



Interim Report

For the Three and Six Months Ended June 30, 2010

July 27, 2010

Pacific Northern Gas Ltd.
Suite 950, 1185 West Georgia Street
Vancouver, BC V6E 4E6 Canada
www.png.ca

Pacific Northern Gas Ltd.

MANAGEMENT'S DISCUSSION AND ANALYSIS

For the Three and Six Months Ended June 30, 2010

Dated July 27, 2010

This Management's Discussion and Analysis ("MD&A") should be read in conjunction with the unaudited consolidated financial statements of Pacific Northern Gas Ltd. (the "Company") as at and for the three and six months ended June 30, 2010. It should also be read in conjunction with the audited consolidated financial statements and MD&A in the Company's Annual Report for the year ended December 31, 2009. Information contained in the 2009 MD&A that is not addressed in this document remains substantially unchanged.

The financial data included in this discussion has been prepared in accordance with Canadian Generally Accepted Accounting Principles ("GAAP") and all dollar amounts are in Canadian dollars unless otherwise indicated.

Additional information concerning the Company, including its most recent Annual Information Form can be found at www.sedar.com.

Forward-Looking Statements

This MD&A includes forward-looking statements. Forward-looking statements relate to, among other things, (i) anticipated growth, financial performance and business prospects (ii) business and economic conditions, (iii) strategies, (iv) regulatory developments, (v) new services, (vi) market forces and (vii) technological developments. Specifically, forward-looking statements are made with respect to:

- The expected timing of and expenditures for development and construction of the KSL Project (see "Business Overview – KSL Project");
- The expected timing for the commencement of transportation service for the potential Merrill Lynch Commodities Inc. ("Merrill Lynch") floating liquefied natural gas ("LNG") project and the cost of reactivating compressor stations to provide such service (see "Business Overview – Capacity Utilization on the Western System");
- Expectations regarding the benefits of the McNair Creek facility acquisition (see "Business of the Company – Renewable Energy Business");
- Expectations for growth of opportunities in renewable energy generation; and
- Expectations for the level of and source of funding for capital expenditure requirements.

Many of these statements can be identified by words such as "believe", "expects", "expected", "will", "intends", "projects", "anticipates", "estimates", "continues" or similar words. 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 regulation by the British Columbia Utilities Commission (the “Commission”);
- the Company’s future growth opportunities;
- 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; and
- operating risks and related insurance coverage and inspection and integrity systems.

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, 2009 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; the impact on the Company’s liquidity if it were to go offside of the covenants in its debt facilities; successful execution of strategic initiatives; the ability of the Company to attract and retain quality employees, and the impact of accounting changes, including the transition to International Financial Reporting Standards. 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.

Non-GAAP Measures

References to “operating margin” are to revenues less cost of gas. Operating margin is not a recognized measure under GAAP and does not have a standardized meaning prescribed by GAAP. Therefore, operating margin may not be comparable to similar measures presented by other issuers. Readers are cautioned that operating margin should not replace revenues as a measure of performance. Management believes operating margin is a meaningful measure of performance because the Company’s gas transmission and distribution financial results are best measured by excluding the cost of gas which is flowed through to customer rates without a mark-up.

Business of the Company

The Company and its wholly-owned subsidiary Pacific Northern Gas (N.E.) Ltd. (“PNG (N.E.)”) are natural gas distribution utilities operating within the Province of British Columbia, Canada.

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"). The Northeast system is comprised of two divisions, the Fort St. John/Dawson Creek division and the Tumbler Ridge division.

Renewable Energy Business

In April 2010, the Company entered into a joint development and operating agreement with Skookum Power Corp ("Skookum Power") gaining access to extensive expertise in hydrology, engineering and commercial development to support its new renewable energy business platform. The principals of Skookum Power are former power company executives with collectively more than 50 years experience in the hydro-electricity and energy sectors.

On April 19, 2010, the Company in partnership with Skookum Power closed the acquisition of the 9.8 megawatt McNair Creek hydro-electricity generation facility ("McNair") from Kiewit Hydropower Investors Inc. and Renewable Power Corp. with the Company holding a 97% share. The McNair facility is located on B.C.'s Sunshine Coast and has been in operation for more than 5 years. The facility's generation is committed for sale under a long-term contract to BC Hydro.

The total purchase price was approximately \$17.4 million and has been funded in part by the assumption of \$9.4 million in non-recourse debt and the remainder in cash payments. The Company's cash purchase obligations were met through drawings on its existing credit facilities. The Company's debt to capitalization will now be approximately 49% after the transaction. The transaction is expected to be cash flow positive for 2010 and is expected to be EPS accretive in 2011.

For the period from the acquisition date to June 30, 2010, the Company recorded after-tax earnings of approximately \$216,000 related to the McNair facility before acquisition and reorganization costs. These transaction costs amounted to approximately \$465,000 after-tax for the six month period ended June 30, 2010.

The investment in the McNair facility represents the launch of the Company's renewable energy 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 cash flows.

Final Negotiated Settlement Agreements for the 2010 Revenue Requirements Applications and the Capital Structure and Equity Risk Premium Application (the "CAP/ROE Application")

On June 23, 2010 the Commission approved the final negotiated settlement agreements in respect of the 2010 revenue requirements applications for the Western system and Northeast system and the CAP/ROE Application (the "final settlement agreements"). The key matters agreed to under the final settlement agreements are summarized as follows:

- The parties agreed the common equity capitalization and risk premiums relative to the benchmark utility return on equity ("ROE") for the Western system division (effective January 1, 2009) and the Fort St. John/Dawson Creek and Tumbler Ridge divisions (effective January 1, 2010) would be as follows:

	Western System Division	Fort St. John/Dawson Creek Division	Tumbler Ridge Division
Common Equity Capitalization	45%	40%	40%
Equity Risk Premiums	65 basis points	40 basis points	65 basis points

On a consolidated basis, this provided the Company with the opportunity to increase overall earnings in 2010 by approximately \$0.6 million or \$0.17 per share of which over \$0.3 million has been recorded to date. Further, an additional \$0.5 million of net income was included in the second quarter to reflect the January 1, 2009 effective date for the Western system common equity capitalization ratio adjustment.

The equity risk premiums are relative to the benchmark utility ROE of 9.50% that became effective July 1, 2009 resulting in the following ROE's in 2009 and 2010 for each division:

Year	Western System Division	Fort St. John/Dawson Creek Division	Tumbler Ridge Division
2009	9.63%	9.38%	9.63%
2010	10.15%	9.90%	10.15%

The 2009 ROE's are lower than applicable in 2010 to account for the fact the benchmark ROE of 9.50% was made effective July 1, 2009.

- The interim rates effective January 1, 2010 were made permanent for 2010. Having regard to the fact the interim rates were based on forecast 2010 costs of service using common equity capitalization and ROE figures that were less than the agreed to figures, the parties agreed the difference between: (i) the 2010 gross margins using the interim rates; and (ii) the costs of service based on the parameters agreed to under the final settlement agreements would be recorded, for future disposition, in the common equity deferral accounts approved by the Commission under Order G-172-09.
- The Company can, at its discretion, use the Merrill Lynch option fees to offset the balance recorded in the Western system common equity deferral account. The Company intends to do so at year end 2010.

KSL Project

The Company continues to pursue a project to loop its mainline transmission system from Kitimat to Summit Lake (the "KSL Project") through its 50% ownership of Pacific Trail Pipelines Limited Partnership ("PTP"). 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 LNG export terminal ("Terminal") to be located approximately 15 kilometers southwest of Kitimat. The KSL Project entails the construction of approximately 470 kilometers of up to 36 inch diameter pipeline and associated compression facilities, at a cost of \$1.2 billion based on estimates made in 2006.

On January 13, 2010 Apache Corporation's subsidiary Apache Canada Ltd. ("Apache") acquired 51% of the Terminal. Apache also acquired a 25.5% interest in PTP from Galveston LNG Inc., the parent company of Kitimat LNG Inc.

On May 18, 2010 EOG Resources Inc.'s Canadian subsidiary EOG Resources Canada Inc. ("EOG") agreed to acquire the shares of Galveston LNG Inc. Through the acquisition, EOG will acquire 49% of the Terminal and a 24.5% interest in PTP.

Subject to a number of conditions, construction of the KSL Project by PTP is planned to commence in 2012 for completion in 2014 when the 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 such as a Certificate of Public Convenience and Necessity ("CPCN") from the Commission and other permits from the B.C. Oil and Gas Commission. The Company will continue working to finalize transportation reservation agreements for the KSL Project in the second half of 2010 at which point it would file its CPCN application with the Commission. The Company can give no assurances that such agreements will be signed or other conditions will be satisfied or that construction of the KSL Project by PTP will proceed.

The Company's share of development expenditures for the KSL Project in the second quarter of 2010 were approximately \$253,000 bringing the total incurred in 2010 to \$529,000 (\$378,000 after income taxes). Subject to the receipt of acceptable financial support from prospective shippers wanting to contract KSL Project gas transportation services, the Company's 50 percent share of KSL Project development costs in the last half of 2010 will total approximately \$2.4 million. These costs would primarily relate to additional engineering and technical studies for the KSL Project pipeline.

Closure of West Fraser Kitimat B.C. Paper Mill

West Fraser Timber Co. Ltd. ("West Fraser") permanently closed its Kitimat B.C. paper mill at the end of January 2010. PNG has a transportation service agreement with West Fraser which specifies a daily contract demand volume of 6.0 MMcf (million cubic feet) per day that expires on December 31, 2013. Under the terms of the transportation agreement, West Fraser pays the Company an annual demand charge of approximately \$2.1 million and is entitled to cancel its obligations by providing the Company with a termination payment that would recover almost 80 percent of the lost revenues under the remaining term of the agreement.

On May 31, 2010 West Fraser provided the Company with the required six months cancellation notice. West Fraser will continue to pay the monthly demand charge due under the transportation agreement until November 2010. The termination payment of just over \$5 million is due on December 1, 2010. The Company expects that the termination payment would be amortized over the remaining life of the agreement, the same regulatory treatment accorded the Methanex Corporation ("Methanex") termination payment made in 2006. In addition, as was the case with the closure of the Methanex plant, the Company will mitigate the impact of lower margin recovery by reducing costs and expects to recover the future loss of margin through standard rate applications to the Commission. If this is the case, the Company anticipates limited impact on future earnings.

Capacity Utilization on the Western System

A Letter Agreement with Merrill Lynch, approved by the Commission on April 23, 2009 provided Merrill Lynch with an option to contract for 75 MMcf per day of firm gas transportation service using existing capacity on the Company's Western system. The Letter Agreement also provided for the parties to negotiate a definitive transportation service agreement ("TSA") for filing with the Commission for acceptance as a filed tariff. Negotiation of the TSA was completed in the second quarter. During the final negotiations, the parties agreed to increase the capacity option from 75 to 80 MMcf per day. The TSA was accepted by the Commission as a filed tariff on June 17, 2010. The TSA documents the option

provisions and the transportation service provisions that would apply following exercise of the option. If Merrill Lynch exercises its option, it is expected to utilize the transportation service to deliver natural gas to a floating LNG vessel to be located on the Douglas Channel near Kitimat, B.C. and to transfer the LNG from the floating LNG plant to other LNG carriers for export.

Merrill Lynch has paid the Company option fees of \$3.5 million to secure its exclusive option until December 31, 2010 to contract for firm gas transportation capacity for a two- to five-year primary term, with a right to renew for an additional two- to fifteen-year term. Merrill Lynch may extend the option period by up to three further six month periods, with payment of \$1 million for each extension.

If service commences under the TSA, the Company's Western system would be at full capacity utilization, generating approximately \$16 million per year of incremental margin for the benefit of the Company and its customers. The cost to reactivate the facilities left idle when Methanex ceased operations in 2005 will be recovered from these incremental revenues. The reactivation costs are in the range of \$1.3 million with the largest single expense being the cost of completing a compressor overhaul at an estimated cost of \$0.5 million. For regulatory purposes, the Company anticipates expensing all reactivation costs in the first year of operation. If service commences by June 30, 2012 all of the option fees previously paid by Merrill Lynch to the Company will be credited to transportation service fees payable in 2012. The option fee credit to Merrill Lynch will be reduced by \$0.5 million if service commences after June 30, 2012 but before December 31, 2012. A further reduction of \$0.5 million will apply if service commences after December 31, 2012. If service does not commence by January 1, 2015 then the transportation service agreement would terminate.

The Company can give no assurances that Merrill Lynch will continue to extend the option or exercise its option to take capacity on the Western system.

Competitiveness of Rates

As a distributor of natural gas, the Company continuously monitors the competitiveness of its natural gas retail rates relative to alternative energy sources in its service area. The Company's current residential rates in all divisions are lower than the current comparable residential electricity rate. PNG expects gas commodity prices payable by the Company during 2010 will continue at existing levels which will maintain the relative competitiveness of gas to electricity.

The Province of British Columbia's (the "Province") Energy Plan 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 have contributed to and are expected to result in higher electricity rates over the long term. The Province implemented a carbon tax on fossil fuel consumption effective July 1, 2008. The carbon tax on natural gas was just under \$0.50 per gigajoule ("GJ") effective July 1, 2008, rising annually by approximately \$0.25 per GJ each July 1, to just under \$1.50 per GJ effective July 1, 2012. Notwithstanding the impacts of carbon tax on natural gas pricing, the cessation of the Methanex termination payment credit amortization and the cancellation of the West Fraser transportation service agreement effective November 2010, the Company expects its retail gas rates will maintain their relative competitiveness with electricity rates as electricity rate increases have been higher than the impact of the carbon tax on natural gas prices. Electricity rates are also expected to rise over time to meet the Province's energy policy objectives as evidenced by the 9 percent increase in residential electricity prices on April 1, 2010.

Overall Performance

Net loss for the three months ended June 30, 2010 was \$0.1 million compared with a net loss of \$0.4 million for the corresponding period in 2009. After providing for preferred share dividends, the basic loss per common share in the three months ended June 30, 2010 was \$0.06 compared with a loss per common share of \$0.13 for the same period in 2009.

The \$0.3 million improvement in earnings can be attributed to a number of factors, including: the higher weighted average ROE earned in the second quarter of 2010 of 10.09% compared to 9.07% in the second quarter of 2009; the impact of the CAP/ROE Application settlement which resulted in a 5% higher equity component (increased to 45%) for the Company's Western system effective January 1, 2009 and a 4% higher equity component (increased to 40%) for the Company's Northeast system effective January 1, 2010; as well as the inclusion of operating results from the McNair acquisition in the second quarter of 2010. This increase has been partially offset by transactions costs of \$0.34 million or \$0.10 per share incurred by the Company for the McNair acquisition and reorganization, and higher expenditures for the KSL Project during 2010. Included in the net loss for the three months ended June 30, 2010 are after-tax charges of \$0.18 million or \$0.05 per share relating to the Company's portion of KSL Project development expenditures compared to costs of \$0.03 million or \$0.01 per share for the corresponding period in 2009.

The McNair acquisition costs have been expensed as a result of the Company's decision to early adopt the new accounting standard for business combinations. The new standard results in the expensing of related acquisition costs rather than their deferral and inclusion as part of the cost of the business acquisition. Excluding these acquisition transaction costs, earnings per common share for the three months ended June 30, 2010 would have been \$0.04 instead of a loss per common share of \$0.06.

Net income for the six months ended June 30, 2010 was \$5.3 million, compared to \$4.8 million for the corresponding period in 2009. After providing for preferred share dividends, basic earnings per common share in the six months ended June 30, 2010 were \$1.44 compared to \$1.26 for the same period in 2009.

The \$0.5 million increase in net income is due mainly to the impact of the CAP/ROE Application settlement, offset by the transaction and reorganization costs of \$0.47 million or \$0.13 per share incurred on the McNair acquisition and higher KSL Project development expenditures in 2010. Included in net income for the six months ended June 30, 2010 and 2009 are after-tax charges for the Company's portion of KSL Project development expenditures of \$0.4 million and \$0.1 million, respectively. Excluding the McNair acquisition transaction costs of \$0.47 million, earnings per common share for the six months ended June 30, 2010 would have been \$1.57 instead of \$1.44.

Residential deliveries were approximately 13% lower in the three months ended June 30, 2010 and lower by 17% in the six months ended June 30, 2010 relative to deliveries over the same periods in 2009. Total commercial deliveries were approximately 9% lower in the three months ended June 30, 2010 and lower by 18% in the six months ended June 30, 2010 relative to deliveries over the same periods in 2009. Management believes that weather was a key factor in the decrease in both the residential and the commercial deliveries, as it was approximately 2% warmer for the three month period ended June 30, 2010 and 10% warmer for the six month period ended June 30, 2010 compared to the same periods in 2009. The weather was also 1% warmer than normal for the three month period ended June 30, 2010, and 3% warmer for the six month period ended June 30, 2010, with "normal" based on the average of actual temperatures in the Company's service areas for the preceding 10 years.

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 the warm weather experienced this period, the Company recorded an after-tax revenue variance of \$0.5 million for the three month period ended June 30, 2010 and \$2.0 million for the six month period ended June 30, 2010 in this deferral account for recovery in future rates.

Industrial deliveries were lower by approximately 33% for both the three month and six month periods ended June 30, 2010 compared to the same periods in 2009. The decrease in industrial deliveries is comprised of a 54% decrease in large industrial customer deliveries, mainly due to the closure of the West Fraser Kitimat liner board mill, combined with a 16% decrease in small industrial deliveries. The decrease in small industrial customer deliveries relate primarily to the Northeast system. Deferral accounts are in place that recover or refund margin differences resulting from deliveries to large industrial customers and to some small industrial customers varying from the forecast approved for rate making purposes.

Results of Operations

Operating revenues in the three months ended June 30, 2010 increased to \$15.2 million compared with \$14.1 million in the corresponding period in 2009. The increase was primarily due to the recognition of the impact of the CAP/ROE Application settlement in the second quarter of 2010 and the impact of the McNair acquisition offset to some extent by the lower commodity cost of gas embedded in rates as a result of declining gas market prices.

Operating revenues in the six months ended June 30, 2010 decreased to \$55.4 million compared with \$62.5 million in the corresponding period in 2009. The decrease was primarily due to the lower commodity cost of gas embedded in rates as a result of declining gas market prices.

Operating margin in the three months ended June 30, 2010 increased to \$10.5 million, as compared with \$8.8 million in the same period in 2009, mainly due to the impact of the higher ROE and common equity components in the second quarter of 2010 compared to the corresponding quarter of 2009.

Operating margin in the six months ended June 30, 2010 increased to \$28.4 million, as compared with \$25.9 million in the same period in 2009, mainly due to the impacts of the higher ROE and higher common equity components and the inclusion of the McNair acquisition in the second quarter of 2010.

Included in project development expenditures and other income deductions for the three month and six month periods ended June 30, 2010 are the Company's pre-tax share of KSL Project development expenditures amounting to \$0.3 million and \$0.5 million, respectively.

The Company filed a report with the Commission in June 2010 on past and projected gas supply costs compared to gas cost recoveries from customers. The report requested the Commission to keep gas commodity cost rates at the same level as approved effective April 1, 2010. On the basis of the report, the Commission approved the Company's request.

Summary of Quarterly Results

The following financial information has been prepared in accordance with Canadian GAAP and is shown in Canadian dollars.

[\$ in thousands, except for per share data]

<i>(unaudited)</i>	Sept. 30, 2009	Dec. 31, 2009	Mar. 31, 2010	June 30, 2010
Revenues	\$10,500	\$31,172	\$40,235	\$15,166
Net income (loss)	\$(1,660)	\$3,436	\$5,488	\$(146)
Earnings (loss) per common share – basic	\$(0.49)	\$0.95	\$1.51	\$(0.06)
Earnings (loss) per common share – diluted	\$(0.49)	\$0.93	\$1.48	\$(0.06)
	Sept. 30, 2008	Dec. 31, 2008	Mar. 31, 2009	June 30, 2009
Revenues	\$13,834	\$41,144	\$48,318	\$14,141
Net income (loss)	\$(1,528)	\$3,159	\$5,156	\$(400)
Earnings (loss) per common share – basic	\$(0.44)	\$0.84	\$1.39	\$(0.13)
Earnings (loss) per common share – diluted	\$(0.44)	\$0.84	\$1.38	\$(0.13)

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% 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

At June 30, 2010, the Company's credit facilities include a \$25 million operating line, two \$15 million risk management facilities and a \$35 million committed 5-year term revolving debt facility. The operating line is subject to borrowing base requirements which may restrict the amount that the Company can borrow under the line at any point in time. In addition, the credit facilities are subject to financial covenants that may act to restrict the amounts that can be borrowed under the operating line and the 5-year term revolving debt facility.

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

As of June 30, 2010, the calculated borrowing base of the operating line was approximately \$9.9 million and actual utilization was \$3.8 million. The Company was in compliance with the financial covenant under its operating line through June 30, 2010.

At June 30, 2010, \$12 million was outstanding under the revolving term facility under 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 acquisition of the McNair facility was funded through drawings on its existing credit facilities.

Accounts receivable at June 30, 2010 were \$17 million lower than at December 31, 2009 mainly due to lower gas sales revenues in the month of June 2010 compared to the month of December 2009 as a result of lower volumes due to the warmer weather and due to lower gas commodity prices.

Accounts payable and accrued liabilities were lower by \$14 million mainly as a result of lower gas purchase costs in June 2010 compared to December 2009 due to much lower gas volumes and gas commodity prices.

The gas purchase variance account has increased by \$2.6 million resulting in an ending recoverable amount of \$3.8 million at June 30, 2010 compared to the ending recoverable balance of \$1.2 million at December 31, 2009. This was mainly due to the net liability fair value of the Company's derivative financial instruments recorded in the gas purchase variance account increasing by \$1.5 million from \$4.0 million at December 31, 2009 to a net liability position of \$5.5 million at June 30, 2010, as well as gas commodity charges recovered through customer rates exceeding gas commodity costs paid by the Company by approximately \$1.1 million during the first six months of 2010.

Consistent with the prior year, the Company expects to make annual funding contributions to its pension plan of approximately \$1.3 million. The actual funding may change following completion of an actuarial valuation in the third quarter of 2010. The Company does not expect this to have a material impact on the Company's liquidity.

Normal Course Issuer Bid

The Company commenced a normal course issuer bid through the facilities of the Toronto Stock Exchange on March 9, 2009 which closed on March 8, 2010. During 2009, the Company had purchased and subsequently cancelled 122,416 common shares at an average price of \$14.69 per share. No share purchases were made in 2010.

Capital Resources

Planned capital spending on the Company's gas distribution utilities in 2010 is primarily directed toward installation of distribution mains and services in the Northeast system as well as transmission mainline rehabilitation in the Western system, and is forecast to be approximately \$7.6 million, of which \$2.8 million has been spent to date. Contractual commitments have yet to be made for major planned capital expenditures for 2010.

Development costs for the KSL Project will be capitalized following completion of suitable commercial arrangements for the Project's transportation capacity. Subject to the receipt of acceptable financial support from prospective shippers wanting to contract this transportation capacity, the Company's 50% share of KSL Project development costs in the last half of 2010 will total approximately \$2.4 million of which the majority is expected to be capitalized.

The Company's capital expenditures will be funded from cash flow from operations and, as required, draws on the Company's debt facilities.

Dividends

The Board of Directors declared a quarterly dividend of 28 cents per share on the Company's common shares, payable September 20, 2010 to shareholders of record at the close of business on September 7, 2010.

The Company, for purposes of the Income Tax Act (Canada), and any similar provincial or territorial legislation, designates all dividends paid 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.

Business Risk Management

A detailed discussion of the Company's significant business risks is provided in the Company's MD&A and Annual Information Form for the year ended December 31, 2009, both of which can be found at www.sedar.com. There were no changes to the Company's significant business risks during the six months ended June 30, 2010 except as described below.

Impact of New Acquisition and Integration

The Company entered into the renewable energy business through its acquisition of the McNair Creek "run of the river" facility which closed on April 19, 2010. The Company will continue to spend time and resources to manage and integrate this new business into its current operations. Significant due diligence was performed prior to the closing of the acquisition, but management cannot provide assurance that it will not be incurring additional risks associated with this new business. In particular, the financial performance of the facility is directly related to levels of precipitation in the catchment area of McNair Creek which can vary from year-to-year.

Off Balance Sheet Arrangements

As of June 30, 2010, the Company had no off-balance sheet arrangements.

Transactions with Related Parties

There were no transactions with related parties during the six month period ended June 30, 2010.

Critical Accounting Estimates

The preparation of the Company's consolidated financial statements in conformity with Canadian GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and the related disclosures. These estimates are based on historical experience and current assumptions, and actual results may differ from these estimates under different assumptions and conditions. There were no material changes in the nature of the Company's critical accounting estimates during the six months ended June 30, 2010 from those disclosed in the Company's MD&A for the year ended December 31, 2009, except for the inclusion of preliminary estimates of fair values attributed to the net identifiable assets on the acquisition of McNair Creek.

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 June 30, 2010 comprise 4 and 15 percent of the Company's operating revenues for the three month and six months periods ended June 30, 2010. 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.

Future Accounting Pronouncements

Transition to International Financial Reporting Standards

In February 2008, the Canadian Accounting Standards Board confirmed that publicly accountable enterprises are required to prepare financial statements in accordance with International Financial Reporting Standards (“IFRS”) for years beginning on or after January 1, 2011, with comparative figures for the previous year. IFRS are issued by the International Accounting Standards Board (“IASB”).

The transition to IFRS will impact the Company’s accounting policies, information technology and data systems, internal control over financial reporting, and financial statement presentation and disclosure. The transition may also impact the Company’s operations, including such areas as contractual arrangements, debt covenants and compensation arrangements.

The Company commenced its IFRS transition project during the third quarter of 2008 and has established an IFRS transition plan and project team. The IFRS transition 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.

During the second quarter of 2010, the Company continued to work on elements of the second phase of the transition plan. In particular, the Company has worked on developing IFRS compliant accounting policies relating to property, plant and equipment. These policies will differ from the Company’s current accounting policies.

A detailed analysis of standards and policy choices available under the standards identified the following areas as having the highest potential impact on the Company’s financial reporting: regulatory assets and liabilities, property, plant and equipment, employee future benefit plans, presentation and disclosure, and the provisions related to the initial adoption of IFRS under IFRS 1, First Time Adoption.

A summary of progress in the review of these areas is as follows:

- **Rate-regulated activities:** On July 23, 2009, the IASB published Exposure Draft, *Rate-regulated Activities*, to develop a standard on rate-regulated activities that clarifies whether regulated entities could or should recognize an asset or liability as a result of rate regulation. As initially presented, this Exposure Draft would allow the Company to continue with balance sheet recognition of regulatory deferrals for rate setting purposes provided the activity is within scope. In July 2010, the IASB met to consider whether regulatory asset and liabilities exist in accordance with its current Framework for the preparation and presentation of financial statements. The IASB decided to continue its deliberations on this project. On July 26, 2010 the Canadian Accounting Standards Board, proposed that qualifying entities with rate regulated activities be permitted, but not required, to continue to apply the existing Canadian GAAP (Part V of the CICA Handbook) for an additional two years. The AcSB expects to issue an exposure draft by the end of July 2010. Management is currently monitoring this latest development.
- **Property, plant and equipment:** The Company has identified the following as differences between current accounting policies and IFRS compliant policies: the capitalization of inspections and major overhauls of the Company’s transmission and distribution assets, the capitalization of overhead costs, the treatment of gains and losses on disposal of assets, the treatment of customer contributions, the

capitalization of borrowing costs and asset retirement obligations. The Company is continuing with its review of these differences and the assessment of policy choices.

- Employee future benefit plans: The Company is continuing with its assessment of policy choices available under the current IFRS standard and is monitoring the ongoing developments related to the standard.
- Presentation and disclosure: The Company has completed the preparation and review of pro forma annual IFRS financial statements and has identified changes to presentation and additional disclosure required under IFRS. The Company continues to assess changes that will be required for interim financial reporting in the year of adoption.
- Derivative financial instruments: The Company currently records the fair value of a fixed-price natural gas supply contract at each reporting date and includes this amount in the fair value of its derivative financial instruments. Under regulatory accounting, an offsetting entry is made to the gas cost variance regulatory account. Under IFRS, the Company's fixed-price natural gas supply contract is a contract to buy or sell a non-financial item in accordance with the Company's expected purchase, sale or usage and will qualify for a scope exemption from being recognized as a financial instrument at fair value. Accordingly, as at January 1, 2010, the application of this exemption will result in a \$1.0 million decrease in derivative financial instrument assets, with an offsetting \$1.0 million debit adjustment to the gas cost variance regulatory account.
- IFRS 1, *First-Time Adoption of IFRS*: The elections and exemptions under IFRS 1 have been reviewed and analyzed, including proposed amendments relating to rate-regulated activities. Decisions that have been made regarding available IFRS 1 exemptions and elections include:
 - IFRS 3, *Business Combinations*: The Company has elected not to retrospectively apply IFRS 3 to business combinations that occurred prior to the January 1, 2010 transition date and such business combinations will not be restated.
 - Property, Plant and Equipment and Intangible Assets: In April 2010, the International Accounting Standards Board ("IASB") approved an IFRS 1 exemption which would allow the Company to use the carrying amount of rate regulated property, plant and equipment and intangible assets, as calculated under Canadian GAAP, as the deemed cost for IFRS on the date of transition. The Company expects to use this exemption.

The Company continues to monitor changes to IFRS standards that may become effective during or shortly after the implementation phase.

During the first quarter of 2010, the Company made changes to its financial information system to record financial transactions for reporting both Canadian GAAP and IFRS in 2010. During the second quarter the Company continues to make changes to its financial information system to record its property, plant and equipment balances under both Canadian GAAP and IFRS. The Company continues to work on changes to its financial information processes to ensure it is able to gather financial information under both Canadian GAAP and IFRS.

The Company continues to provide training to key employees and will develop an external communication plan which will depend on the nature and magnitude of changes to the financial statements expected under IFRS.

The Company has reviewed the effect of the IFRS conversion on its debt agreements and hedging activities and does not expect the conversion of IFRS to significantly impact these activities or requirements.

The Company's transition plans are on schedule and further updates on the status of key activities for this project will be provided in future MD&A's.

Financial Instruments 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 June 30, 2010 the Company had no interest rate hedging contracts outstanding.

During the second quarter of 2010, the Company completed its annual gas contracting and gas price risk management plan and filed it with the Commission for review and acceptance. The annual gas contracting plan covered proposed gas purchases over the November 1, 2010 to October 31, 2011 period while the gas price risk management plan provided for hedging gas purchases over the November 1, 2010 through October 31, 2012 period. The Company proposed implementing the hedges in stages over the May 2010 to February 2012 period. The Commission accepted the plan as filed and made comments on information to be included in the 2011 plan. Each hedging transaction is approved by the Company's price risk management plan committee.

At June 30, 2010, the Company had outstanding natural gas swap contracts and collar contracts relating to natural gas supply as follows:

Financial instrument	Notional quantity (gigajoules)	Percent of annual gas purchases (%)	Delivery period	Price range (per gigajoule)	Estimated net fair value receivable (payable) (\$000's)
Natural gas swap contracts	2 986 900	30.6	Jul 2010 – Oct 2012	\$5.47 to \$9.11	(5,234)
Collar contracts	98 600	1.0	Jul 2010 – Oct 2010	\$5.30 to \$7.05 (floors) \$6.77 to \$10.06 (caps)	(226)
	3 085 500	31.6			(5,460)

The fair value reflects the estimated amounts that the Company would receive or pay at June 30, 2010 to terminate the natural gas swap contracts and 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.

At December 31, 2009, the Company had outstanding fixed price contracts, natural gas swap contracts, and collar contracts relating to natural gas supply as follows:

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 value reflects the estimated amounts that the Company would receive or pay at December 31, 2009 to terminate the fixed price contracts, natural gas swap contracts, and collar contracts, based on the estimated net cash flows under the terms of each contract.

Disclosure Controls and Procedures and Internal Controls over Financial Reporting

Disclosure controls and procedures are controls and other procedures that are designed to: (a) provide reasonable assurance that material information required to be disclosed by the Company is accumulated and communicated to management to allow timely decisions regarding required disclosure; and (b) ensure that information required to be disclosed by the Company is recorded, processed, summarized, and reported within the time periods specified in applicable securities legislation.

Management is responsible for designing, establishing and maintaining the Company's system of internal control over financial reporting. The Company's internal control system was designed based on the framework outlined in Internal Control – Integrated Framework released by the Committee of Sponsoring Organizations of the Treadway Commission to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes, in accordance with Canadian GAAP.

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 June 30, 2010. 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 June 30, 2010 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 unaudited interim consolidated financial statements and the Board of Directors approved the documents prior to their release.

The certifying officers have limited the scope of their certification in accordance with National Instrument 52-109 for the design of disclosure controls and procedures and internal controls over financial reporting to exclude controls, policies and procedures resulting from the acquisition of McNair on April 19, 2010. The business segment is described under Business of the Company – Renewable Energy Business. The Company's financial results include revenues of \$0.6 million and a net loss of \$0.2 million and its consolidated balance sheet includes \$19.9 million in total assets and \$11.8 million total liabilities related to McNair.

Management, under the supervision of the certifying officers, has evaluated the overall risk, reviewed the results of operations with operating management and confirmed that consistent controls have operated since the Company's acquisition of McNair. Management is confident in the reliability of financial reporting and the preparation of financial statements included in the Company's consolidated results. In 2010, the Company will certify that the internal controls over financial reporting and the disclosure controls and procedures are designed and effective under National Instrument 52-109.

Outstanding Share Data

Pacific Northern Gas Ltd. had 3,608,104 common shares and 200,000 preferred shares outstanding as of July 27, 2010. These are the only issued securities of the Company and it has no securities outstanding which may be converted into voting or equity securities other than as noted below.

As at July 27, 2010 there were 318,400 stock options granted and outstanding (representing 8.8% of issued and outstanding common shares). Each option is exercisable for one common share.

"Roy G. Dyce"

President and Chief Executive Officer
July 27, 2010

Interim Consolidated Financial Statements

(Unaudited)

For the Three and Six Months Ended June 30, 2010

Pacific Northern Gas Ltd.
CONSOLIDATED STATEMENTS OF INCOME (LOSS) AND
COMPREHENSIVE INCOME (LOSS)
(Unaudited)

[\$ in thousands, except per share data]	For the six months ended June 30		For the three months ended June 30	
	2010	2009	2010	2009
Revenues:				
Gas sales and transportation services	42,020	49,431	12,969	12,327
Off system gas sales	11,157	9,537	94	62
Other [note 6]	2,224	3,491	2,103	1,752
	55,401	62,459	15,166	14,141
Cost of gas:				
Gas sales	15,811	27,054	4,536	5,241
Off system sales	11,157	9,537	94	62
	26,968	36,591	4,630	5,303
	28,433	25,868	10,536	8,838
Operating and maintenance	6,171	6,201	3,140	3,042
Administrative and general	4,757	3,752	2,458	1,871
Depreciation and amortization	4,281	4,016	2,181	2,001
Municipal and other taxes	2,367	2,292	1,194	1,146
	17,576	16,261	8,973	8,060
	10,857	9,607	1,563	778
Finance fees	3,037	2,795	1,588	1,430
Project development expenditures [note 7]	529	102	253	39
Income (loss) before income taxes and non-controlling interests	7,291	6,710	(278)	(691)
Income tax expense (recovery) [note 8]	1,951	1,954	(130)	(291)
Income (loss) before non-controlling interests	5,340	4,756	(148)	(400)
Non-controlling interests	2	—	2	—
Net income (loss) and comprehensive income (loss)	5,342	4,756	(146)	(400)
Earnings (loss) per common share: [note 9]				
Basic	\$1.44	\$1.26	(\$0.06)	(\$0.13)
Diluted	\$1.41	\$1.26	(\$0.06)	(\$0.13)

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

Pacific Northern Gas Ltd.
CONSOLIDATED BALANCE SHEETS
(Unaudited)

[\$ in thousands]	June 30 2010	December 31 2009
ASSETS		
Current assets:		
Cash and cash equivalents <i>[note 17]</i>	1,736	1,511
Accounts receivable <i>[note 15]</i>	4,613	21,618
Gas purchase variance recoverable	3,803	1,165
Income taxes recoverable	1,826	—
Inventories of natural gas and supplies	787	1,079
Prepaid expenses and other	642	940
Derivative financial instruments <i>[note 14]</i>	—	1,029
Future income taxes	643	1,288
	14,050	28,630
Plant, property and equipment	192,241	178,420
Intangible assets	1,778	1,795
Regulatory and other assets	16,409	11,364
Goodwill <i>[note 5]</i>	2,875	—
	227,353	220,209
LIABILITIES		
Current liabilities:		
Bank indebtedness	—	2,579
Accounts payable and accrued liabilities	7,657	21,617
Income taxes payable	—	1,041
Other taxes payable	3,976	3,525
Derivative financial instruments <i>[note 14]</i>	4,780	4,298
Long-term debt due within one year	3,778	2,800
	20,191	35,860
Long-term debt, non-current portion	86,121	71,779
Regulatory and other liabilities <i>[note 14]</i>	6,990	5,684
Future income taxes	19,522	16,450
	132,824	129,773
EQUITY		
Preferred shares	5,000	5,000
Common shares <i>[note 10]</i>	9,005	8,890
Contributed surplus	4,286	3,699
Retained earnings	76,008	72,847
Total shareholders' equity	94,299	90,436
Non-controlling interest <i>[note 3]</i>	230	—
Total equity	94,529	90,436
	227,353	220,209

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

On behalf of the Board:

“Roy G. Dyce”		“Robert F. Chase”
Director		Director

Pacific Northern Gas Ltd.
CONSOLIDATED STATEMENTS OF EQUITY
(Unaudited)

[\$ in thousands]	For the six months ended June 30		For the three months ended June 30	
	2010	2009	2010	2009
Preferred shares				
Balance, beginning and end of period	5,000	5,000	5,000	5,000
Common shares				
Balance, beginning of period	8,890	9,161	8,971	9,094
Share repurchase under normal course issuer bid [note 10]	—	(212)	—	(145)
Employee stock options exercised	115	—	34	—
Balance, end of period	9,005	8,949	9,005	8,949
Contributed surplus				
Balance, beginning of period	3,699	3,610	4,096	3,629
Stock option expense [note 11]	63	59	17	18
Share repurchase under normal course issuer bid [note 10]	—	(68)	—	(46)
Employee stock options exercised	524	—	173	—
Balance, end of period	4,286	3,601	4,286	3,601
Retained earnings				
Balance, beginning of period	72,847	70,953	77,330	75,018
Net income (loss)	5,342	4,756	(146)	(400)
Dividends – preferred shares	(169)	(169)	(169)	(169)
Dividends – common shares	(2,012)	(1,670)	(1,007)	(828)
Share repurchase under normal course issuer bid [note 10]	—	(887)	—	(638)
Balance, end of period	76,008	72,983	76,008	72,983
Total shareholders' equity, end of period	94,299	90,533	94,299	90,533
Non-controlling interest				
Balance, beginning of period	—	—	—	—
Non-controlling interest upon acquisition [note 3]	232	—	232	—
Net loss attributable to non-controlling interest	(2)	—	(2)	—
Balance, end of period	230	—	230	—
Total equity, end of period	94,529	90,533	94,529	90,533

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

Pacific Northern Gas Ltd.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

[\$ in thousands]	For the six months ended June 30		For the three months ended June 30	
	2010	2009	2010	2009
OPERATING ACTIVITIES				
Net income (loss)	5,342	4,756	(146)	(400)
Add (deduct) items not involving cash:				
Future income taxes <i>[note 8]</i>	2,322	(360)	1,507	346
Depreciation and amortization	4,281	4,016	2,181	2,001
Amortization of Methanex termination payment deferral <i>[note 6]</i>	—	(3,274)	—	(1,640)
Stock option expense <i>[note 11]</i>	63	59	17	18
Imputed interest on regulatory assets and liabilities	160	(43)	(3)	(44)
Other	108	(48)	190	(55)
	12,276	5,106	3,746	226
Changes in operating assets and liabilities <i>[note 17]</i>	(4,097)	13,065	3,321	10,952
Net cash provided by operating activities	8,179	18,171	7,067	11,178
INVESTING ACTIVITIES				
Additions to short-term investments	—	(2,000)	—	(2,000)
Additions to plant, property and equipment	(2,561)	(3,152)	(1,646)	(1,904)
Acquisition, net of cash acquired <i>[note 5]</i>	(7,329)	—	(7,329)	—
Net cash used in investing activities	(9,890)	(5,152)	(8,975)	(3,904)
FINANCING ACTIVITIES				
Repayment of bank indebtedness	(2,579)	(2,998)	(2,461)	—
Debt refinancing costs	(115)	—	—	—
Issuance of long-term debt	6,000	3,000	6,000	—
Repayment of long-term debt	(60)	(3,000)	(60)	(3,000)
Share repurchase under normal course issuer bid <i>[note 10]</i>	—	(1,167)	—	(829)
Employee stock options exercised <i>[note 11]</i>	639	—	207	—
Dividends paid	(2,181)	(1,839)	(1,176)	(997)
Contribution from non-controlling interest <i>[note 3]</i>	232	—	232	—
Net cash provided by (used in) financing activities	1,936	(6,004)	2,742	(4,826)
Increase in cash during the period	225	7,015	834	2,448
Cash and cash equivalents, beginning of period	1,511	577	902	5,144
Cash and cash equivalents, end of period	1,736	7,592	1,736	7,592

Supplemental cash flow information *[note 17]*

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

PACIFIC NORTHERN GAS LTD.
NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS
For the three months and six months ended June 30, 2010
(Unaudited)

1. DESCRIPTION OF THE BUSINESS

Pacific Northern Gas Ltd. (the “Company”) and its wholly-owned subsidiary, Pacific Northern Gas (N.E.) Ltd. (“PNG (N.E.)”), are engaged in the transportation and distribution of natural gas in northern British Columbia, Canada. The Company and PNG (N.E.) are subject to regulation 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 in partnership with Skookum Power Corp. acquired a 100% interest in Kiewit McNair Creek Investors Corp., McNair Creek Hydro Corp. and their subsidiary (collectively “McNair Creek”) which operate a 9.8 megawatt ‘run of river’ hydro-electricity generation facility located on British Columbia’s Sunshine Coast [see note 5]. The transaction was effected through the Company’s 97%-owned subsidiary 0873560 B.C. Ltd. McNair Creek is a non-regulated business and currently operates under a long-term supply agreement with BC Hydro.

2. BASIS OF PRESENTATION

These interim 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, except that disclosures do not conform, in all respects, to the requirements for annual consolidated financial statements.

These interim consolidated financial statements follow the same accounting policies and methods of their application as the Company’s most recent annual consolidated financial statements for the year ended December 31, 2009, except as described below in note 4.

While management believes that the disclosures presented are adequate to make the information not misleading, these interim consolidated financial statements and notes should be read in conjunction with the Company’s most recent annual audited consolidated financial statements for the year ended December 31, 2009.

Earnings for interim reporting periods may not be indicative of results for the fiscal year due to weather variations and other factors. Specifically, due to the seasonal nature of the sale of natural gas for heating purposes, the Company generally reports net income in the first and fourth quarters of the year, and losses in the second and third quarters.

All financial figures are presented in Canadian dollars.

PACIFIC NORTHERN GAS LTD.
NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS
For the three months and six months ended June 30, 2010
(Unaudited)

3. PRINCIPLES OF CONSOLIDATION

These consolidated financial statements include the accounts of the Company, its wholly-owned subsidiary PNG (N.E.), its 97%-owned subsidiary 0873560 B.C. Ltd. [see note 5], 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 7].

The results of operations, cash flows, financial position and non-controlling interest of 0873560 B.C. Ltd. have been included in these financial statements from the date of incorporation.

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

4. ACCOUNTING CHANGES

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.

The early adoption of these standards by the Company resulted in additional disclosure related to a business acquisition that closed on April 19, 2010 [see note 5] and the expensing of the related acquisition costs incurred of \$0.5 million, rather than their deferral and inclusion as part of the cost of the business acquisition.

PACIFIC NORTHERN GAS LTD.
NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS
For the three months and six months ended June 30, 2010
(Unaudited)

5. ACQUISITION

On April 19, 2010, through its 97%-owned subsidiary, 0873560 B.C. Ltd., the Company acquired a 100% interest in McNair Creek. 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 cash flows.

The subsidiary paid \$7.3 million in cash on closing (net of cash acquired) and estimates it will pay an additional \$0.6 million upon finalization of post-closing adjustments. The subsidiary is also responsible for contingent payments to a former shareholder of McNair Creek equal to 0.75% of future revenues. Acquisition costs of \$0.5 million incurred in connection with the acquisition have been expensed in administrative and general costs.

The Company has accounted for this acquisition as a purchase business combination with the subsidiary as the acquirer. The purchase price has been allocated on a preliminary basis 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. To the extent that the purchase price exceeds the fair value of the net identifiable tangible and intangible assets, the subsidiary has recorded goodwill. The final fair-value estimates could be materially different from those currently being used. Management is continuing to assess the estimated fair value for certain assets and liabilities acquired including property, plant and equipment, intangible assets and future income taxes, the valuations of which are less advanced due to the inherent complexities associated with their valuations.

The Company has engaged a third party to review the valuation of the assets acquired and liabilities assumed. The following table summarizes the preliminary fair values of the identifiable assets acquired and liabilities assumed:

Preliminary Purchase Price Allocation

[\$ in thousands]	
Assets	
Current assets	689
Property, plant and equipment ⁽¹⁾	15,478
Intangible assets	15
	16,182
Liabilities	
Current liabilities	178
Long-term debt ⁽²⁾	9,413
Future income taxes	1,394
	10,985
Net identifiable assets acquired	5,197
Goodwill ⁽³⁾	2,875
Net assets acquired	8,072

PACIFIC NORTHERN GAS LTD.
NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS
For the three months and six months ended June 30, 2010
(Unaudited)

5. ACQUISITION (continued)

Purchase price payment	
Cash paid on closing, net of cash acquired	7,329
Contingent consideration	120
Estimated to be paid subsequent to closing	623
	8,072

(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. As at the acquisition date this contract was assessed as an unfavourable operating lease as the price for electricity sold under the contract was less than the then current market price for electricity. As required, the fair value of the unfavourable lease has been included in the determination of the preliminary 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 repayments 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 \$0.1 million at June 30, 2010.

(3) Goodwill

On a preliminary basis, goodwill of \$2.9 million has been recognized on the acquisition and relates to management's expectation of increased outputs, successful future contract renewals, a location which is in close proximity to customer load and weather patterns, which allow for the generation of electricity during peak demand periods. Goodwill recognized on the acquisition is not deductible for tax purposes.

Accounting Policies

As a result of the acquisition, the Company established the following significant accounting policies:

Business combinations

The Company has chosen to early adopt new accounting standards related to business combinations, consolidated financial statements and non-controlling interests to account for its acquisition of McNair Creek. As per note 4, early adoption of these standards has resulted in additional disclosure related to the transaction and in the expensing of \$0.5 million in related acquisition costs which would have previously been included in the cost of the business acquisition.

PACIFIC NORTHERN GAS LTD.
NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS
For the three months and six months ended June 30, 2010
(Unaudited)

5. ACQUISITION (continued)

Segment reporting

With the acquisition of McNair Creek, the Company has entered into a new business segment, the generation and sale of electricity. This change has resulted in the Company presenting segmented information as disclosed in note 18.

Goodwill

As noted, goodwill has been recorded on this transaction. Goodwill is recorded at cost and represents the difference between the purchase price of acquisition and the fair value assigned to the identifiable assets acquired and liabilities assumed. Goodwill is not amortized, but is tested annually for impairment.

Operating Results

The results of McNair Creek have been included in these interim consolidated financial statements from April 19, 2010, the date of acquisition, and include \$0.6 million in revenue and a net loss of \$0.2 million related to these operations. On a pro-forma basis, had the acquisition occurred on January 1, 2010, the Company's revenue from this operation for the period to June 30, 2010 would have been \$1.2 million and net loss for the period would have been \$0.1 million.

As noted above, the allocation of the purchase price is still preliminary and subject to finalization.

6. TERMINATION PAYMENT DEFERRALS

Methanex Corporation

As approved by the Commission, a termination payment received from Methanex Corporation ("Methanex") for approximately \$23.3 million was recorded in 2006, net of income taxes of \$7.96 million, as an interest bearing credit deferral. This payment was amortized into income over the period from March 1, 2006 to October 31, 2009. For the three month and six month periods ended June 30, 2009, \$1.6 million and \$3.3 million of the termination payment was included in other revenue, respectively.

West Fraser Timber Co. Ltd.

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. paper mill. West Fraser will continue to pay the monthly demand charge due under the transportation agreement until November 30, 2010, and a termination payment of just over \$5 million is expected 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.

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7. JOINT VENTURES

The following amounts represent the Company's 50% proportionate interest in assets, liabilities, revenues, expenditures and cash flows of Pacific Trail Pipelines Limited Partnership and its general partner, Pacific Trail Pipelines Management Inc.:

[\$ in thousands]

	June 30 2010		December 31 2009	
Balance Sheet				
Current assets	\$ 185		75	
Non-current assets	—		—	
Current liabilities	(140)		(33)	
Non-current liabilities	—		—	
Income Statement				
	For the six months ended June 30 2010	2009	For the three months ended June 30 2010	2009
Revenues	—	—	—	—
Expenses	529	102	253	39
Net loss	(529)	(102)	(253)	(39)
Cash Flow				
Cash provided by (used in):				
Operations	(392)	(157)	(293)	(67)
Financing	546	100	298	100
Investments	—	—	—	—
Increase (decrease) in cash	154	(57)	5	33

8. INCOME TAX EXPENSE

[\$ in thousands]

	For the six months ended June 30 2010	2009	For the three months ended June 30 2010	2009
Current income tax expense (recovery)	(371)	2,314	(1,637)	(637)
Future income tax expense (recovery)	2,322	(360)	1,507	346
	1,951	1,954	(130)	(291)

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9. EARNINGS (LOSS) PER COMMON SHARE

[\$ in thousands, except share and per share amounts]	For the six months ended June 30		For the three months ended June 30	
	2010	2009	2010	2009
Net income (loss)	5,342	4,756	(146)	(400)
Less: Dividends on preferred shares	(169)	(169)	(85)	(84)
Net income (loss) attributable to common shares	5,173	4,587	(231)	(484)
Basic weighted-average number of shares outstanding	3,586,828	3,635,408	3,596,319	3,609,991
Effect of dilutive securities:				
Stock options	83,496	15,842	—	—
Diluted weighted-average number of shares outstanding	3,670,324	3,651,250	3,596,319	3,609,991
Net income (loss) per common share				
Basic	\$1.44	\$1.26	(\$0.06)	(\$0.13)
Diluted	\$1.41	\$1.26	(\$0.06)	(\$0.13)

For the six month period ended June 30, 2010, no stock options were excluded from the computation of diluted weighted-average number of shares because the exercise prices of these options were lower than the average market price of the Company's common shares during this period. For the six month period ended June 30, 2009, 211,140 stock options were excluded because the exercise prices of these options were higher than the average market price of the Company's common shares during that period.

For the three month period ended June 30, 2010, 95,437 stock options (2009 – 183,640) were excluded from the computation of diluted weighted-average number of shares as the Company reported a net loss and therefore including these shares would have an anti-dilutive effect on earnings per share.

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10. COMMON SHARES

[\$ in thousands, except number of shares]	Number of shares	Share capital
Balance, December 31, 2008	3,664,580	9,161
Issue of shares under share option plan	13,800	35
Share repurchase	(122,416)	(306)
Balance, December 31, 2009	3,555,964	8,890
Issue of shares under share option plan	46,200	115
Balance, June 30, 2010	3,602,164	9,005

During the three and six month periods ended June 30, 2010, the Company issued 32,600 and 46,200 common shares, respectively, on the exercise of stock options (2009 – nil).

The Company commenced a normal course issuer bid through the facilities of the Toronto Stock Exchange on March 9, 2009. This bid closed on March 8, 2010, and no share purchases were made during the three and six month periods ended June 30, 2010. During the three and six month periods ended June 30, 2009, the Company purchased and subsequently cancelled 54,200 and 81,116 common shares, respectively.

11. SHARE-BASED COMPENSATION

Stock Option Plan

There were no stock option awards made during the three month period ended June 30, 2010 (2009 – nil). During the six month period ended June 30, 2010, the Company granted 38,300 stock options with a total fair value of \$102,000 (2009 – 62,800 stock options with a total fair value of \$50,000). The fair value of option awards 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 share options granted for the periods noted:

	Six months ended June 30	
	2010	2009
Number of options awarded	38,300	62,800
Stock option fair value	\$2.66	\$0.80
Stock option exercise price	\$22.72	\$12.24
Expected volatility (annualized)	20.2%	22.3%
Dividend yield	4.9%	7.5%
Risk free interest rate	3.1%	2.2%
Estimated option life (years)	7.5	7.5

The share-based compensation expense recorded for the three and six months ended June 30, 2010 was \$17,000 and \$63,000, respectively (2009 - \$18,000 and \$59,000, respectively).

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11. SHARE-BASED COMPENSATION (continued)

The following table provides a summary of the changes to the Company's share option plan during the periods noted:

	Six months ended June 30			
	2010		2009	
	Number of options	Weighted- average exercise price [\$]	Number of options	Weighted- average exercise price [\$]
Outstanding, beginning of period	332,240	15.85	296,720	16.70
Granted	38,300	22.72	62,800	12.24
Exercised	(46,200)	15.24	—	—
Forfeited	—	—	(280)	18.10
Expired	—	—	(13,200)	24.50
Outstanding, end of period	324,340	16.96	346,040	15.59
Weighted-average exercise price of options exercisable at end of period		16.85		15.67

The following table summarizes information about share options outstanding and exercisable as at June 30, 2010:

Exercise price [\$]	Number of options outstanding	Weighted- average exercise price [\$]	Weighted- average remaining life [years]	Number of options exercisable
6.50 – 9.99	—	—	—	—
10.00 – 14.99	130,000	13.04	5.2	94,480
15.00 – 19.99	135,940	18.58	6.4	116,090
20.00 – 24.50	58,400	22.03	7.6	27,760
	324,340	16.96	6.1	238,330

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11. SHARE-BASED COMPENSATION (continued)

Deferred Share Unit Plan

The following table provides a summary of the changes to the Company's deferred share unit plan:

[Units]	For the six months ended June 30		For the three months ended June 30	
	2010	2009	2010	2009
Outstanding, beginning of period	24,545	17,824	26,763	21,108
Issued	3,576	5,449	1,358	2,165
Redemptions	—	(2,395)	—	(2,395)
Outstanding, end of period	28,121	20,878	28,121	20,878

The following table provides a summary of the changes to the liability associated with the Company's deferred share unit plan:

[\$ in thousands]	For the six months ended June 30		For the three months ended June 30	
	2010	2009	2010	2009
Balance, beginning of period	460	241	610	254
Expensed	257	123	107	110
Redemptions	—	(30)	—	(30)
Balance, end of period	717	334	717	334

12. RELATED PARTY TRANSACTIONS

There were no transactions with related parties during the three or six month periods ended June 30, 2010 and June 30, 2009.

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13. 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 June 30, 2010 under various gas supply contracts expiring through 2015 were as follows:

[\$ in thousands]	
2010	9,914
2011	14,353
2012	3,203
2013	49
2014	49
Thereafter	41
Total	27,609

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 June 30, 2010.

14. FINANCIAL INSTRUMENTS

Financial instruments by category

The fair value of the Company's financial instruments, including derivatives, reflects point-in-time estimates 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]	June 30, 2010		December 31, 2009	
	Carrying value	Estimated fair value	Carrying value	Estimated fair value
Held for trading				
Cash and cash equivalents	1,736	1,736	1,511	1,511
Loans and receivables				
Accounts receivable	4,613	4,613	21,618	21,618
Other financial liabilities				
Bank indebtedness	—	—	2,579	2,579
Accounts payable and accrued liabilities	7,657	7,657	21,617	21,617
Long-term debt, including current portion	89,899	100,079	74,579	82,674

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14. 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 carrying value, reflecting the short-term maturity of these instruments. The fair value of the Company's long-term debt is estimated by reference to quoted market prices for similar instruments, taking into account credit risk.

Derivative financial instruments

The Company hedges exposures to fluctuations in natural gas prices through the use of derivative financial instruments. The Company has a hedge line of credit of \$15 million (2009 - \$15 million) with its bank operating line provider that allows it to transact its natural gas swaps and collars and is secured by the pledge of a \$20 million debenture.

In January 2010, the Company entered into a second risk management facility with a new provider allowing it to hedge natural gas purchases in the amount of \$15 million. This facility is also secured by the pledge of a \$20 million debenture and has two financial covenants, one which requires the Company's debt leverage not to exceed 65 percent, and a 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 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 increases to 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 to the extent of a total maximum exposure of \$15 million under each of its available facilities.

The following tables summarize the valuation of the Company's derivative financial instruments related to natural gas supply as at the dates noted:

As at June 30, 2010					Estimated
Financial instrument	Notional quantity	Percent of annual gas purchases	Delivery period	Price range	net fair value receivable (payable)
	(gigajoules)	(%)		(per gigajoule)	(\$000's)
Natural gas swap contracts	2 986 900	30.6	Jul 2010 – Oct 2012	\$5.47 to \$9.11	(5,234)
Collar contracts	98 600	1.0	Jul 2010 – Oct 2010	\$5.30 to \$7.05 (floors)	(226)
				\$6.77 to \$10.06 (caps)	
	3 085 500	31.6			(5,460)

Of the \$5.5 million liability at June 30, 2010, \$4.8 million is recorded as a current liability and \$0.7 million recorded in non-current regulatory and other liabilities on the interim consolidated balance sheet.

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14. 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)

Of the \$4 million net liability at December 31, 2009, \$1 million is recorded as a current asset, \$4.3 million is recorded as a current liability and \$0.7 million is recorded in non-current regulatory and other liabilities on the interim consolidated balance sheet.

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

These estimated fair market values have no impact on earnings due to the regulated nature of the Company's operations. Based on the current regulatory process, any gains or losses arising from utility related financial instruments are recorded in the gas purchase variance account as part of the cost of gas to be received from or refunded to customers in future rates.

15. 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, physical off system gas sales and electricity sales and does not expect any counterparties to fail to meet its obligations. Should the Company incur a financial loss in its regulated activities 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.

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15. RISK MANAGEMENT (continued)

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 of residential and commercial customers based on past experience. The Company actively reviews the adequacy of its allowance for doubtful accounts.

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

[\$ in thousands]	June 30 2010	December 31 2009
Core market – residential and commercial	4,390	18,746
Industrial customers	685	948
Off-system sales customers	—	3,831
Other	595	137
	5,670	23,662
Less: Allowance for doubtful accounts	(1,057)	(2,044)
	4,613	21,618

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

[\$ in thousands]	June 30 2010	December 31 2009
Unbilled revenues	3,440	10,729
Past due 0 to 30 days (current)	1,120	10,747
Past due 31 to 90 days	281	384
Past due over 91 days	829	1,802
	5,670	23,662
Less: Allowance for doubtful accounts	(1,057)	(2,044)
	4,613	21,618

Changes in the allowance for doubtful accounts are as follows:

[\$ in thousands]	June 30 2010	December 31 2009
Balance, beginning of period	2,044	1,735
Provision for doubtful accounts	133	313
Write-off of bad debts, net of recoveries, and other	(1,120)	(4)
Balance, end of period	1,057	2,044

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15. RISK MANAGEMENT (continued)

Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet obligations associated with financial liabilities and commitments as they become due. The Company manages liquidity risk through the management of its capital structure and financial leverage. It also regularly monitors actual and projected cash flows. The Company believes that future cash flows generated from operations and access to additional liquidity through capital and banking markets will be adequate to meet its financial obligations in the foreseeable future. The Company's overall liquidity risk has improved slightly from December 31, 2009, with the increase in the availability of credit under its operating line, risk management facilities and 5-year term revolving debt facility.

On January 19, 2010, the Company arranged a second \$15 million risk management facility which matures on July 18, 2011, and on February 2, 2010 the Company amended its committed 5-year term revolving debt facility by increasing the credit available under the facility to \$35 million and extending the maturity date to January 30, 2015.

As at June 30, 2010, the Company's credit facilities include a \$25 million operating line, two \$15 million risk management facilities and a \$35 million committed 5-year term revolving debt facility. The operating line is subject to borrowing base requirements which may restrict the amount that the Company can borrow under the line at any point in time. As of June 30, 2010, the calculated borrowing base of the operating line was approximately \$9.9 million and actual utilization was \$3.8 million, and \$12 million was outstanding under the \$35 million revolving debt facility at June 30, 2010 via Bankers Acceptance equivalent loans.

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

The Company maintains regular dialogue with the financial institutions that provide 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.

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.

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15. RISK MANAGEMENT (continued)

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.

The commodity price for electricity can also be volatile. However, as all of the electricity generated by the McNair Creek facility is sold under a long-term fixed-price contract, exposure to market price changes for this non-regulated activity is considered to be negligible.

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 related to its regulated operations.

16. 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 June 30, 2010: long-term debt and shareholders' equity totaling \$184.2 million (December 31, 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 equity equal to the investment 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.

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16. CAPITAL MANAGEMENT (continued)

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 almost 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.

17. SUPPLEMENTAL CASH FLOW INFORMATION

[\$ in thousands]	June 30 2010	December 31 2009
Cash and cash equivalents:		
Cash and bank balances	1,736	503
Short-term demand deposits	—	1,008
	1,736	1,511

[\$ in thousands]	For the six months ended June 30		For the three months ended June 30	
	2010	2009	2010	2009
Changes in operating assets and liabilities:				
(Increase) decrease in:				
Accounts receivable	17,123	22,212	12,314	16,566
Inventories of supplies and natural gas	292	1,339	156	168
Prepaid expenses and other	869	429	894	194
Income taxes receivable	(1,826)	—	(1,826)	—
Increase (decrease) in:				
Accounts payable and accrued liabilities	(15,090)	(16,491)	(6,512)	(5,572)
Gas purchase variance account	(1,288)	2,157	(530)	(1,028)
Income taxes payable	(1,041)	1,086	(1,173)	(936)
Other taxes payable	431	144	1,149	140
Changes in regulatory assets and liabilities	(3,567)	2,189	(1,151)	1,420
Attributable to operating activities	(4,097)	13,065	3,321	10,952
Cash interest and tax payments:				
Income taxes paid	2,496	1,176	573	301
Interest paid	2,726	2,787	1,710	1,747

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17. SUPPLEMENTAL CASH FLOW INFORMATION (continued)

Non-cash transactions:	June 30 2010	December 31 2009
Property, plant and equipment purchases included in accounts payable and accrued liabilities	92	133

18. 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 5], 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 three and six month periods ended June 30, 2010. Comparative information has not been presented as the Company operated in a single business segment during these periods.

Three months ended June 30, 2010

[\$ in thousands]	Gas Transmission and Distribution	Renewable Energy	Consolidated
Revenues	14,585	581	15,166
Cost of gas	4,630	—	4,630
	9,955	581	10,536
Operating and maintenance	3,140	—	3,140
Administrative and general	2,031	427	2,458
Depreciation and amortization	2,107	74	2,181
Municipal and other taxes	1,173	21	1,194
	1,504	59	1,563
Finance fees	1,441	147	1,588
Project development expenditures	253	—	253
Income (loss) before income taxes and non-controlling interests	(190)	(88)	(278)
Income tax expense (recovery)	(171)	41	(130)
Income (loss) before non-controlling interests	(19)	(129)	(148)
Non-controlling interests	—	2	2
Net income (loss) and comprehensive income (loss)	(19)	(127)	(146)

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18. SEGMENTED INFORMATION (continued)

Six months ended June 30, 2010

[\$ in thousands]	Gas Transmission and Distribution	Renewable Energy	Consolidated
Revenues	54,820	581	55,401
Cost of gas	26,968	—	26,968
	27,852	581	28,433
Operating and maintenance	6,171	—	6,171
Administrative and general	4,160	597	4,757
Depreciation and amortization	4,207	74	4,281
Municipal and other taxes	2,346	21	2,367
	10,968	(111)	10,857
Finance fees	2,890	147	3,037
Project development expenditures	529	—	529
Income (loss) before income taxes and non-controlling interests	7,549	(258)	7,291
Income tax expense (recovery)	1,958	(7)	1,951
Income (loss) before non-controlling interests	5,591	(251)	5,340
Non-controlling interests	—	2	2
Net income (loss) and comprehensive income (loss)	5,591	(249)	5,342

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

As at and for the six months ended June 30, 2010

[\$ in thousands]	Gas Transmission and Distribution	Renewable Energy	Consolidated
Capital expenditures	2,561	—	2,561
Plant, property & equipment	176,837	15,404	192,241
Goodwill	—	2,875	2,875
Assets	207,469	19,884	227,353
Liabilities	121,034	11,790	132,824

19. COMPARATIVE FIGURES

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