTHERN GAS LTD.  
FORM 52-109F2  
CERTIFICATION OF INTERIM FILINGS**

I, Roy G. Dyce, the Chief Executive Officer of Pacific Northern Gas Ltd., certify that:

1. I have reviewed the interim filings (as this term is defined in Multilateral Instrument 52-109 *Certification of Disclosure in Issuers' Annual and Interim Filings*) of Pacific Northern Gas Ltd., (the issuer) for the interim period ended September 30, 2008;
2. Based on my knowledge, the interim filings do not contain any untrue statement of a material fact or omit to state a material fact required to be stated or that is necessary to make a statement not misleading in light of the circumstances under which it was made, with respect to the period covered by the interim filings; and
3. Based on my knowledge, the interim financial statements together with the other financial information included in the interim filings fairly present in all material respects the financial condition, results of operations and cash flows of the issuer, as of the date and for the periods presented in the interim filings; and
4. The issuer's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures and internal control over financial reporting for the issuer, and we have:
  - (a) designed such disclosure controls and procedures, or caused them to be designed under our supervision, to provide reasonable assurance that material information relating to the issuer, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which the interim filings are being prepared; and
  - (b) designed such internal control over financial reporting, or caused it to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with the issuer's GAAP; and
5. I have caused the issuer to disclose in the interim MD&A any change in the issuer's internal control over financial reporting that occurred during the issuer's most recent interim period that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting.

*"Roy G. Dyce"*

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Roy G. Dyce  
Chief Executive Officer

Date: November 3, 2008

**PACIFIC NORTHERN GAS LTD.  
FORM 52-109F2  
CERTIFICATION OF INTERIM FILINGS**

I, Janet P. Kennedy, the Vice President, Finance of Pacific Northern Gas Ltd. (certifying as the chief financial officer of the Company), certify that:

1. I have reviewed the interim filings (as this term is defined in Multilateral Instrument 52-109 *Certification of Disclosure in Issuers' Annual and Interim Filings*) of Pacific Northern Gas Ltd., (the issuer) for the interim period ended September 30, 2008;
2. Based on my knowledge, the interim filings do not contain any untrue statement of a material fact or omit to state a material fact required to be stated or that is necessary to make a statement not misleading in light of the circumstances under which it was made, with respect to the period covered by the interim filings; and
3. Based on my knowledge, the interim financial statements together with the other financial information included in the interim filings fairly present in all material respects the financial condition, results of operations and cash flows of the issuer, as of the date and for the periods presented in the interim filings; and
4. The issuer's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures and internal control over financial reporting for the issuer, and we have:
  - (a) designed such disclosure controls and procedures, or caused them to be designed under our supervision, to provide reasonable assurance that material information relating to the issuer, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which the interim filings are being prepared; and
  - (b) designed such internal control over financial reporting, or caused it to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with the issuer's GAAP; and
5. I have caused the issuer to disclose in the interim MD&A any change in the issuer's internal control over financial reporting that occurred during the issuer's most recent interim period that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting.

*"Janet P. Kennedy"*

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Janet P. Kennedy  
Vice President, Finance  
(certifying as chief financial officer)

Date: November 3, 2008