

# DRIVING EFFICIENCY

CATALYST PAPER 2010 SECOND QUARTER REPORT  
for the three months ended June 30, 2010

# Q2

Catalyst



## COMPANY PROFILE

Catalyst Paper manufactures diverse specialty mechanical printing papers, newsprint and pulp. Its customers include retailers, publishers and commercial printers in North America, Latin America, the Pacific Rim and Europe. With five mills, located in British Columbia and Arizona, Catalyst has a combined annual production capacity of 2.5 million tonnes. Effective in September 2010, the Elk Falls mill will be permanently shut bringing annual capacity to 2.0 million tonnes. The company is headquartered in Richmond, British Columbia, Canada and its common shares trade on the Toronto Stock Exchange under the symbol CTL. Catalyst is listed on the Jantzi Social Index(R) and is ranked by Corporate Knights magazine as one of the 50 Best Corporate Citizens in Canada.

### Table of contents

---

01 PRESIDENT'S MESSAGE

04 MANAGEMENT'S DISCUSSION AND ANALYSIS

30 CONSOLIDATED FINANCIAL STATEMENTS

# PRESIDENT'S MESSAGE

Two major factors affected our second quarter results. First, a modest recovery in paper demand and pricing helped boost sales revenues and volumes. Second, we announced the permanent closure of two high cost operations.



## TO OUR SHAREHOLDERS

One-time closure costs for our Elk Falls and Paper Recycling Divisions of \$302.0 million – asset impairment charges being the lion's share – took a big bite out of our financial returns this quarter, but the resulting fixed cost savings will begin in Q3 with annualized savings of \$13 million expected in fiscal 2011.

Our post-quarter announcement that our Elk Falls and Paper Recycling operations will close sets the stage for a concentrated sales and product development focus around mills that still have the potential to compete. In the short-term, our priority is to strengthen the financial fundamentals of our company and what follows is a brief overview of the numbers and the market realities we are navigating through.

Catalyst Paper recorded a net loss for the quarter of \$368.4 million (\$0.96 per common share) on sales of \$299.4 million. This compares to a net loss of \$44.1 million (\$0.12 per common share) in the preceding quarter on sales of \$273.3 million, and a net loss of \$1.9 million (\$0.01 per common share) in Q2 of 2009 on sales of \$300.7 million.

A higher net loss was driven mostly by impairment, severance and other closure costs related to the Elk Falls and Paper Recycling Divisions.

Before specific items, our net loss was \$43.9 million (\$0.11 per common share) compared to \$37.6 million (\$0.10 per common share) in the preceding quarter and \$25.6 million (\$0.06 per common share) in Q2 of 2009. Specific items included a \$21.3 million after-tax foreign exchange loss on the translation of long-term debt.

EBITDA improved to negative \$0.4 million from negative \$16.2 million in the preceding quarter, and EBITDA before specific items was positive \$10.5 million compared to negative \$2.1 million. This reflected modest recovery in paper prices, substantial recovery in pulp prices, and higher sales volumes. Offsetting these factors were labour and other input costs and the higher Canadian dollar.

Paper markets recovered somewhat for both coated and uncoated mechanical grades. Combined with recent capacity shuts, this resulted in better industry operating rates. Demand for directory remained weak, while newsprint was flat. NBSK pulp markets continued to be tight in the quarter.

Market conditions supported our price increases across several specialty paper grades and these were partially to largely in place by quarter-end. Newsprint price increases were also implemented and a pulp price increase was fully implemented in the quarter.

Newsprint curtailment during the quarter was significant, at 52 per cent of total newsprint capacity. Conversely, market conditions supported the restart of the second line of pulp production at Crofton in late April.

On the financing and liquidity side, the private placement of US\$110 million of Class B, 11 per cent secured notes due December 15, 2016 closed during the quarter. After financing costs, this resulted in net proceeds of \$93.4 million and improved available liquidity. As of quarter-end, US\$35.5 million of 8.625 per cent senior notes due June 2011 were reclassified from long-term debt to current liabilities.

Property tax-related outcomes during the quarter were mixed. An agreement-in-principle with Powell River has the potential to deliver significant tax relief while reducing municipal service costs for the City. Meanwhile, the B.C. Court of Appeal dismissed our challenge of

North Cowichan's 2009 assessment and we are seeking leave to appeal that matter to the Supreme Court of Canada. We have also filed new petitions challenging North Cowichan's 2010 tax levy, and the regional district portion of Campbell River's 2010 tax bill. With the exception of North Cowichan, all 2010 municipal property tax bills have been paid in full, and we continue to actively seek solutions outside the courts.

Looking out to the latter half of 2010, we expect modest improvement in paper markets, including newsprint, with a seasonally stronger third quarter. We are heightening our focus on new products and marketing initiatives to ensure our sales offer is well-recognized and positioned effectively against a backdrop of evolving demand. On the pulp side, prices are expected to soften during the third quarter, and we will continue

to be challenged by a strong Canadian dollar and high input costs.

We are releasing our Q2 results near the 45-day mark of my tenure as CEO and I want to acknowledge and thank Denis Jean, a member of our Board, who stepped in as interim CEO prior to my arrival. Four new directors were appointed to the Board in the second quarter – Douglas Hayhurst, Alan Miller, Dallas Ross and Geoff Plant, Q.C. – while Gary Collins resigned.

On July 29th, the Company also announced the retirement of Chairman Michel Desbiens and the resignation of Amit Wadhwaney from the Board. Benjamin Duster IV, a director since 2006, was named the new chairman. On behalf of the Board, I extend our welcome to the newcomers and our thanks to Michel, Gary and Amit for service as directors during a period of extensive business restructuring.

Our intent as a leadership team is clear and that is to improve overall operating methods and costs for the balance of 2010 and into 2011. Needless to say, burning cash at the rate of the first half of this year is not sustainable and focused action plans are already underway to tackle ONP availability and costs, production quality, product development, pricing, and legacy information systems. The objective is simple – to significantly change our organization in order to steadily improve financial results.



**Kevin J. Clarke**

President and Chief Executive Officer  
July 29, 2010

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

### **TABLE OF CONTENTS**

1. Overview and Highlights	06
2. Segmented Results	12
3. Liquidity and Capital Resources	18
4. Related Party Transactions	20
5. Contingent Liabilities	21
6. Guarantees and Indemnities	21
7. Summary of Quarterly Results	22
8. Non-GAAP Measures	22
9. Critical Accounting Policies and Estimates	26
10. Changes in Accounting Policies	26
11. Impact of Accounting Pronouncements Affecting Future Periods	26
12. Risks and Uncertainties	27
13. Sensitivity Analysis	28
14. Outlook	28
15. Disclosure Controls and Internal Control Over Financial Reporting	29
<b>CONSOLIDATED FINANCIAL STATEMENTS</b>	<b>30</b>

# MANAGEMENT'S DISCUSSION AND ANALYSIS

---

The following management's discussion and analysis ("MD&A") of Catalyst Paper Corporation (the "Company", "we", "us", and "our") should be read in conjunction with our interim consolidated financial statements for the three-month and six-month periods ended June 30, 2010 and June 30, 2009, and our audited annual consolidated financial statements for the year ended December 31, 2009 and the notes thereto, which have been prepared in accordance with generally accepted accounting principles ("GAAP") in the United States ("U.S."). Information on the impact of Canadian GAAP on our interim consolidated earnings and consolidated balance sheets is presented in note 20, "Reconciliation of United States and Canadian Generally Accepted Accounting Principles" of our interim consolidated financial statements for the three-months and six-months ended June 30, 2010. Additional information about the Company, including our most recent Annual Information Form is available on our website at [www.catalystpaper.com](http://www.catalystpaper.com), or the Canadian Securities Administrator's electronic filing website at [www.sedar.com](http://www.sedar.com).

Throughout this discussion, references are made to certain measures that are not measures of performance under U.S. GAAP, including operating earnings, EBITDA, EBITDA before specific items, average delivered cash costs per tonne before specific items, net earnings (loss) attributable to the Company before specific items, net earnings (loss) per share attributable to the Company's common shareholders before specific items, and free cash flow. Management believes that these non-GAAP measures are useful in evaluating the performance of the Company and its business segments. These non-GAAP measures are defined and reconciled to their nearest GAAP measure in Section 8, "Non-GAAP Measures".

In this MD&A, unless otherwise indicated, all dollar amounts are expressed in Canadian dollars. The term "dollars" and the symbols "\$" and "CDN\$" refer to Canadian dollars and the term "U.S. dollars" and the symbol "US\$" refer to United States dollars.

In this MD&A, the term "tonne" and the symbol "MT" refer to a metric tonne and the term "ton" or the symbol "ST" refer to a short ton, a measure of weight equal to 0.9072 metric tonnes, and the symbol "Bdt" refers to bone dry tonnes. Use of these symbols is in accordance with industry practice.

The information in this report is as at July 29, 2010, which is the date of filing in conjunction with our press release announcing our results for the second quarter of 2010. Disclosure contained in this document is current to July 29, 2010, unless otherwise stated.

### Cautionary Statement Regarding Forward-looking Statements

This MD&A contains forward-looking statements including those under the headings “Strategy Update”, “Liquidity and Capital Resources”, “Contingent Liabilities”, “Risks and Uncertainties”, and “Outlook”. Forward-looking statements are statements that address or discuss activities, events or developments that we expect or anticipate may occur in the future, including statements relating to overall economic conditions, future cost savings, capital expenditures, demand for our products, product prices and advertising levels, production volumes, future cash flows and liquidity, currency rates, covenant compliance, severance obligations, strength of markets, availability of fibre, curtailment of operations, and the impact of labour disruptions affecting suppliers. These forward-looking statements can be identified by the use of statements that include words such as “believe”, “expect”, “anticipate”, “intend”, “plan”, “likely”, “predicts”, “estimates”, “forecasts”, and similar words or phrases or the negative of these statements. These forward-looking statements reflect our current views and are based on certain assumptions including assumptions as to future economic conditions and courses of action as well as other factors we believe are appropriate in the circumstances. Such forward-looking statements are subject to risks and uncertainties and no assurance can be given that any of the events anticipated by such statements will occur or, if they do occur, what benefit we will derive from them. A number of factors could cause actual results, performance or developments to differ materially from those expressed or implied by such forward-looking statements, including:

- the impact of general economic conditions in the United States, Canada and other countries in which we do business;
- market conditions and demand for our products and the outlook for inventories, production and pricing;
- declines in advertising and circulation;
- expected cash flows, capital expenditures and completion of capital projects;
- our ability and that of our agents to sell our products in export markets;
- the implementation of trade restrictions and sanctions in jurisdictions we market our products;
- business strategies and measures to implement strategies;
- our history of losses;
- the cyclical nature of our business;
- the effects of intense competition;
- competitive strengths, goals, expansion and growth of our business and operations;
- shifts in industry capacity;
- fluctuations in foreign exchange or interest rates;
- our ability to successfully obtain cost savings from our cost reduction initiatives;
- labour unrest;
- fluctuations in the availability and cost of raw materials, including fibre and energy;
- implementation of environmental legislation requiring capital for operational changes;
- the availability of qualified personnel or management;
- the outcome of certain litigation or disputes;
- conditions in the capital markets and our ability to obtain financing and refinance existing debt; and
- other factors beyond our control.

Additional information concerning these and other factors can be found in Section 12 of this MD&A under the heading “Risks and Uncertainties”. We disclaim any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law.

Investors are cautioned not to place undue reliance on these forward-looking statements. No forward-looking statement is a guarantee of future results.

# 1 OVERVIEW AND HIGHLIGHTS

## BUSINESS OVERVIEW

We are the largest producer of mechanical printing papers in western North America and we also produce NBSK pulp. Our business is comprised of three business segments: specialty printing papers, newsprint, and pulp. Specialty printing papers include lightweight coated, uncoated mechanical, and directory paper. We are the only producer of lightweight coated paper in western North America. We currently operate five pulp and paper mills, four of which are located in British Columbia in Crofton, Port Alberni, Powell River, and Campbell River ("Elk Falls") and a 100% recycled paper mill located in Snowflake, Arizona. On July 6, 2010, we announced the permanent closure of our Elk Falls mill to take effect in September 2010 which will remove 153,000 tonnes of specialty printing papers capacity and 373,000 tonnes of newsprint capacity on an annualized basis, as well as the permanent closure of our paper recycling facility in Coquitlam. Our combined annual production capacity will decrease from 2,507,000 tonnes to 1,981,000 tonnes of pulp and paper product. Additional information related to our business segments, product profile, production capacity by mill location and product line, and our geographic sales distribution is provided on pages 9 to 13 of our 2009 Annual Report. Our production capacity by mill and product line, reflecting the closure of our Elk Falls mill, is summarized in the following chart:

### Capacity by Mill Location and Product Line <sup>1</sup>

Mill location	Number of paper machines	Specialty printing papers <sup>1</sup>			Newsprint <sup>1</sup>	Pulp	Total
		Uncoated mechanical	Lightweight coated	Directory	Newsprint	NBSK pulp	
Crofton, B.C. <sup>2</sup>	3	-	-	183,000	234,000	403,000 <sup>3</sup>	820,000
Port Alberni, B.C.	2	-	231,000	112,000	-	-	343,000
Powell River, B.C.	3	368,000	-	-	104,000	-	472,000
Snowflake, Arizona	2	65,000	-	-	281,000	-	346,000
Total capacity (tonnes)		433,000	231,000	295,000	619,000	403,000	1,981,000
% of total capacity		22%	12%	15%	31%	20%	100%

<sup>1</sup> Capacities expressed in the above table can vary as the Company is able to switch production between products, particularly newsprint, directory and machine-finished uncoated grades.

<sup>2</sup> We have indefinitely curtailed the No. 1 paper machine at Crofton, removing the equivalent of 140,000 tonnes of newsprint production on an annualized basis. The capacity and number of machines noted in the above table have not been adjusted to reflect this indefinite curtailment.

<sup>3</sup> Total pulp capacity at Crofton is 403,000 tonnes, of which 343,000 tonnes are designated as market pulp with the remainder being consumed internally.

## SECOND QUARTER OVERVIEW

Our results for the second quarter were negatively affected by impairment, severances and other closure charges of \$302.0 million related to the Elk Falls mill and the Coquitlam paper recycling facility. Excluding these specific charges, our results improved modestly compared to the first quarter as a result of higher pulp production levels and improved pulp and paper prices in Q2. Compared to the same quarter of last year, our results continued to be adversely affected by the strength of the Canadian dollar, rising input costs and lower year-over-year paper prices.

### Financial Performance

The Company recorded a net loss attributable to the Company and a net loss attributable to the Company before specific items of \$368.4 million and \$43.9 million, respectively, in Q2 compared to \$44.1 million and \$37.6 million, respectively, in Q1. EBITDA and EBITDA before specific items were negative \$0.4 million and \$10.5 million, respectively, in Q2 compared to negative \$16.2 million and negative \$2.1 million in Q1.

## SELECTED FINANCIAL INFORMATION

(In millions of Canadian dollars, except where otherwise stated)	YTD	2010 Q2	Q1	TOTAL	Q4	2009 <sup>1</sup> Q3	Q2	Q1
Sales	\$ 572.7	\$ <b>299.4</b>	\$ 273.3	\$ 1,223.5	\$ 295.0	\$ 266.9	\$ 300.7	\$ 360.9
Operating earnings (loss)	(372.8)	<b>(323.9)</b>	(48.9)	(40.8)	(41.1)	(10.0)	(21.5)	31.8
EBITDA <sup>2</sup>	(16.6)	<b>(0.4)</b>	(16.2)	123.2	14.1	25.9	14.3	68.9
– before specific items <sup>2</sup>	8.4	<b>10.5</b>	(2.1)	141.1	15.5	25.9	26.6	73.1
Net earnings (loss) attributable to the Company	(412.5)	<b>(368.4)</b>	(44.1)	(4.4)	(35.8)	13.2	(1.9)	20.1
– before specific items <sup>2</sup>	(81.5)	<b>(43.9)</b>	(37.6)	(58.8)	(21.8)	(19.8)	(25.6)	8.4
EBITDA margin <sup>2</sup>	(2.9%)	<b>(0.1%)</b>	(5.9%)	10.1%	4.8%	9.7%	4.8%	19.1%
– before specific items <sup>2</sup>	1.5%	<b>3.5%</b>	(0.8%)	11.5%	5.3%	9.7%	8.8%	20.3%
Net earnings (loss) per share attributable to the Company's common shareholders (in dollars)								
– basic and diluted	\$ (1.08)	\$ <b>(0.96)</b>	\$ (0.12)	\$ (0.01)	\$ (0.09)	\$ 0.03	\$ (0.01)	\$ 0.06
– before specific items <sup>2</sup>	(0.21)	<b>(0.11)</b>	(0.10)	(0.15)	(0.06)	(0.05)	(0.06)	0.02
(In thousands of tonnes)								
Sales	788.7	<b>404.5</b>	384.2	1,494.9	395.7	346.4	358.9	393.9
Production	778.2	<b>403.0</b>	375.2	1,475.4	404.4	348.5	330.9	391.6

1 Refer to Section 10, "Changes in Accounting Policies" for a discussion of the change in our policy with respect to classification of gains and losses on certain of our derivative financial instruments and translation of foreign currency-denominated working capital balances effective January 1, 2010. Prior period comparative information has been restated.

2 Refer to Section 8, "Non-GAAP Measures."

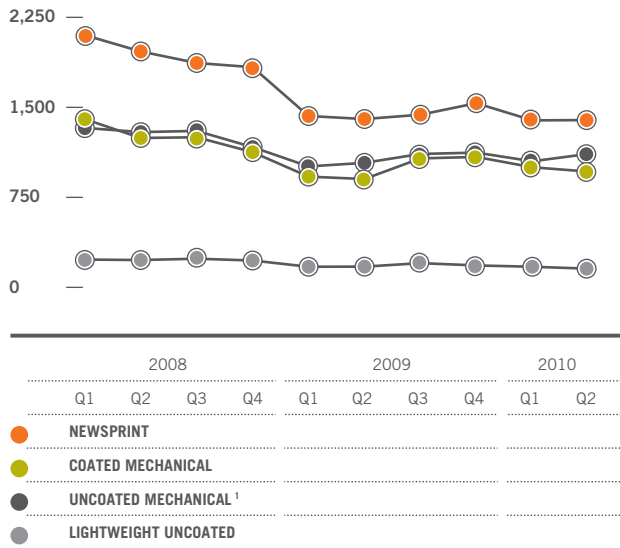
### Market Overview

North American demand for our coated and uncoated mechanical grades continued to recover compared to weak demand levels of a year ago. Demand for directory paper remained weak, while newsprint demand was flat for the quarter. Overall, market conditions improved for all paper grades due to stabilizing North American demand, strong export shipments, and relatively low inventory levels. Benchmark paper prices improved modestly for all of our grades other than directory grades where benchmark prices remained stable. Nevertheless, overall business conditions remained challenging, and high levels of newsprint production curtailment continued in Q2.

### North American Paper Demand

(In thousands of metric tonnes)

(Source: PPPC)



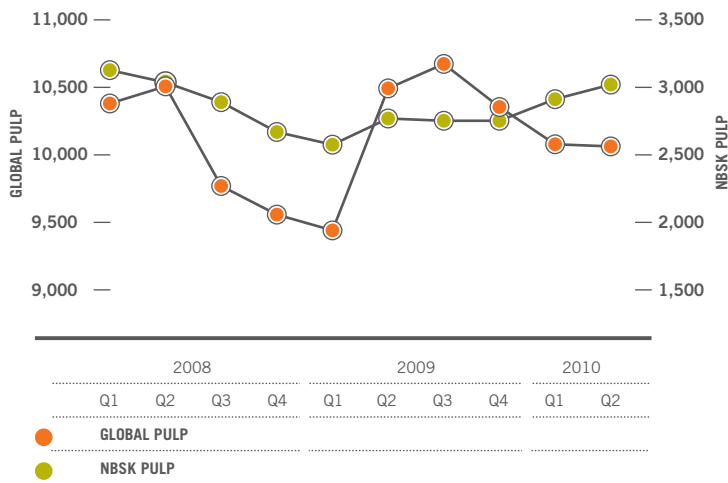
1 Uncoated mechanical is comprised of high-gloss and standard grades.

Led by strong demand from North America and Europe, NBSK pulp shipments increased quarter-over-quarter and year-over-year and inventories remained at relatively low levels. Global pulp shipments fell by 4.1% for the quarter compared to last year due in part to supply disruptions. Industry operating rates remained high in Q2, enabling us to bring our pulp operations back to full production capacity in late April. NBSK pulp benchmark prices continued to improve in Q2.

### Global and NBSK Pulp Shipments

(In thousands of metric tonnes)

(Source: PPPC)



## Production Curtailment

The Elk Falls paper machines and the No. 1 paper machine at Crofton remained indefinitely curtailed throughout the quarter.

### Q2 2010 Production Curtailment

(In thousands of tonnes)	Specialty printing papers	Newsprint	Market pulp	Total
Crofton	–	34.9	7.2	42.1
Elk Falls	38.0	93.1	–	131.1
Total	38.0	128.0	7.2	173.2
Curtailment as a % of capacity <sup>1</sup>	14%	52%	8%	28%

1 Total capacity includes Elk Falls mill capacity of 153,000 tonnes of specialty printing papers and 373,000 tonnes of newsprint on an annualized basis.

### Permanent Closure of the Elk Falls Mill and the Coquitlam Paper Recycling Facility

As a result of our announcement on July 6, 2010 related to the closure of the Elk Falls mill and the Coquitlam paper recycling facility, we recorded a \$302.0 million charge for impairment, severances, and other closure costs in Q2. The decision to close the Elk Falls mill was made in light of weak markets for commodity paper grades combined with uncompetitive manufacturing costs, including labour, municipal taxes, fibre, and other input costs. The charge was comprised of asset-impairment and closure costs of \$292.3 million and \$9.7 million in related severance costs associated with approximately 120 Elk Falls mill employees who will be impacted by the closure of this mill. The Coquitlam paper recycling facility was indefinitely idled in mid-February and the related severance costs for affected employees were recorded in Q1.

The fixed costs associated with continuing to maintain these sites while production has been fully curtailed were approximately \$11 million for the six-month period ended June 30, 2010. These closures are expected to deliver cost savings beginning in Q3. Annualized fixed cost savings of approximately \$13 million are expected in 2011, with the balance of the savings realized as we dispose of the assets at these facilities. Going forward, these closures will improve the viability of our business and will allow us to move forward with greater certainty in terms of our sales and product development strategies.

### Property Tax Dispute

We continue to pursue a fair and sustainable level of municipal property taxes for major industry in the B.C. communities in which we operate. Our actions both through the courts and through discussions with governments are summarized on pages 15 and 16 of our 2009 Annual Report. On April 22, 2010, the B.C. Court of Appeal dismissed our appeal of the 2009 property taxes assessed by the District of North Cowichan, declining to strike-down the North Cowichan by-law. We have filed for leave to appeal this decision to the Supreme Court of Canada. On June 7, 2010, we also filed a petition with the Supreme Court of B.C. with respect to the 2010 property taxes levied by the District of North Cowichan. All outstanding taxes, penalties and interest relating to 2009 property taxes have been paid.

On June 14, 2010, the Company filed a petition with the B.C. Supreme Court with respect to the Strathcona Regional District portion of the property taxes collected by the City of Campbell River for 2010. In December 2009, the Supreme Court of B.C. had ruled in favour of the Company for the 2009 Strathcona Regional District portion of the provincial property taxes, stating that these regional taxes were calculated incorrectly. Despite this ruling, the City of Campbell River calculated the 2010 regional taxes in the same manner as it had employed in 2009.

A total of \$19.2 million in municipal and provincial property taxes for 2010 was levied by the four B.C. municipalities where we have mills. On July 2, 2010, we paid the full amount of property taxes levied of \$12.8 million to three of the four B.C. municipalities. In North Cowichan, we were levied a total of \$6.4 million in municipal and provincial property taxes for 2010 of which we paid the full amount of the provincial taxes and \$1.5 million of the \$5.5 million in municipal property taxes, pending the outcome of legal proceedings. The amount of unpaid property taxes, together with the 10% penalty for late payment, was \$4.4 million as of July 29, 2010.

Our property tax expense and liability has been recorded based on the full amount of property taxes levied for 2010.

### Financing, Liquidity, and Capital Assets

On May 19, 2010, we closed the private placement of US\$110 million of Class B, 11% senior secured notes due December 15, 2016 at an offering price of 86% of the principal amount. Net proceeds of \$93.4 million, after issuance costs of approximately \$5 million, will be used for general corporate purposes.

### Appointment of President and Chief Executive Officer

Kevin J. Clarke was appointed President and Chief Executive Officer, effective June 21, 2010. Denis Jean, who held this position on an interim basis after the departure of Richard Garneau, continues as a member of the Board of directors. During the quarter, four new members were appointed to the Board of directors and one member resigned.

### STRATEGY UPDATE

Our objective is to return to profitability and maximize cash flows by focusing on reducing manufacturing costs and optimizing our brands and customer base. Additional information related to our corporate strategy, including key performance drivers and indicators, can be found on pages 20 to 23 of our 2009 Annual Report.

### 2010 Key Priorities

An update on our second quarter progress towards our 2010 key priorities follows:

#### Focus on cash flows and liquidity:

- Free cash flow was negative \$21.9 million, and liquidity increased by \$88.8 million largely due to net proceeds generated from the private placement of the Class B, 11% senior secured notes; and
- Expended \$2.8 million towards capital projects in Q2, in line with previously announced expectations for spending in 2010.

#### Match production to customer orders and keep inventories at appropriate levels:

- Returned our pulp production to full capacity given improved market conditions; and
- Continued to curtail newsprint production in response to the steady decline in demand over the last several years. Paper curtailment represented approximately 32% of capacity and paper finished goods inventory levels as at June 30, 2010 of 48,100 tonnes compared to 46,500 tonnes at March 31, 2010, and a quarterly average of 54,100 tonnes for 2009.

#### Develop higher-value grades at the B.C. mills and produce 100% recycled high-bright and directory grades at the Snowflake mill:

- Developed Electrabrite Book, our new book grade at our Powell River mill;
- Developed Electracote Brite, our new coated grade at our Port Alberni mill; and
- Developed Electrabrite Lite at our Snowflake mill, a 100% recycled and FSC certified grade, ideal for environmentally conscious retailers.

#### Implement initiatives to reduce fixed costs:

- Seeking leave to appeal to the Supreme Court of Canada in response to the B.C. Court of Appeal's dismissal of the North Cowichan 2009 property tax petition and filed a petition with the Supreme Court of B.C. with respect to the 2010 North Cowichan property taxes;
- Filed a petition with the B.C. Supreme Court related to the Strathcona Regional District portion of the City of Campbell River's 2010 property taxes;
- Mill fixed costs increased \$4.2 million compared to the prior quarter, due to higher power costs, increased maintenance and labour costs due to the restart of the second pulp production line at Crofton and a union contract wage increase effective May 2010; and
- Announced the permanent closure of our Elk Falls mill and Coquitlam paper recycling facility. Our priority will be to reduce the fixed costs associated with maintaining these sites starting in Q3.

#### Continue to implement plans to reduce labour costs to \$80 per tonne at all mills and develop more flexible and efficient work practices:

- Continued to address legacy costs and other issues with the local unions at each of our operating sites and to adjust manning and work practices at our mills to reduce manufacturing costs and gain competitiveness.

Improve the safety performance at all mills, with a target lost time incident (“LTI”) rate of 1.0 and medical injury rate (“MIR”) of 3.0:

- Continued to focus on workplace and work practice audits, although results were mixed: the LTI rate for Q2 deteriorated from 1.2 in Q1 to 1.8, while the MIR for Q2 improved from 5.7 in Q1 to 3.0.

## CONSOLIDATED RESULTS OF OPERATIONS

### Sales

#### Q2 2010 vs. Q1 2010

Sales increased by 9.5% primarily due to higher pulp sales volumes and prices, offset in part by a slightly stronger CDN\$ in Q2.

#### Q2 2010 vs. Q2 2009

Sales decreased by 0.4% due to a stronger CDN\$ and lower specialty printing paper prices in 2010, largely offset by higher pulp, coated and uncoated paper sales volumes, and higher pulp prices.

#### 2010 YTD vs. 2009 YTD

Sales decreased by 13.4% due to lower newsprint and directory sales volumes, lower paper prices, and a stronger CDN\$ in 2010, partially offset by higher pulp, coated and uncoated paper sales volumes and higher pulp prices in 2010.

### EBITDA Before Specific Items

The following table provides variances between periods for EBITDA and EBITDA before specific items:

(In millions of dollars)	Q1 2010	Q2 2009	2009 YTD
<b>EBITDA in comparative period<sup>1</sup></b>	<b>\$ (16.2)</b>	<b>\$ 14.3</b>	<b>\$ 83.2</b>
Specific items: restructuring costs	14.1	12.3	16.5
<b>EBITDA before specific items in comparative period<sup>1</sup></b>	<b>(2.1)</b>	<b>26.6</b>	<b>99.7</b>
Paper prices	5.1	(22.7)	(81.2)
Pulp prices	9.4	24.6	32.8
Impact of Canadian dollar on sales, inclusive of hedging <sup>2</sup>	(3.0)	(24.6)	(56.9)
Volume and mix	9.9	39.4	(2.9)
Furnish mix and costs	(4.6)	(24.0)	1.5
Other variable costs	1.7	(13.0)	5.2
Fixed costs	(4.6)	(2.0)	15.1
Selling, general and administrative costs	–	1.8	1.6
Lower of cost or market impact on inventory, net of inventory change	(1.5)	1.1	(4.6)
Other, net	0.2	3.3	(1.9)
<b>EBITDA before specific items in the current period<sup>1</sup></b>	<b>10.5</b>	<b>10.5</b>	<b>8.4</b>
Specific items: restructuring costs	(10.9)	(10.9)	(25.0)
<b>EBITDA in the current period<sup>1</sup></b>	<b>\$ (0.4)</b>	<b>\$ (0.4)</b>	<b>\$ (16.6)</b>

1 Refer to Section 8, “Non-GAAP Measures.”

2 Estimated total impact on EBITDA of average foreign exchange effective rate movement is negative \$3 million from Q1 2010 to Q2 2010, negative \$22 million from Q2 2009 to Q2 2010, and negative \$50 million from 2009 YTD to 2010 YTD.

### Operating Earnings (Loss)

#### Q2 2010 vs. Q1 2010

The operating loss increased by \$275.0 million due to the Q2 asset-impairment and closure costs of \$292.3 million, offset in part by higher EBITDA of \$15.8 million and lower depreciation and amortization of \$1.5 million in Q2.

**Q2 2010 vs. Q2 2009**

The operating loss increased by \$302.4 million due to the asset-impairment and closure costs of \$292.3 million in the current quarter and lower EBITDA of \$14.7 million, offset in part by reduced depreciation and amortization expense of \$4.6 million in the current quarter.

**2010 YTD vs. 2009 YTD**

The operating loss deteriorated by \$383.1 million due the asset-impairment and closure costs of \$292.3 million and lower EBITDA of \$99.8 million in the 2010 period, offset in part by reduced depreciation and amortization expense of \$9.0 million.

**Net Earnings (Loss) Attributable to the Company****Q2 2010 vs. Q1 2010**

Net loss attributable to the Company deteriorated by \$324.3 million primarily due to increased after-tax operating losses of \$288.9 million, an after-tax foreign exchange loss on the translation of long-term debt of \$21.3 million compared to an after-tax gain of \$11.7 million in Q1.

**Q2 2010 vs. Q2 2009**

Net loss attributable to the Company deteriorated by \$366.5 million, primarily due to increased after-tax operating losses of \$308.8 million, an after-tax foreign exchange loss on the translation of long-term debt of \$21.3 million compared to an after-tax gain of \$32.2 million in 2009.

**2010 YTD vs. 2009 YTD**

Net loss attributable to the Company deteriorated by \$430.7 million, primarily due to the decline in after-tax operating earnings of \$366.1 million, the absence of an after-tax gain on cancellation of long-term debt compared to an after-tax gain of \$26.1 million in 2009, and an after-tax loss on the translation of U.S. dollar denominated debt of \$9.6 million in 2010 compared to an after-tax gain of \$21.5 million in 2009.

## 2 SEGMENTED RESULTS

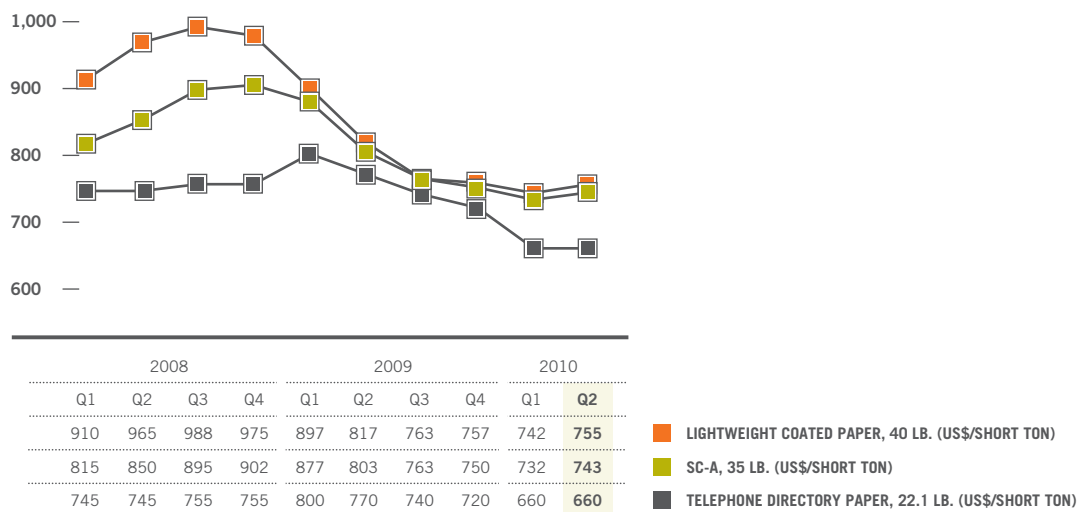
**SPECIALTY PRINTING PAPERS**

(In millions of Canadian dollars, except where otherwise stated)	Three months ended June 30			Six months ended June 30		
	2010	2009 <sup>1</sup>	Change	2010	2009 <sup>1</sup>	Change
Sales	\$ 165.1	\$ 206.7	\$ (41.6)	\$ 329.2	\$ 424.3	\$ (95.1)
Operating earnings (loss)	(120.1)	2.8	(122.9)	(140.4)	30.6	(171.0)
Depreciation and amortization	19.0	22.8	(3.8)	40.3	46.0	(5.7)
EBITDA <sup>2</sup>	2.2	25.6	(23.4)	3.2	76.6	(73.4)
– before specific items <sup>2</sup>	5.5	35.4	(29.9)	11.3	88.4	(77.1)
EBITDA margin <sup>2</sup>	1.3%	12.4%	(11.1%)	1.0%	18.1%	(17.1%)
– before specific items <sup>2</sup>	3.3%	17.1%	(13.8%)	3.4%	20.8%	(17.4%)
(In thousands of tonnes)						
Sales	208.9	215.6	(6.7)	415.1	424.6	(9.5)
Production	209.1	204.8	4.3	421.3	425.3	(4.0)

1 Refer to Section 10, "Changes in Accounting Policies" for a discussion of the change in our policy with respect to classification of gains and losses on certain of our derivative financial instruments and translation of foreign currency-denominated working capital balances effective January 1, 2010. Prior period comparative information has been restated.

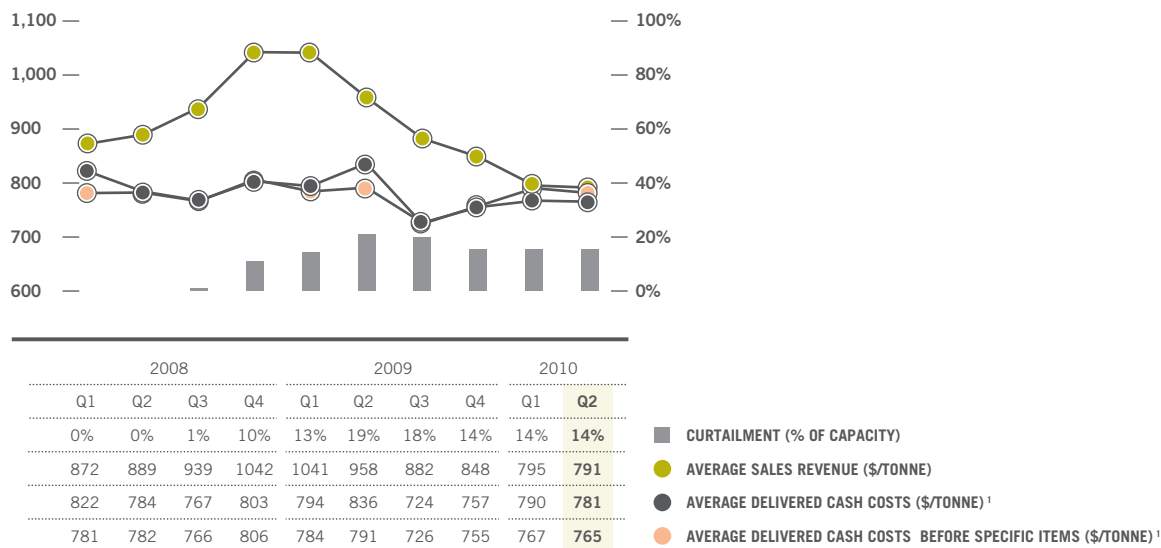
2 Refer to Section 8, "Non-GAAP Measures."

**Specialty Printing Papers Benchmark Price Trends**  
Average delivered to U.S. benchmark transaction price (US\$)  
(Source: RISI)



The following chart summarizes the operating performance of our specialty printing papers segment:

**Specialty Printing Papers Trends**



<sup>1</sup> Average delivered cash costs per tonne consist of cost of sales, excluding depreciation and amortization, and including the impact of SG&A, restructuring costs, and impairment. Average delivered cash costs per tonne before specific items consist of cost of sales, excluding depreciation and amortization, and including the impact of SG&A, but excluding the impact of restructuring costs and impairment.

## Segment Overview

North American demand for coated mechanical and high gloss paper grades declined marginally compared to the prior quarter but improved compared to the same quarter last year. Demand for standard grades increased substantially quarter-over-quarter and compared to the same quarter last year (refer to Section 1, "Overview and Highlights", for North American paper demand graph). These factors, combined with recent industry capacity shuts and relatively low mill and printer inventory levels caused industry operating rates to improve across coated, high-gloss, and standard uncoated grades. Benchmark prices for these grades improved modestly from lows reached at the end of Q1, although average prices quarter-over-quarter were relatively flat. Improved market conditions and unsustainably low prices were impetus for us to announce price increases for all grades. In addition to the price increases announced during Q1, we announced a US\$50 per short ton increase for ElectraStar and ElectraStar Max superbrite grades effective May 15, 2010, an increase of US\$40 per short ton for Electrabrite grades effective June 1, 2010, and a US\$60 per short ton price increase for uncoated soft calendered grades and lightweight coated grades effective June 2010. The announced price increases for uncoated mechanical high brights and super brights were largely implemented during the quarter, and the announced price increases for uncoated soft calendered and lightweight coated mechanical grades were partially implemented during Q2 as customers with existing pricing agreements will begin to pay higher prices in July 2010. We expect to continue to implement the price increases in Q3 as market conditions continue to improve.

Market conditions for directory paper remained challenging in Q2. Compared to the prior quarter, North American directory shipments and industry operating rates declined in Q2 and benchmark prices were unchanged. However, compared to the same quarter last year, industry operating rates improved, and this, combined with higher input costs and lower inventory levels in Q2 led us to announce a price increase of US\$70 per short ton for all directory grade sales not under contract, effective July 1, 2010.

## Operational Performance

### Q2 2010 vs. Q2 2009

- Sales volume decreased marginally mainly due to lower directory sales volumes.
- Average sales revenue decreased \$167 per tonne, reflecting lower average transaction prices and the negative impact of the stronger CDN\$.
- Average delivered cash costs decreased \$55 per tonne due to lower chemical, labour, salary, and restructuring costs, offset in part by higher distribution, furnish, power, and steam fuel costs.

### 2010 YTD vs. 2009 YTD

- Sales volume decreased marginally due to lower directory sales volumes and a full period of production curtailment related to the Elk Falls No. 2 paper machine compared to production curtailment from February 23, 2009 in the 2009 period.
- Average sales revenue decreased \$206 per tonne, reflecting lower average transaction prices and the negative impact of the stronger CDN\$.
- Average delivered cash costs decreased \$30 per tonne due to lower chemical, steam fuel, labour, salary, maintenance, and restructuring costs, offset in part by higher distribution, furnish, and power costs.

## NEWSPRINT

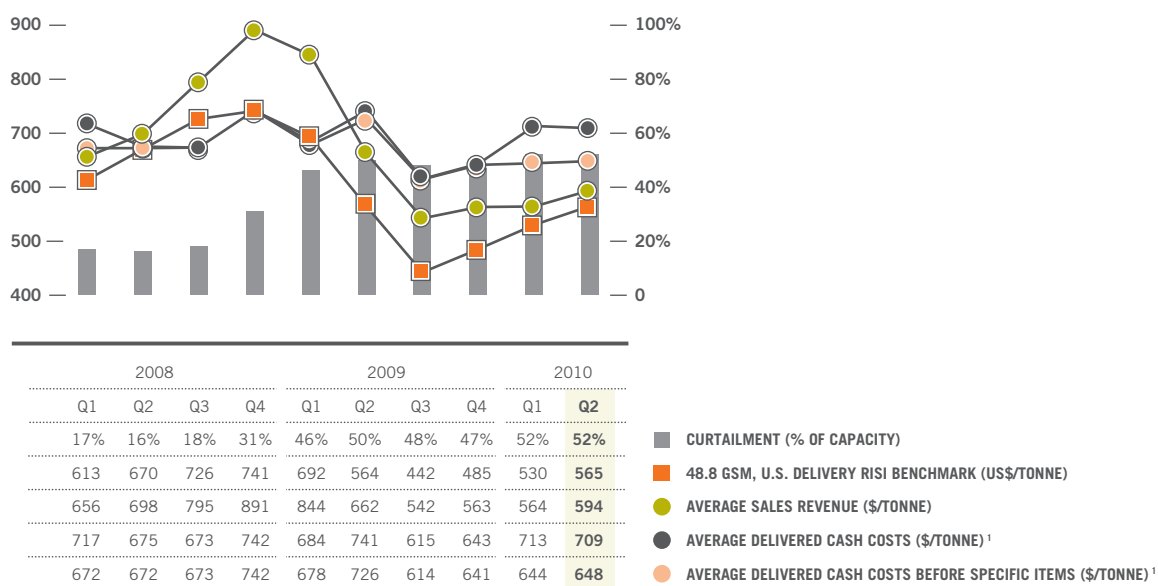
(In millions of Canadian dollars, except where otherwise stated)	Three months ended June 30			Six months ended June 30		
	2010	2009 <sup>1</sup>	Change	2010	2009 <sup>1</sup>	Change
Sales	\$ 73.1	\$ 86.8	\$ (13.7)	\$ 142.6	\$ 192.5	\$ (49.9)
Operating earnings (loss)	(211.8)	(22.4)	(189.4)	(238.1)	(13.8)	(224.3)
Depreciation and amortization	8.6	11.9	(3.3)	16.7	23.3	(6.6)
EBITDA <sup>2</sup>	(14.2)	(10.5)	(3.7)	(32.4)	9.5	(41.9)
– before specific items <sup>2</sup>	(6.7)	(8.6)	1.9	(16.4)	12.1	(28.5)
EBITDA margin <sup>2</sup>	(19.4%)	(12.1%)	(7.3%)	(22.7%)	4.9%	(27.7%)
– before specific items <sup>2</sup>	(9.2%)	(9.9%)	0.7%	(11.5%)	6.3%	(17.8%)
(In thousands of tonnes)						
Sales	123.1	131.0	(7.9)	246.2	256.4	(10.2)
Production	124.5	126.1	(1.6)	238.2	258.6	(20.4)

1 Refer to Section 10, "Changes in Accounting Policies" for a discussion of the change in our policy with respect to classification of gains and losses on certain of our derivative financial instruments and translation of foreign currency-denominated working capital balances effective January 1, 2010. Prior period comparative information has been restated.

2 Refer to Section 8, "Non-GAAP Measures."

The following chart summarizes the operating performance of our newsprint segment:

### Newsprint Trends



1 Average delivered cash costs per tonne consist of cost of sales, excluding depreciation and amortization, and including the impact of SG&A, restructuring costs, and impairment. Average delivered cash costs per tonne before specific items consist of cost of sales, excluding depreciation and amortization, and including the impact of SG&A, but excluding the impact of restructuring costs and impairment.

## Segment Overview

U.S. newsprint consumption continued to decline year-over-year in Q2, although the decline was not as pronounced as in prior quarters. Canadian demand increased year-over-year, partly offsetting the decline in U.S. demand. Exports remained very strong during the quarter. Furthermore, the combined effects of newsprint capacity closures as well as declining mill and U.S. consumer inventories, resulted in higher industry operating rates. Newsprint benchmark prices increased in Q2. We continued to implement our previously announced price increases during Q2, and expect to realize more of the US\$25 per tonne price increases for each of the months of May and June for U.S. shipments in Q3.

## Operational Performance

### Q2 2010 vs. Q2 2009

- Sales volume decreased due to higher curtailment in the current quarter and a shift to uncoated mechanical grades in the current quarter.
- Average sales revenue decreased \$68 per tonne due to lower transaction prices and the negative impact of the stronger CDN\$.
- Average delivered cash costs decreased \$32 per tonne due to lower chemical, labour, salary and other fixed costs, as well as the positive effect of the year-over-year write-down of raw materials inventory, offset in part by higher restructuring, furnish, energy and other variable supplies and materials costs.

### 2010 YTD vs. 2009 YTD

- Sales volume decreased due to higher production curtailment related to Crofton No. 1 and Elk Falls No. 5 paper machines in 2010 and a shift to uncoated mechanical grades in the 2010 period.
- Average sales revenue decreased \$172 per tonne due to lower transaction prices and the negative impact of the stronger CDN\$.
- Average delivered cash costs decreased \$2 per tonne due to savings achieved through continued emphasis on fixed cost reductions.

## PULP

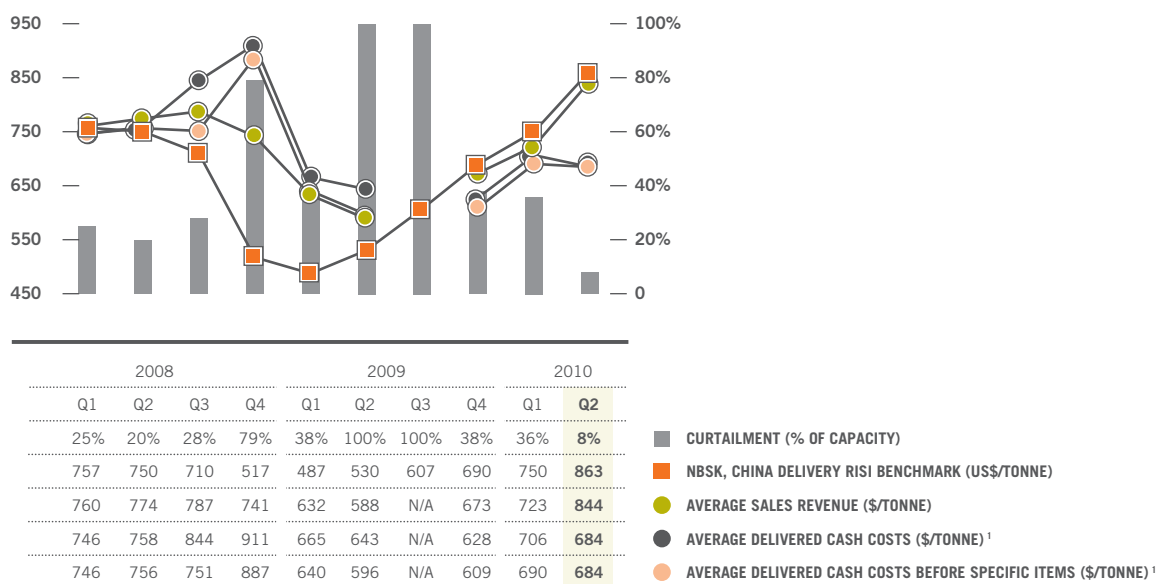
(In millions of Canadian dollars, except where otherwise stated)	Three months ended June 30			Six months ended June 30		
	2010	2009 <sup>1</sup>	Change	2010	2009 <sup>1</sup>	Change
Sales	\$ 61.2	\$ 7.2	\$ 54.0	\$ 100.9	\$ 44.8	\$ 56.1
Operating earnings (loss)	8.0	(1.9)	9.9	5.7	(6.5)	12.2
Depreciation and amortization	3.6	1.1	2.5	6.9	3.6	3.3
EBITDA <sup>2</sup>	11.6	(0.8)	12.4	12.6	(2.9)	15.5
– before specific items <sup>2</sup>	11.7	(0.2)	11.9	13.5	(0.8)	14.3
EBITDA margin <sup>2</sup>	19.0%	(11.1%)	30.1%	12.5%	(6.5%)	19.0%
– before specific items <sup>2</sup>	19.1%	(2.8%)	21.9%	13.4%	(1.8%)	15.2%
(In thousands of tonnes)						
Sales	72.5	12.3	60.2	127.4	71.8	55.6
Production	69.4	–	69.4	118.7	38.6	80.1

1 Refer to Section 10, "Changes in Accounting Policies" for a discussion of the change in our policy with respect to classification of gains and losses on certain of our derivative financial instruments and translation of foreign currency-denominated working capital balances effective January 1, 2010. Prior period comparative information has been restated.

2 Refer to Section 8, "Non-GAAP Measures."

The following chart summarizes the operating performance of our pulp segment:

### Pulp Trends



1 Average delivered cash costs per tonne consist of cost of sales, excluding depreciation and amortization, and including the impact of SG&A, restructuring costs, and impairment. Average delivered cash costs per tonne before specific items consist of cost of sales, excluding depreciation and amortization, and including the impact of SG&A, but excluding the impact of restructuring costs and impairment.

### Segment Overview

NBSK pulp markets were tight in Q2, as the supply interruptions that occurred in the first quarter, most notably those stemming from the Chilean earthquake, kept inventories low and operating rates high despite the downward trend in pulp shipments to China. Benchmark prices improved steadily quarter-over-quarter and improved significantly compared to the same quarter of 2009. Pulp price increases announced for Q1 and the US\$90 per tonne increase announced for April 2010 were fully implemented by the end of the quarter. We restarted the second line of Crofton pulp production in late April, reinstating 181,000 tonnes of market and internal production on an annualized basis. During the quarter, we incurred an additional \$2.7 million in maintenance costs related to the restart of this pulp line, compared to \$2.3 million in Q1.

### Operational Performance

#### Q2 2010 vs. Q2 2009

- Sales volume increased significantly in Q2 due to lower production curtailment in the current quarter.
- Average sales revenue increased by \$256 per tonne due to higher average transaction prices, offset in part by the negative effect of a stronger CDN\$.
- Average delivered cash costs period-over-period are not comparable as there was no production in Q2 2009. The average delivered cash costs for the comparative quarter reflect the costs of sales from opening inventory, and costs that are distorted by the impact of write-downs of raw materials inventory.

**2010 YTD vs. 2009 YTD**

- Sales volume increased significantly due to lower levels of curtailment in the 2010 period.
- Average sales revenue increased by \$168 per tonne due to higher average transaction prices, and lower sales allowances, offset in part by the negative effect of a stronger CDN\$.
- Average delivered cash costs period-over-period are not comparable as there was no production in Q2 2009. The average delivered cash costs for the comparative year-to-date period are distorted by the impact of write-downs of raw materials inventory.

## 3 LIQUIDITY AND CAPITAL RESOURCES

### SELECTED FINANCIAL INFORMATION

(In millions of Canadian dollars, except where otherwise stated)	Three months ended June 30			Six months ended June 30		
	2010	2009	Change	2010	2009	Change
Cash flows provided (used) by operations before changes in non cash working capital	\$ (20.5)	\$ (1.7)	\$ (18.8)	\$ (55.0)	\$ 37.1	\$ (92.1)
Changes in non-cash working capital	(4.4)	69.9	(74.3)	0.3	53.2	(52.9)
Cash flows provided (used) by						
Operations	(24.9)	68.2	(93.1)	(54.7)	90.3	(145.0)
Investing activities	(1.8)	0.9	(2.7)	1.6	(0.8)	2.4
Financing activities	68.8	(33.5)	102.3	70.8	(52.9)	123.7
Capital spending	2.8	2.2	0.6	6.0	5.8	0.2
Depreciation and amortization	31.2	35.8	(4.6)	63.9	72.9	(9.0)
Impairment and other closure costs	292.3	–	292.3	292.3	–	292.3
Net debt to net capitalization at June 30	65%	48%	17%	65%	48%	17%

Refer to page 43 of our 2009 Annual Report for a discussion of the nature and sources of funding for our principal cash requirements.

### OPERATING ACTIVITIES

Cash flows from operating activities in the current quarter declined compared to the same quarter last year, primarily due to a reduction in EBITDA and an increase in working capital requirements in Q2 driven by higher operating rates in the current quarter. These effects were offset in part by reduced interest payments in 2010 stemming from a \$7.0 million interest payment normally due in June that was made in March.

### INVESTING ACTIVITIES

Cash used by investing activities increased compared to the same quarter last year. Capital spending in Q2 related primarily to maintenance of business compared to spending primarily for the TMP upgrade at Port Alberni which was completed during 2009.

### FINANCING ACTIVITIES

Cash provided by financing activities in Q2 increased compared to the same quarter last year, primarily due to the issuance of the new Class B, 11% senior secured notes for net proceeds of \$93.4 million, as well as the decrease in quarter-over-quarter repayments on the ABL Facility in Q2.

## CAPITAL RESOURCES

Availability on the ABL Facility and total liquidity is summarized in the following table:

(In millions of Canadian dollars)	2010			2009		
	Q2	Q1	Q4	Q3	Q2	Q1
Borrowing base	\$ 167.8	\$ 144.8	\$ 147.9	\$ 151.5	\$ 159.4	\$ 241.5
Letters of credit	(25.3)	(24.0)	(24.1)	(24.2)	(24.8)	(25.8)
Amount drawn	–	(25.0)	(14.5)	(25.0)	–	(38.8)
Minimum excess availability	(35.0)	(35.0)	(35.0)	(35.0)	(35.0)	(35.0)
Available to be drawn <sup>1</sup>	107.5	60.8	74.3	67.3	99.6	141.9
Cash on hand	100.8	58.7	83.1	90.6	41.6	6.0
Total liquidity	\$ 208.3	\$ 119.5	\$ 157.4	\$ 157.9	\$ 141.2	\$ 147.9

1 The Company's ABL Facility is subject to certain financial covenants as disclosed in our interim consolidated financial statements for the three and six months ended June 30, 2010 in note 9, "Long-term debt."

Compared to the same quarter last year, the Company's available liquidity increased by \$67.1 million. The increase is primarily due to \$93.4 million in net proceeds received from the new bond issue. Availability under the ABL Facility is determined by a borrowing base, calculated primarily on balances of eligible accounts receivable and inventory balances less certain reserves, including the covenant to maintain excess availability above \$35.0 million. For additional information related to Excess Availability refer to our interim consolidated financial statements for the three and six months ended June 30, 2010, in note 9 "Long-term debt."

At July 29, 2010, the Company had 381,753,490 common shares issued and outstanding. At July 29, 2010, the Company also had 2,188,074 stock options outstanding, exercisable for 2,188,074 common shares of the Company.

## DEBT

On May 19, 2010, we completed the private placement of US\$110 million in aggregate principal amount of Class B, 11% senior secured notes due December 15, 2016 at an offering price of 86% of the principal amount, generating net proceeds of \$93.4 million, after expenses of approximately \$5 million. We intend to use the proceeds for general corporate purposes.

At June 30, 2010, US\$35.5 million of 8.625% senior notes due June 2011 was reclassified from long-term debt to current liabilities. The ABL Facility contains a covenant requiring that a refinancing of our 2011 Notes be completed on or before March 15, 2011. This covenant will be satisfied if, by March 15, 2011, the aggregate outstanding debt owing under the 2011 Notes does not exceed US\$17.7 million.

At June 30, 2010, the Company was in compliance with the covenants under both our ABL Facility and senior notes. For details on covenant compliance, refer to our interim consolidated financial statements for the three and six months ended June 30, 2010 note 9, "Long-term debt."

## CREDIT RATING

On May 19, 2010, Standard & Poor's assigned its issue-level and recovery ratings to the Company's newly-issued US\$110 million Class B, 11% senior secured notes due December 2016. Standard & Poor's issue rating for these notes of CCC+ is consistent with their long-term corporate credit rating for the Company. Standard & Poor's assigned these notes a recovery rating of '4' indicating average recovery in the event of default. At the same time, Standard & Poor's revised their outlook on the Company to stable from negative.

Moody Investors Service assigned the same issue-level rating to the Class B, 11% senior secured notes due December 2016 as it assigned to the 11% senior secured notes issued on March 10, 2010.

## FINANCIAL INSTRUMENTS

Financial instruments of the Company consist primarily of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities, long-term debt, and derivatives. Derivatives are used to reduce exposure to currency and price risk associated with revenues, energy costs and debt. For a description of the nature and extent of risk to the Company from our financial instruments, as well as our respective accounting treatment of financial instruments, refer to our consolidated financial statements for the year ended December 31, 2009, note 26, "Financial instruments", and in section 10, "Changes in Accounting Policies." For the methods and assumptions we use to determine fair value of financial instruments, refer to note 25, "Fair value measurement" of those statements. Our methods and assumptions for determining fair value of financial instruments have not changed materially since those used in the preparation of our consolidated financial statements for the year ended December 31, 2009.

### Revenue Risk Management Instruments

At June 30, 2010, we had foreign currency options and forward contracts with a notional principal of US\$346 million with major financial institutions. At June 30, 2010 period-end exchange rates, these instruments were reported at their fair value of \$5.4 million. Effective April 1, 2010, we no longer designate our U.S. dollar revenue risk management instruments as cash flow hedges for accounting purposes. For cash flow hedges that were in place as at March 31, 2010, the effective portion of changes in the fair value accumulated as at March 31, 2010 have been deferred and recorded in "Accumulated other comprehensive income (loss)". When the hedge item is recorded in earnings, the corresponding gain or loss on the hedge will be reclassified with "Accumulated other comprehensive income (loss)" to "Sales".

The following table is a summary of our revenue risk management instruments outstanding at June 30, 2010 and related sensitivities to a US\$0.05 change in the U.S. dollar relative to the Canadian dollar:

(In millions of dollars)	Notional principal amount (US\$)	Mark-to-market				
		June 30, 2010		Sensitivity to US\$0.05 change		
		US\$/CDN\$	0.94	1.00	0.95	0.90
		CDN\$/US\$	1.06	1.00	1.05	1.11
<b>2010</b>						
Q3	\$ 112	\$ 2.6	\$ 7.3	\$ 3.3	\$ (0.4)	
Q4	94	1.1	5.2	1.9	(1.6)	
<b>2011</b>						
Q1	51	0.7	2.8	1.1	(0.6)	
Q2	37	0.6	2.1	0.8	(0.4)	
Thereafter	52	0.4	2.5	0.8	(1.0)	
	\$ 346	\$ 5.4	\$ 19.9	\$ 7.9	\$ (4.0)	

### Cost Risk Management Instruments

At June 30, 2010, we were party to agreements to fix the purchase price of approximately 1.1 million gigajoules of natural gas, representing approximately 47% of our annual natural gas exposure. These instruments were reported at their fair value, which was \$0.3 million at June 30, 2010.

## 4 RELATED PARTY TRANSACTIONS

A description of our related parties can be found on page 48 of our 2009 Annual Report. We had no significant related party transactions to report in Q2.

## 5 CONTINGENT LIABILITIES

The Company's contingent liabilities at December 31, 2009 are described on pages 49 and 50 of our 2009 Annual Report and included contingent liabilities for severance payments, a claim for return of payments made to Quebecor World (USA), and claims for certain post-retirement benefits for certain retired employees. An update to these contingencies follows:

### Severances

The decision to permanently close the Elk Falls mill during the quarter resulted in the Company recording \$9.7 million in severances for approximately 120 employees who are expected to be impacted. The recording of this liability has eliminated the contingent severance obligation with respect to these employees.

With the restart of the second line of pulp production at Crofton, Crofton employees who were on lay-offs as at December 31, 2009 have been recalled. This action has eliminated the contingent severance obligation with respect to these employees.

As a result of restructuring and other initiatives announced in prior quarters, as of June 30, 2010, there were approximately 60 hourly employees at the Powell River and Port Alberni mills that were on lay-offs and have rights of recall ranging from 13 to 24 months. These employees may at any time forfeit their rights of recall in exchange for severance payments. If all affected employees exercise their severance rights at some point and thereby forfeit their recall rights, the total severance payment would be approximately \$3 million. We did not record a liability for this contingency as at June 30, 2010 as the likelihood, timing, and extent of any potential liability were not determinable.

### Application to Labour Relations Board Regarding Certain Post-Retirement Benefits

The CEP Locals 1, 76, 592 and 686 (the "Locals"), representing hourly employees at the Company's Powell River and Port Alberni mills, have applied to the Labour Relations Board of B.C. for a declaration that the Company is responsible for certain post-retirement medical and extended health benefits for some retired employees who were represented by the Locals and who retired from MacMillan Bloedel Limited, now doing business as Weyerhaeuser Company Ltd. The Labour Relations Board declined to rule on the Locals' application or the Company's defence to the claim on the basis that this matter is a dispute under the collective agreement and accordingly a matter to be determined by arbitration. At this point, Locals 1, 76 and 592 have filed grievances. The grievance proceeding for Local 76 is expected to take place in December 2010. The other two proceedings have not been scheduled. The extent of the Company's liability for this claim remains unknown at this time although the Company estimates that it would incur costs of between \$2 million and \$4 million annually to provide these additional benefits.

### Short-term Incentive Plan and Benefit Claim

In May 2010, a salaried employee of the Company commenced an action against the Company in the Supreme Court of B.C. seeking a payment under the Company's 2009 Short-term Incentive Plan and damages in connection with the reduction of certain employee benefits. The employee is proposing to seek certification of the action as a class proceeding on behalf of all salaried employees entitled to Short-term Incentive Plan payments and who were affected by the benefit reduction. We dispute the claims made and intend to vigorously defend this action and any certification proceedings which may be brought. Given the early stage of these proceedings it is not possible to determine the likelihood, timing and extent of any potential liability. As such, we did not record a liability for this contingency as at June 30, 2010.

For additional information, refer to our interim consolidated financial statements for the three and six months ended June 30, 2010 note 19, "Contingent liabilities."

## 6 GUARANTEES AND INDEMNITIES

We provided certain indemnities with regard to several business dispositions covering potential environmental, tax and employment liabilities. A description of these indemnities and guarantees and their impact on our results of operations and financial position for the year ended December 31, 2009 can be found on pages 50 and 51 of our 2009 Annual Report. These have not changed materially since December 31, 2009.

## 7 SUMMARY OF QUARTERLY RESULTS

The following table highlights selected financial information for the eight consecutive quarters ending June 30, 2010:

(In millions of dollars, except per share amounts)	2010			2009 <sup>1</sup>			2008 <sup>1</sup>	
	Q2	Q1	Q4	Q3	Q2	Q1	Q4	Q3
Sales	\$ 299.4	\$ 273.3	\$ 295.0	\$ 266.9	\$ 300.7	\$ 360.9	\$ 499.9	\$ 511.1
EBITDA <sup>2</sup>	(0.4)	(16.2)	14.1	25.9	14.3	68.9	73.1	60.6
Net earnings (loss) attributable to the Company	(368.4)	(44.1)	(35.8)	13.2	(1.9)	20.1	(48.5)	(10.9)
Net earnings (loss) per share attributable to the Company's common shareholders								
– basic and diluted	\$ (0.96)	\$ (0.12)	\$ (0.09)	\$ 0.03	\$ (0.01)	\$ 0.06	\$ (0.13)	\$ (0.03)

1 Refer to Section 10, "Changes in Accounting Policies" for a discussion of the change in our policy with respect to classification of gains and losses on certain of our derivative financial instruments and translation of foreign currency-denominated working capital balances effective January 1, 2010. Prior period comparative information has been restated.

2 Refer to Section 8, "Non-GAAP Measures."

For summary financial information about Powell River Energy Inc., a variable interest entity for which we are the primary beneficiary, refer to note 4, "Variable interest entities," of our interim consolidated financial statements for the three and six months ended June 30, 2010.

The following table reconciles the average spot exchange rate to the Company's effective exchange rate for the eight consecutive quarters ending June 30, 2010:

US\$/CDN\$ foreign exchange	2010			2009 <sup>1</sup>			2008 <sup>1</sup>	
	Q2	Q1	Q4	Q3	Q2	Q1	Q4	Q3
Average spot rate	0.973	0.961	0.947	0.911	0.855	0.803	0.825	0.961
(Favourable)/unfavourable impact of hedging*	(0.024)	(0.023)	(0.013)	(0.005)	0.005	0.029	0.028	(0.003)
Average effective rate	0.949	0.938	0.934	0.906	0.860	0.832	0.853	0.958
* Impact of effective portion of hedging (in millions of dollars)	\$ 5.2	\$ 4.9	\$ 2.7	\$ 1.3	\$ (1.2)	\$ (9.7)	\$ (13.4)	\$ 0.8

1 Refer to Section 10, "Changes in Accounting Policies" for a discussion of the change in our policy with respect to classification of gains and losses on certain of our derivative financial instruments and translation of foreign currency-denominated working capital balances effective January 1, 2010. Prior period comparative information has been restated.

## 8 NON-GAAP MEASURES

Management uses certain measures that are not defined by U.S. GAAP to evaluate the performance of the Company, and as a result, the measures as employed by management may not be comparable to similarly titled measures reported by other entities. These non-GAAP measures should not be considered by an investor as an alternative to their nearest respective GAAP measure. The Company's non-GAAP measures include operating earnings (loss), EBITDA (earnings before interest, taxes, depreciation and amortization, impairment and other closure costs, and before other non-operating income

and expenses), EBITDA before specific items, EBITDA margin, EBITDA margin before specific items, average delivered cash costs per tonne before specific items, net earnings (loss) attributable to the Company before specific items, net earnings (loss) per share attributable to the Company's common shareholders before specific items, and free cash flow.

Specific items are items of an unusual or non-recurring nature, or items that are subject to material volatility based on factors outside of management's control. Specific items include: foreign exchange gain or loss on long-term debt, gain on cancellation of long-term debt, asset-impairment and other closure costs, restructuring costs, and certain income tax adjustments.

Refer to the tables below for reconciliations of our non-GAAP measures to their nearest GAAP measure:

### EBITDA AND EBITDA BEFORE SPECIFIC ITEMS

EBITDA as defined equates to operating earnings (loss) plus depreciation and amortization and impairment and other closure costs. EBITDA margin and EBITDA margin before specific items are defined as EBITDA and EBITDA before specific items as a percentage of sales. These measures enable comparison of consolidated and segment operating results between periods without regard to debt service, income taxes, capital expenditure requirements, and specific items.

#### Reconciliation to Net Earnings (Loss) Attributable to the Company:

(In millions of Canadian dollars)	YTD	2010 Q2	Q1	Total	Q4	2009 <sup>1</sup> Q3	Q2	Q1
Net earnings (loss) attributable to the Company	\$ (412.5)	\$ (368.4)	\$ (44.1)	\$ (4.4)	\$ (35.8)	\$ 13.2	\$ (1.9)	\$ 20.1
Net earnings (loss) attributable to non-controlling interest	(0.3)	0.3	(0.6)	(1.2)	0.7	(0.9)	(1.1)	0.1
Net earnings (loss)	(412.8)	(368.1)	(44.7)	(5.6)	(35.1)	12.3	(3.0)	20.2
Depreciation and amortization	63.9	31.2	32.7	146.6	37.8	35.9	35.8	37.1
Impairment	292.3	292.3	–	17.4	17.4	–	–	–
(Gain) loss on cancellation of long-term debt	–	–	–	(30.7)	–	–	–	(30.7)
Foreign exchange (gain) loss on long-term debt	7.7	21.3	(13.6)	(75.3)	(11.1)	(38.9)	(37.9)	12.6
Other expense, net	8.4	4.9	3.5	29.1	4.3	5.7	12.0	7.1
Interest expense, net	34.8	18.0	16.8	69.3	16.6	16.5	16.3	19.9
Income tax expense (recovery)	(10.9)	–	(10.9)	(27.6)	(15.8)	(5.6)	(8.9)	2.7
EBITDA	(16.6)	(0.4)	(16.2)	123.2	14.1	25.9	14.3	68.9
Specific items:								
Restructuring costs								
Specialty printing papers	\$ 8.1	\$ 3.3	\$ 4.8	\$ 11.7	\$ 0.4	\$ (0.5)	\$ 9.8	\$ 2.0
Newsprint	16.0	7.5	8.5	3.0	0.2	0.2	1.9	0.7
Pulp	0.9	0.1	0.8	3.2	0.8	0.3	0.6	1.5
Total specific items	25.0	10.9	14.1	17.9	1.4	–	12.3	4.2
EBITDA before specific items	\$ 8.4	\$ 10.5	\$ (2.1)	\$ 141.1	\$ 15.5	\$ 25.9	\$ 26.6	\$ 73.1

1 Refer to Section 10, "Changes in Accounting Policies" for a discussion of the change in our policy with respect to classification of gains and losses on certain of our derivative financial instruments and translation of foreign currency-denominated working capital balances effective January 1, 2010. Prior period comparative information has been restated.

## NET EARNINGS (LOSS) ATTRIBUTABLE TO THE COMPANY BEFORE SPECIFIC ITEMS

Specific items are defined above, and the exclusion of such items from net earnings (loss) attributable to the Company facilitates the comparison of financial results between periods.

### Reconciliation to Net Earnings (Loss) Attributable to the Company:

(In millions of Canadian dollars and after-taxes, except where otherwise stated)	YTD	2010 Q2	Q1	Total	Q4	2009 <sup>1</sup> Q3	Q2	Q1
Net earnings (loss) attributable to the Company	\$ (412.5)	\$ (368.4)	\$ (44.1)	\$ (4.4)	\$ (35.8)	\$ 13.2	\$ (1.9)	\$ 20.1
Specific items:								
(Gain) loss on cancellation of long-term debt	—	—	—	(26.1)	—	—	—	(26.1)
Foreign exchange loss (gain) on long-term debt	9.6	21.3	(11.7)	(64.0)	(9.5)	(33.0)	(32.2)	10.7
Impairment and loss on disposal	292.3	292.3	—	13.1	13.1	—	—	—
Restructuring costs	21.0	10.9	10.1	12.5	1.0	—	8.5	3.0
Notes exchange costs	5.9	—	5.9	1.5	1.5	—	—	—
Income tax adjustments	2.2	—	2.2	8.6	7.9	—	—	0.7
Net earnings (loss) attributable to the Company before specific items	\$ (81.5)	\$ (43.9)	\$ (37.6)	\$ (58.8)	\$ (21.8)	\$ (19.8)	\$ (25.6)	\$ 8.4
Net earnings (loss) per share attributable to the Company's common shareholders in dollars:								
As reported	\$ (1.08)	\$ (0.96)	\$ (0.12)	\$ (0.01)	\$ (0.09)	\$ 0.03	\$ (0.01)	\$ 0.06
Before specific items	(0.21)	(0.11)	(0.10)	(0.15)	(0.06)	(0.05)	(0.06)	0.02

<sup>1</sup> Refer to Section 10, "Changes in Accounting Policies" for a discussion of the change in our policy with respect to classification of gains and losses on certain of our derivative financial instruments and translation of foreign currency-denominated working capital balances effective January 1, 2010. Prior period comparative information has been restated.

## FREE CASH FLOW

Free cash flow excludes working capital and certain other sources and uses of cash, which are disclosed in the consolidated statements of cash flows. This measure allows us to assess our ability to generate funds to repay debt, assists in cash flow forecasting, and is used as a performance measure for salaried employees.

### Reconciliation to Cash Provided by Operating Activities Less Cash Used by Investing Activities:

(In millions of Canadian dollars)	YTD	2010 Q2	Q1	Total	Q4	2009 <sup>1</sup> Q3	Q2	Q1
Cash provided (used) by operating activities	\$ (54.7)	\$ (24.9)	\$ (29.8)	\$ 101.4	\$ 4.8	\$ 6.3	\$ 68.2	\$ 22.1
Cash provided (used) by investing activities	1.6	(1.8)	3.4	(2.9)	(1.6)	(0.5)	0.9	(1.7)
Proceeds from the sale of property, plant and equipment and other assets	(7.0)	(0.2)	(6.8)	(4.5)	(0.9)	(0.4)	(0.5)	(2.7)
Other investing activities	(0.6)	(0.8)	0.2	(4.1)	(2.2)	(0.1)	(2.6)	0.8
Non-cash working capital changes except change in taxes and interest	0.6	10.1	(9.5)	(96.5)	(42.7)	0.7	(74.3)	19.8
Other	1.6	(4.3)	5.9	55.6	36.8	3.3	10.1	5.4
<b>Free cash flow</b>	<b>\$ (58.5)</b>	<b>\$ (21.9)</b>	<b>\$ (36.6)</b>	<b>\$ 49.0</b>	<b>\$ (5.8)</b>	<b>\$ 9.3</b>	<b>\$ 1.8</b>	<b>\$ 43.7</b>

1 Refer to Section 10, "Changes in Accounting Policies" for a discussion of the change in our policy with respect to classification of gains and losses on certain of our derivative financial instruments and translation of foreign currency-denominated working capital balances effective January 1, 2010. Prior period comparative information has been restated.

### Management's Calculation of Free Cash Flow:

(In millions of Canadian dollars)	YTD	2010 Q2	Q1	TOTAL	Q4	2009 <sup>1</sup> Q3	Q2	Q1
EBITDA	\$ (16.6)	\$ (0.4)	\$ (16.2)	\$ 123.2	\$ 14.1	\$ 25.9	\$ 14.3	\$ 68.9
Interest expense, excluding amortization	(35.0)	(18.5)	(16.5)	(66.5)	(15.9)	(15.9)	(15.5)	(19.2)
Capital expenditures	(6.0)	(2.8)	(3.2)	(11.5)	(4.7)	(1.0)	(2.2)	(3.6)
Income taxes received (paid)	0.2	0.1	0.1	(0.5)	(0.1)	0.3	(0.3)	(0.4)
Employee future benefits, expense over (under) cash contributions <sup>2</sup>	(1.1)	(0.3)	(0.8)	4.3	0.8	—	5.5	(2.0)
<b>Free cash flow</b>	<b>\$ (58.5)</b>	<b>\$ (21.9)</b>	<b>\$ (36.6)</b>	<b>\$ 49.0</b>	<b>\$ (5.8)</b>	<b>\$ 9.3</b>	<b>\$ 1.8</b>	<b>\$ 43.7</b>

1 Refer to Section 10, "Changes in Accounting Policies" for a discussion of the change in our policy with respect to classification of gains and losses on certain of our derivative financial instruments and translation of foreign currency-denominated working capital balances effective January 1, 2010. Prior period comparative information has been restated.

2 Free cash flow is adjusted to reflect the cash impact of employee future benefits rather than the accounting expense which is included in EBITDA.

## 9 CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of financial statements requires companies to establish accounting policies and to make estimates that affect both the amount and timing of recording of assets, liabilities, revenues and expenses. Some of these estimates require judgments about matters that are inherently uncertain and actual results could differ from estimates.

On an ongoing basis, we review our estimates based upon currently available information. The discussion on the accounting policies that require management's most difficult, subjective and complex judgments, and which are subject to a fair degree of measurement uncertainty can be found on pages 57 to 61 of the Company's 2009 Annual Report. During Q2, we recorded an asset-impairment charge as a result of our decision to permanently close the Elk Falls mill and Coquitlam paper recycling facility. Refer to section 1, "Overview" for further details.

## 10 CHANGES IN ACCOUNTING POLICIES

Effective January 1, 2010, we changed our policy on the classification of foreign exchange gains and losses on the ineffective portion of our derivative financial instruments, on the portion that is excluded from the assessment of hedge effectiveness, and on translation of monetary assets and liabilities denominated in foreign currencies. The respective foreign exchange gains and losses previously recognized in "Sales" are now recognized in "other expense, net". We continue to classify the effective portion of gains or losses on our currently designated U.S. dollar revenue risk management instruments in "Sales", the same income statement line item as the hedged item is classified in.

In addition, we changed our policy on the classification of changes in the fair value of all derivative commodity swap agreements not designated as hedges for accounting purposes that were previously recognized in "Sales" and "Cost of sales, excluding depreciation and amortization". The changes in the fair value related to these instruments are now recognized in "Other expense, net".

During 2010, we adopted the following new pronouncements issued by the Financial Accounting Standards Board ("FASB"):

- In June 2009, the FASB amended the Consolidation Topic of the Accounting Standards Codification, as it relates to the consolidation of variable interest entities. The amendments change how an entity determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. The determination of whether a company is required to consolidate an entity is based on, among other things, the entity's purpose and design and the company's ability to direct the activities of the entity that most significantly impact the entity's economic performance. The amendments to this topic are effective January 1, 2010. The amendments had no impact on our consolidated financial statements or disclosures.
- In February 2010, the FASB amended its guidance on subsequent events contained in the Accounting Standards Codification. The amendments eliminate the requirement to disclose the date through which an entity has evaluated subsequent events. We adopted the amended guidance in our consolidated financial statement disclosures for our interim financial statements for periods beginning on or after January 1, 2010.

## 11 IMPACT OF ACCOUNTING PRONOUNCEMENTS AFFECTING FUTURE PERIODS

There were no new pronouncements issued by the FASB that may impact our consolidated financial statements for future periods.

## 12 RISKS AND UNCERTAINTIES

The Company faces risks and uncertainties which fall into the general business areas of markets, international commodity prices, currency exchange rates, environmental issues, fibre supply, government regulation and policy, and for Canadian companies, trade barriers and potential impacts of Aboriginal rights, including unresolved Aboriginal land claims in B.C.

In order to address these risks and effectively manage them, we have developed a process for managing risk and the interrelationships risks have with our strategic plan. We provide regular updates to the Audit Committee, work with corporate and operational management to identify, measure, and prioritize the critical risks facing the Company, and manage these risks by ensuring that they are adequately addressed through mitigating procedures where appropriate. The objectives of the risk-management function include developing a common framework for understanding what constitutes principal business risks, ensuring that risk management activities are aligned with business strategies, and providing an effective mechanism for governance in the area of risk management.

A description of our risks and uncertainties can be found on pages 63 to 74 of our 2009 Annual Report, and on pages 31 to 33 of our Q1 2010 Report. Our update for the second quarter as of July 29, 2010 can be found below:

The Company's debt at December 31, 2009 is summarized in note 14, "Long-term debt" of our consolidated financial statements for the year ended December 31, 2009. Subsequent to year-end, on March 10, 2010, we completed a bond exchange and issued new recourse notes on May 19, 2010 as disclosed in note 9 of our interim consolidated financial statements for the three and six months ended June 30, 2010, resulting in total debt of \$867.5 million at June 30, 2010 compared to \$775.6 million at December 31, 2009. A number of our risks and uncertainties at December 31, 2009 referenced our total debt or our individual debt instruments as of that date, and these risks and uncertainties also apply to the total debt and the individual debt instruments outstanding at June 30, 2010. These risks and uncertainties include those under the following headings: "The Company's substantial debt may impair our financial and operating flexibility"; "We are exposed to the risks of exchange rate fluctuations"; and "A change of legal control of the Company could be materially adverse to the Company."

### **Resignation of President and Chief Executive Officer effective May 31, 2010.**

Effective June 21, 2010, Kevin Clarke was appointed our new President and Chief Executive Officer following the resignation of Richard Garneau on May 31, 2010. Accordingly, the risks and uncertainties associated with the leadership transitions and identified under the heading "The Company's current President and Chief Executive Officer has resigned from such positions effective May 31, 2010" in the "Risks and Uncertainties" section of our 2009 Annual Report are no longer applicable.

### **The Company has withheld payment of a portion of the assessed property taxes.**

Following the B.C. Court of Appeal dismissal of our North Cowichan petition in May 2010, we abandoned our other three appeals and paid all of our outstanding 2009 property taxes and applicable penalties and interest to the four municipalities. Accordingly the risks and uncertainties associated with the non-payment of the 2009 property taxes to these four municipalities identified under this heading in the "Risks and Uncertainties" section of our 2009 Annual Report are no longer applicable.

The total amount of unpaid property taxes owing for 2010 to North Cowichan as at July 29, 2010, together with the 10% penalty for late payment, is \$4.4 million. There are risks and uncertainties associated with the Company not paying all of our 2010 property taxes to North Cowichan when due. These risks and uncertainties are the same as those identified under this heading in the "Risks and Uncertainties" section of our 2009 Annual Report with respect to the non-payment of 2009 property taxes.

### **The Company is subject to significant environmental regulation.**

In May 2010, the U.S. Environmental Protection Agency set thresholds for greenhouse gas permits under the Clean Air Act. This will affect the Snowflake mill starting July 1, 2011 when facilities discharging more than 100,000 tons per year of greenhouse gases will be subject to permit requirements. On the basis that the Snowflake mill continues to operate at full production capacity, we expect that the mill's greenhouse gas emissions will be above this threshold. At this time, it is too early to tell what impact this may have on the Company until the U.S. Environmental Protection Agency and the Snowflake mill begin discussions on the permit process.

## 13 SENSITIVITY ANALYSIS

Our earnings are sensitive to fluctuations in product prices, foreign exchange, energy and fibre costs as described on page 74 of our Annual Report and summarized in the following table:

(In millions of Canadian dollars, except per-share amounts)	EBITDA <sup>1</sup>	Net earnings <sup>2</sup>	Earnings per share
<b>Product prices<sup>3</sup></b>			
A US\$10 per tonne change in the sales price of:			
Specialty printing papers	\$ 9	\$ 6	\$ 0.02
Newsprint	5	4	0.01
Pulp	3	2	0.01
<b>Foreign exchange<sup>4</sup></b>			
A US\$0.01 change in the U.S. dollar relative to the Canadian dollar	5	3	0.01
<b>Energy cost sensitivity<sup>5</sup></b>			
A 5% change in the price of:			
Natural gas and oil – direct purchases	1	1	0.00
Electricity – direct purchases	6	4	0.01
Coal	1	1	0.00
<b>Fibre sensitivity<sup>5</sup></b>			
A US\$5 per unit change in the price of:			
Wood chips (Bdt)	8	6	0.02
ONP (ST)	2	1	0.00

1 Refer to Section 8, "Non-GAAP measures."

2 Based on an expected tax rate of 28.5%.

3 Based on sales of Q2 2010 annualized production and foreign exchange rate of US\$0.97.

4 Based on Q2 2010 annualized net cash flows and a movement to US\$0.98 from US\$0.97 and excluding our hedging program and the impact of the translation of U.S. dollar-denominated debt.

5 Based on Q2 2010 annualized consumption levels and an exchange rate of US\$0.97.

## 14 OUTLOOK

We continue to expect modest improvements to market conditions for our paper products for the balance of 2010. Contract prices for coated and uncoated mechanical grades will increase in July 2010 and prices should remain firm in the next quarter due to prevailing low inventory levels and the expectation of higher operating rates as Q3 is traditionally a strong quarter for shipments and demand. We announced a US\$70 per short ton price increase for all spot directory grade shipments effective July 1, 2010. Given the low volume of non-contracted sales we expect for the remainder of the year, this price increase is unlikely to have a substantial impact on our net earnings and cash flows in 2010. We have also announced a US\$40 per tonne price increase for U.S. newsprint shipments, effective September 1, 2010 while pulp prices are expected to soften in the coming quarter.

Despite improving market conditions and continuing savings on fixed costs, our net earnings, cash flows, and liquidity in coming quarters will continue to be challenged by the strength of the Canadian dollar, and rising fibre and other variable input costs. Our projection for capital spending in 2010 of \$20 million has not changed. We remain focused on reducing our cost base, conserving cash, and improving our product mix. Our progress to-date on our key priorities for 2010 is provided in Section 1, "Overview and Highlights" and these remain the main focus going forward.

### Production Curtailment

Based on our revised annualized production capacity, we forecast that our Q3 production curtailment will be 35,300 tonnes of newsprint at our Crofton mill, or 23% of newsprint capacity in Q3.

## 15 DISCLOSURE CONTROLS AND INTERNAL CONTROL OVER FINANCIAL REPORTING

A summary of the Company's regulatory requirements for the evaluation of internal controls and subsequent reporting of the results of that evaluation can be found on page 78 of the Company's 2009 Annual Report. Based on an evaluation of the design and operation of the Company's disclosure controls and procedures conducted under the supervision and with the participation of management, the Company's chief executive officer and chief financial officer concluded that such disclosure controls and procedures (as defined in Canada under National Instrument 52-109 and in Rules 13a-15(e) and 15d-15(e) under the United States Securities Exchange Act of 1934), were effective as at December 31, 2009.

We did not make any significant changes in internal controls over financial reporting during the most recent three month and six month periods ended June 30, 2010 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting. Management has limited the scope of the design and maintenance of adequate disclosure controls and procedures and internal control over financial reporting to exclude controls, policies and procedures of Powell River Energy Inc., a variable interest entity in which we are the primary beneficiary.

The Company's Audit Committee, as part of its oversight role, has reviewed and recommended the approval of this MD&A to the Board of directors. The Board of directors has read and approved this MD&A.

## CONSOLIDATED BALANCE SHEETS

(in millions of Canadian dollars)	June 30, 2010	December 31, 2009
	(unaudited)	
<b>Assets</b>		
Current assets		
Cash and cash equivalents	\$ 100.8	\$ 83.1
Accounts receivable (note 17 (a))	114.4	101.5
Inventories (note 5)	147.3	178.3
Prepays and other (note 6)	22.9	25.2
	385.4	388.1
Property, plant and equipment (note 13)	1,346.1	1,664.7
Other assets (note 7)	38.8	38.0
	<b>\$ 1,770.3</b>	<b>\$ 2,090.8</b>
<b>Liabilities</b>		
Current liabilities		
Accounts payable and accrued liabilities (note 8)	\$ 175.4	\$ 173.3
Current portion of long-term debt (note 9)	38.8	1.0
	214.2	174.3
Long-term debt (note 9)	828.7	774.6
Employee future benefits (note 10)	260.9	294.6
Other long-term obligations	20.2	13.4
Future income taxes (note 15)	27.1	22.8
Deferred credits	15.5	15.5
	1,366.6	1,295.2
<b>Equity</b>		
Shareholders' equity		
Common stock: no par value; unlimited shares authorized; issued and outstanding: 381,753,490 shares (December 31, 2009 – 381,753,490 shares)	1,035.0	1,035.0
Preferred stock: par value determined at time of issue; authorized 100,000,000 shares; issued and outstanding: nil shares	–	–
Additional paid-in capital	16.4	16.4
Deficit	(597.6)	(185.1)
Accumulated other comprehensive income (loss) (note 11)	(31.4)	(52.7)
	422.4	813.6
Non-controlling interest (deficit) (note 4)	(18.7)	(18.0)
	403.7	795.6
	<b>\$ 1,770.3</b>	<b>\$ 2,090.8</b>

Contingent liabilities (note 19)

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

On behalf of the Board:



**Kevin J. Clarke**  
Director



**Thomas S. Chambers**  
Director

## CONSOLIDATED STATEMENTS OF EARNINGS (LOSS)

(Unaudited and in millions of Canadian dollars, except where otherwise stated)	Three months ended June 30,		Six months ended June 30,	
	2010	2009	2010	2009
<b>Sales</b>	\$ 299.4	\$ 300.7	\$ 572.7	\$ 661.6
<b>Operating expenses</b>				
Cost of sales, excluding depreciation and amortization	278.8	262.2	543.5	539.5
Depreciation and amortization	31.2	35.8	63.9	72.9
Selling, general and administrative	10.1	11.9	20.8	22.4
Restructuring (note 12 and 13)	10.9	12.3	25.0	16.5
Impairment and other closure costs (note 13)	292.3	—	292.3	—
	623.3	322.2	945.5	651.3
<b>Operating earnings (loss)</b>	(323.9)	(21.5)	(372.8)	10.3
Interest expense, net	(18.0)	(16.3)	(34.8)	(36.2)
Gain on cancellation of long-term debt (note 9)	—	—	—	30.7
Foreign exchange gain (loss) on long-term debt	(21.3)	37.9	(7.7)	25.3
Other expense, net (note 14)	(4.9)	(12.0)	(8.4)	(19.1)
<b>Earnings (loss) before income taxes</b>	(368.1)	(11.9)	(423.7)	11.0
Income tax expense (recovery) (note 15)	—	(8.9)	(10.9)	(6.2)
<b>Net earnings (loss)</b>	(368.1)	(3.0)	(412.8)	17.2
Net (earnings) loss attributable to non-controlling interest	(0.3)	1.1	0.3	1.0
<b>Net earnings (loss) attributable to the Company</b>	\$ (368.4)	\$ (1.9)	\$ (412.5)	\$ 18.2
Basic and diluted net earnings (loss) per share attributable to the Company's common shareholders (in dollars)	\$ (0.96)	\$ (0.01)	\$ (1.08)	\$ 0.05
Weighted average number of Company common shares outstanding (in millions)	381.8	381.8	381.8	381.8

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

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**

(Unaudited and in millions of Canadian dollars)	Three months ended June 30,		Six months ended June 30,	
	2010	2009	2010	2009
Net earnings (loss)	\$ (368.1)	\$ (3.0)	\$ (412.8)	\$ 17.2
Other comprehensive income (loss), net of taxes:				
Employee future benefits liability adjustment, net of taxes	6.9	—	23.3	—
Reclassification of amortization of employee future benefits, net of taxes	0.5	0.6	1.0	1.3
Unrealized net gain on cash flow revenue hedges, net of taxes	—	8.6	4.2	5.1
Reclassification of net (gain) loss on cash flow revenue hedges, net of taxes	(3.7)	0.9	(7.2)	7.7
Foreign currency translation adjustments, net of related hedging activities, net of taxes	0.7	(3.4)	—	(1.9)
Unrealized gain (loss) on interest rate hedges, net of taxes	—	(1.1)	0.1	(1.1)
Other comprehensive income, net of taxes	4.4	5.6	21.4	11.1
<b>Total comprehensive income (loss)</b>	<b>(363.7)</b>	<b>2.6</b>	<b>(391.4)</b>	<b>28.3</b>
Comprehensive (income) loss attributable to non-controlling interest:				
Net (earnings) loss	(0.3)	1.1	0.3	1.0
Other comprehensive income, net of taxes	—	—	(0.1)	—
Comprehensive (income) loss attributable to non-controlling interest	(0.3)	1.1	0.2	1.0
<b>Comprehensive income (loss) attributable to the Company</b>	<b>\$ (364.0)</b>	<b>\$ 3.7</b>	<b>\$ (391.2)</b>	<b>\$ 29.3</b>

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

## CONSOLIDATED STATEMENTS OF EQUITY

(in millions of Canadian dollars)	Equity attributable to the Company						
	Common stock		Additional paid-in capital	Retained earnings (deficit)	Accumulated other comprehensive income (loss)	Non-controlling interest (deficit)	Total
	Number of shares	\$					
Balance as at December 31, 2008	381,753,490	\$ 1,035.0	\$ 14.6	\$ (180.7)	\$ (46.4)	\$ (15.9)	\$ 806.8
Stock option compensation expense	—	—	1.8	—	—	—	1.8
Net earnings (loss)	—	—	—	(4.4)	—	(1.2)	(5.6)
Distributions to non-controlling interest	—	—	—	—	—	(0.3)	(0.3)
Other comprehensive loss, net of tax	—	—	—	—	(6.3)	(0.6)	(6.9)
Balance as at December 31, 2009	381,753,490	\$ 1,035.0	\$ 16.4	\$ (185.1)	\$ (52.7)	\$ (18.0)	\$ 795.6
Stock option compensation expense	—	—	—	—	—	—	—
Net earnings (loss)	—	—	—	(412.5)	—	(0.3)	(412.8)
Distributions to non-controlling interest	—	—	—	—	—	(0.5)	(0.5)
Other comprehensive income, net of tax	—	—	—	—	21.3	0.1	21.4
Balance as at June 30, 2010 (unaudited)	<b>381,753,490</b>	<b>\$ 1,035.0</b>	<b>\$ 16.4</b>	<b>\$ (597.6)</b>	<b>\$ (31.4)</b>	<b>\$ (18.7)</b>	<b>\$ 403.7</b>

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

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited and in millions of Canadian dollars)	Three months ended June 30,		Six months ended June 30,	
	2010	2009	2010	2009
<b>Cash flows provided (used) by:</b>				
<b>Operations</b>				
Net earnings (loss)	\$ (368.1)	\$ (3.0)	\$ (412.8)	\$ 17.2
Items not requiring (providing) cash				
Depreciation and amortization	31.2	35.8	63.9	72.9
Impairment and other closure costs (note 13)	292.3	—	292.3	—
Future income taxes	0.1	(8.4)	(10.9)	(5.6)
Foreign exchange (gain) loss on long-term debt	21.3	(37.9)	7.7	(25.3)
Gain on cancellation of long-term debt (note 9)	—	—	—	(30.7)
Employee future benefits, expense over (under) cash contributions	(0.3)	5.5	(1.1)	3.5
Increase (decrease) in other long-term obligations	(0.4)	1.5	(2.1)	1.2
(Gain) loss on disposal of property, plant and equipment	(0.2)	3.9	(6.0)	2.7
Other	3.6	0.9	14.0	1.2
Changes in non-cash working capital				
Accounts receivable	(10.9)	50.0	(12.9)	84.6
Inventories	(1.2)	35.6	12.0	38.4
Prepays and other	5.2	9.6	2.5	14.2
Accounts payable and accrued liabilities	2.5	(25.3)	(1.3)	(84.0)
Cash flows provided (used) by operations	(24.9)	68.2	(54.7)	90.3
<b>Investing</b>				
Additions to property, plant and equipment	(2.8)	(2.2)	(6.0)	(5.8)
Proceeds from sale of property, plant and equipment	0.2	0.5	7.0	3.2
Decrease in other assets	0.8	2.6	0.6	1.8
Cash flows provided (used) by investing activities	(1.8)	0.9	1.6	(0.8)
<b>Financing</b>				
Decrease in revolving loan and loan payable	(25.0)	(38.8)	(14.5)	(60.1)
Proceeds on termination of debt foreign currency contracts	—	10.4	—	34.8
Settlement on purchase of debt securities	—	(4.9)	—	(26.9)
Proceeds on issuance of Class B senior secured notes (note 9)	98.4	—	98.4	—
Deferred financing costs	(4.3)	0.1	(4.3)	(0.1)
Note exchange costs	—	—	(8.3)	—
Decrease in other long-term debt	(0.3)	(0.3)	(0.5)	(0.6)
Cash flows provided (used) by financing activities	68.8	(33.5)	70.8	(52.9)
Cash and cash equivalents, increase in the period	42.1	35.6	17.7	36.6
Cash and cash equivalents, beginning of period	58.7	6.0	83.1	5.0
<b>Cash and cash equivalents, end of period</b>	<b>\$ 100.8</b>	<b>\$ 41.6</b>	<b>\$ 100.8</b>	<b>\$ 41.6</b>
<b>Supplemental disclosures:</b>				
Income taxes paid (received)	\$ (0.1)	\$ 0.3	\$ (0.2)	\$ 0.7
Net interest paid	12.9	15.5	35.2	34.7
Non-cash exchange of 8.625% senior notes	—	—	(327.1)	—
Non-cash issuance of 11.0% senior notes	—	—	287.2	—
Non-cash difference in carrying value of senior notes on modification	—	—	39.9	—

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

## CONSOLIDATED BUSINESS SEGMENTS

(Unaudited and in millions of Canadian dollars)

Three months ended June 30, 2010	Specialty printing papers	Newsprint	Pulp	Total
Sales	\$ 165.1	\$ 73.1	\$ 61.2 <sup>1</sup>	\$ 299.4
Depreciation and amortization	19.0	8.6	3.6	31.2
Restructuring (note 12)	3.3	7.5	0.1	10.9
Impairment and other closure costs (note 13)	103.3	189.0	—	292.3
Operating earnings (loss)	(120.1)	(211.8)	8.0	(323.9)
Additions to property, plant and equipment	2.3	0.4	0.1	2.8

### Three months ended June 30, 2009

Sales	\$ 206.7	\$ 86.8	\$ 7.2 <sup>1</sup>	\$ 300.7
Depreciation and amortization	22.8	11.9	1.1	35.8
Restructuring (note 12)	9.8	1.9	0.6	12.3
Operating earnings (loss)	2.8	(22.4)	(1.9)	(21.5)
Additions to property, plant and equipment	1.4	0.8	—	2.2

### Six months ended June 30, 2010

Sales	\$ 329.2	\$ 142.6	\$ 100.9 <sup>1</sup>	\$ 572.7
Depreciation and amortization	40.3	16.7	6.9	63.9
Restructuring (note 12)	8.1	16.0	0.9	25.0
Impairment and other closure costs (note 13)	103.3	189.0	—	292.3
Operating earnings (loss)	(140.4)	(238.1)	5.7	(372.8)
Additions to property, plant and equipment	5.2	0.6	0.2	6.0

### Six months ended June 30, 2009

Sales	\$ 424.3	\$ 192.5	\$ 44.8 <sup>1</sup>	\$ 661.6
Depreciation and amortization	46.0	23.3	3.6	72.9
Restructuring (note 12)	11.8	2.6	2.1	16.5
Operating earnings (loss)	30.6	(13.8)	(6.5)	10.3
Additions to property, plant and equipment	3.3	2.3	0.2	5.8

<sup>1</sup> Pulp sales are stated net of inter-segment pulp sales of \$5.7 million for the three months ended June 30, 2010 (three months ended June 30, 2009 – \$5.4 million) and \$7.1 million for the six months ended June 30, 2010 (six months ended June 30, 2009 – \$13.1 million).

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited and in millions of Canadian dollars, except where otherwise stated)

**1. BASIS OF PRESENTATION**

The consolidated financial statements include the accounts of the Company and, from their respective dates of acquisition of control or formation, its wholly owned subsidiaries and partnerships. In addition, the consolidated financial statements include the accounts of the Company's joint venture, Powell River Energy Inc. ("PREI"), a variable interest entity ("VIE"). All inter-company transactions and amounts have been eliminated on consolidation.

Effective for the year ended December 31, 2009, the Company adopted U.S. generally accepted accounting principles ("U.S. GAAP") for presentation of its consolidated financial statements for Canadian and United States reporting requirements. Historically, the Company has presented its annual and interim consolidated financial statements in accordance with Canadian generally accepted accounting principles ("Canadian GAAP") with reconciliation in its annual consolidated financial statements to U.S. GAAP for material recognition and measurement differences. As a result of this transition to U.S. GAAP, the Company has presented its 2009 annual audited consolidated financial statements in accordance with U.S. GAAP, including a reconciliation to Canadian GAAP for material recognition and measurement differences in note 33, "Reconciliation of United States and Canadian Generally Accepted Accounting Principles" and restated its interim consolidated financial statements for 2009.

The accompanying unaudited interim consolidated financial statements have been prepared in accordance with U.S. GAAP, on a basis consistent with those followed in the December 31, 2009 audited annual consolidated financial statements, except as disclosed in note 3 below. These unaudited interim consolidated financial statements do not include all information and note disclosures required by U.S. GAAP for annual financial statements, and therefore should be read in conjunction with the December 31, 2009 audited consolidated financial statements and the notes thereto. In the opinion of the Company, the unaudited interim consolidated financial statements contained herein contain all the information and note disclosures necessary to fairly present the results of the interim periods included. The results for the periods included herein may not be indicative of the results for the entire year.

**2. SEGMENTED INFORMATION**

The Company operates in three business segments:

Specialty printing papers	• Manufacture and sale of mechanical specialty printing papers
Newsprint	• Manufacture and sale of newsprint
Pulp	• Manufacture and sale of long-fibre Northern Bleached Softwood Kraft pulp

The segments are managed separately. Five manufacturing facilities, including a paper recycling facility, are located in the province of British Columbia, Canada and one manufacturing facility is located in Arizona, U.S.A. Inter segment sales consist of pulp transfers at cost up to December 31, 2009, and at market prices thereafter. The Company has not restated its comparative numbers for this change in policy as the change is not material to the comparative numbers. However, this change could be material in future periods if pulp market prices increase or average costs decrease.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited and in millions of Canadian dollars, except where otherwise stated)

### 3. SIGNIFICANT ACCOUNTING POLICIES

Effective January 1, 2010, the Company changed its policy on the classification of foreign exchange gains and losses on the ineffective portion of its U.S. dollar revenue risk management instruments, on the portion that is excluded from the assessment of hedge effectiveness, and on translation of working capital balances denominated in foreign currencies. The respective foreign exchange gains and losses previously recognized in "Sales" are now recognized in "Other expense, net". In addition, the Company also changed its policy on the classification of changes in the fair value of all commodity swap agreements not designated as hedges for accounting purposes that were previously recognized in "Sales" and "Cost of sales, excluding depreciation and amortization". The changes in the fair value related to these instruments are now recognized in "Other expense, net". The new policies adopted are considered preferable as they increase the transparency of the economic hedging activity. These changes were applied retrospectively.

For the three and six months ended June 30, 2009, the above changes resulted in an increase of \$9.2 million and \$17.6 million, respectively, to "Sales" and \$1.0 million and \$1.6 million, respectively, to "Cost of sales, excluding depreciation and amortization", with an offsetting decrease of \$8.2 million and \$16.0 million, respectively, to "Other expense, net".

Effective April 1, 2010, the Company no longer designates its U.S. dollar revenue risk management instruments as cash flow hedges for accounting purposes. The effective portion of gains or losses accumulated as at March 31, 2010 on its previously designated U.S. dollar revenue risk management instruments are continuing to be recorded in the same income statement line items as the hedged item in "Sales".

#### Recently Implemented Accounting Changes

In June 2009, the Financial Accounting Standards Board ("FASB") further amended the Consolidation Topic of the Accounting Standards Codification, as it relates to the consolidation of VIE's. The amendments change how an entity determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. Qualified special-purpose entities are no longer exempt from consolidation requirements. The determination of whether a company is required to consolidate an entity is based on, among other things, an entity's purpose and design and a company's ability to direct the activities of the entity that most significantly impact the entity's economic performance. The amendments to this Topic become effective on January 1, 2010. The Company has assessed the impact of these amendments and has determined that these amendments have no impact on the Company's consolidated financial statements or disclosures as the Company continues to be the primary beneficiary in PREI.

In February 2010, the FASB amended its guidance on subsequent events contained in the Accounting Standards Codification. The amendments eliminate the requirement to disclose the date through which an entity has evaluated subsequent events. The Company adopted the amended guidance in its consolidated financial statement disclosures for its interim financial statements for periods beginning on or after January 1, 2010.

#### Changes in Future Accounting Standards

There were no new pronouncements issued by the FASB that may impact the Company's consolidated financial statements for future periods.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited and in millions of Canadian dollars, except where otherwise stated)

**4. VARIABLE INTEREST ENTITIES**

The Company has a 50.0% interest in PREI and consolidates 100% of it as PREI is a VIE in which the Company is the primary beneficiary. PREI consists of an integrated hydroelectric power generating, transmission and distribution system which includes two hydroelectric stations in B.C. with installed capacity of 82 Megawatts. The Company purchases 100% of the power generated by PREI.

The Company has limited access to PREI's assets, which generally take the form of interest on loans, management fees and earnings distributions based on the Company's interest in PREI. In addition, creditors of PREI have recourse limited to the assets in PREI. Condensed financial information with respect to PREI is as follows:

	Three months ended June 30,		Six months ended June 30,	
	2010	2009	2010	2009
<b>Condensed statements of earnings (loss)</b>				
Sales – affiliate <sup>1</sup>	\$ 5.5	\$ 3.7	\$ 10.9	\$ 7.8
Cost of sales, excluding depreciation and amortization	1.5	1.5	2.7	3.0
Depreciation and amortization	0.8	0.8	3.7	1.6
	2.3	2.3	6.4	4.6
Operating earnings	3.2	1.4	4.5	3.2
Interest expense	(2.1)	(2.5)	(4.4)	(4.4)
Interest expense – affiliate <sup>1</sup>	(0.5)	(0.6)	(1.2)	(1.4)
Other expense, net	–	(1.1)	–	(1.0)
Income tax recovery	–	0.6	0.5	1.6
<b>Net earnings (loss)</b>	<b>0.6</b>	<b>(2.2)</b>	<b>(0.6)</b>	<b>(2.0)</b>
<b>Other comprehensive income (loss)</b>	<b>–</b>	<b>–</b>	<b>0.2</b>	<b>–</b>
<b>Total comprehensive income (loss) <sup>2</sup></b>	<b>\$ 0.6</b>	<b>\$ (2.2)</b>	<b>\$ (0.4)</b>	<b>\$ (2.0)</b>

1 Balances with Catalyst Paper Corporation.

2 50% is included in the Company's non-controlling interest (deficit) balances.

	June 30, 2010	December 31, 2009
<b>Condensed balance sheets</b>		
Current assets		
Cash and cash equivalents	\$ 5.1	\$ 5.5
Other	2.4	2.0
Property, plant and equipment	109.7	112.8
	\$ 117.2	\$ 120.3
Current liabilities		
Accounts payable and accrued liabilities	\$ 3.4	\$ 5.5
Long-term debt (note 9)	113.8	112.9
Long-term debt – affiliate <sup>1</sup>	20.8	20.8
Future income taxes	16.6	17.1
Equity <sup>2</sup>	(37.4)	(36.0)
	\$ 117.2	\$ 120.3

1 Balances with Catalyst Paper Corporation.

2 50% is included in the Company's non-controlling interest (deficit) balances.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited and in millions of Canadian dollars, except where otherwise stated)

The Company has identified one other potential VIE, but has not been able to obtain the financial information necessary to evaluate whether the entity is a VIE, or if the entity is a VIE, whether the Company is the primary beneficiary. The Company has entered into a building lease agreement with this potential VIE whereby the Company has agreed to continue making the prescribed lease payments directly to the financial institution holding the mortgage on the building in the event the lessor is no longer able to meet its contractual obligations. As at June 30, 2010, the principal amount of the mortgage was \$7.2 million (December 31, 2009 – \$7.9 million). This agreement does not increase the Company's liability beyond the obligation under the building lease.

### 5. INVENTORIES

The components of inventories were as follows:

	June 30, 2010	December 31, 2009
Finished goods		
Specialty printing papers	\$ 24.0	\$ 19.7
Newsprint	8.1	11.5
Pulp	1.2	6.4
Total finished goods	33.3	37.6
Work-in-progress	0.9	0.5
Raw materials – wood chips, pulp logs and other	32.0	36.4
Operating and maintenance supplies and spare parts (note 13)	81.1	103.8
	\$ 147.3	\$ 178.3

At June 30, 2010, the Company had applied write-downs of \$1.2 million to finished goods inventory (December 31, 2009 – \$1.7 million) and \$2.5 million to raw materials inventory (December 31, 2009 – \$3.6 million).

### 6. PREPAIDS AND OTHER

The components of prepaids and other were as follows:

	June 30, 2010	December 31, 2009
Derivative financial instruments	\$ 5.3	\$ 15.9
Future income tax assets	13.1	4.8
Property taxes, insurance and licenses	1.5	1.9
Other	3.0	2.6
	\$ 22.9	\$ 25.2

### 7. OTHER ASSETS

The components of other assets were as follows:

	June 30, 2010	December 31, 2009
Deferred financing costs	\$ 14.8	\$ 10.7
Deferred charges and other	8.9	9.6
Derivative financial instruments	0.4	3.1
Accrued benefit asset – pension plan	0.2	0.2
Future income tax assets	14.5	14.4
	\$ 38.8	\$ 38.0

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited and in millions of Canadian dollars, except where otherwise stated)

**8. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES**

The components of accounts payable and accrued liabilities were as follows:

	June 30, 2010	December 31, 2009
Trade payables	\$ 87.9	\$ 83.2
Accrued payroll and related liabilities	28.7	34.7
Property taxes, and related penalties and interest	10.8	15.1
Accrued interest	11.6	10.8
Restructuring	12.1	5.2
Accrued benefit obligation – pension plan	6.7	6.7
Accrued benefit obligation – other employee future benefit plans	7.3	7.3
Payables related to capital projects	1.1	2.3
Other	9.2	8.0
	<b>\$ 175.4</b>	<b>\$ 173.3</b>

**9. LONG-TERM DEBT**

	June 30, 2010	December 31, 2009
<b>Recourse</b>		
Senior notes, 8.625% due June 2011 (US\$35.5 million; December 31, 2009 – US\$354.2 million)	\$ 37.8	\$ 371.6
Senior notes, 7.375% due March 2014 (US\$250.0 million)	268.5	265.4
Senior secured notes, 11.0% due December 2016 (US\$280.4 million)	297.4	–
Modification – difference in carrying value of 8.625% and 11.0% senior secured notes (US\$38.3 million) on exchange	38.5	–
Class B senior secured notes, 11.0% due December 2016 (US\$110.0 million)	100.8	–
	<b>743.0</b>	<b>637.0</b>
Revolving asset based loan facility of up to \$330.0 million due August 2013	–	14.5
Capital lease obligations	10.7	11.2
	<b>753.7</b>	<b>662.7</b>
<b>Non-recourse</b>		
First mortgage bonds, 6.447% due July 2016	95.0	94.1
Subordinated promissory notes	18.8	18.8
	<b>113.8</b>	<b>112.9</b>
Total debt	<b>867.5</b>	<b>775.6</b>
Less: current portion	<b>(38.8)</b>	<b>(1.0)</b>
<b>Total long-term debt</b>	<b>\$ 828.7</b>	<b>\$ 774.6</b>

On May 19, 2010, the Company issued US\$110.0 million of Class B 11.0% senior secured notes due December 15, 2016 at 86% of the principal amount, in a private placement. Net proceeds of \$93.4 million, after financing costs of approximately \$5 million, will be used for general corporate purposes. The new notes rank equally in right of payment with all of the Company's existing and future senior secured notes. The notes are secured on a first-priority basis by all of the Company's assets, with the exception of assets securing the Company's existing \$330 million revolving asset based loan facility (the "ABL Facility").

On March 10, 2010, the Company completed the exchange of US\$318.7 million of its 8.625% senior unsecured notes, due June 2011, ("2011 Notes") for US\$280.4 million of new 11.0% senior secured notes, due December 2016 ("2016 Notes"). For each US\$1,000 in principal amount of the 2011 Notes exchanged, the Company issued US\$880 in principal

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited and in millions of Canadian dollars, except where otherwise stated)

amount of the 2016 Notes. As the cash flows of the principal and interest on a discounted basis over the life of the outstanding 2016 Notes issued did not differ by more than 10% compared to the cash flows of the principal and interest on a discounted basis over the life of the 2011 Notes, the 2016 Notes were accounted for as a modification of the 2011 Notes. Accordingly, the 2016 Notes were recorded at the carrying value of the 2011 Notes exchanged of US\$318.7 million. The excess of US\$38.3 million of the carrying value of the 2011 Notes exchanged over the principal amount of the 2016 Notes issued remained as part of the carrying value of the debt on the balance sheet. This difference of US\$38.3 million is being amortized as a reduction of interest expense, under the effective interest rate method, until the maturity of the 2016 Notes. As the exchange was accounted for as a modification, the legal and other non-finance expenses of \$10.5 million associated with the exchange were expensed, of which \$8.3 million was expensed in the three months ended March 31, 2010. As of June 30, 2010, US\$35.5 million of 2011 Notes remain outstanding and have been reclassified to current liabilities on the Company's balance sheet as at June 30, 2010.

The indentures governing the Company's senior notes contain customary restrictive covenants, including restrictions on incurring additional indebtedness, certain restricted payments including dividends and investments in other persons, the creation of liens, sale and leaseback transactions, certain amalgamations, mergers, consolidations and the use of proceeds arising from certain sales of assets and certain transactions with affiliates. Pursuant to a consent solicitation conducted concurrently with the exchange offer, substantially all of these restrictive covenants were eliminated with respect to the 2011 Notes that remain outstanding after the exchange offer, although certain covenants, including restrictions on the creation of liens and certain assets sales, remain applicable to the 2011 Notes. Collateral provided on the 2016 Notes consists of a first charge on substantially all of the assets of the Company, other than the ABL First Charge Collateral as described below (the "2016 Notes First Charge Collateral") and a second charge on the ABL First Charge Collateral. The indentures governing the 7.375% senior notes, due March 2014, ("2014 Notes") and the 2016 Notes limit the ability of the Company to incur debt, other than "permitted debt", if the Company cannot meet a fixed charge coverage ratio of 2.0:1. The Company's fixed charge coverage ratio under these indentures, calculated on a 12-month trailing average, was 0.0:1 at June 30, 2010 (December 31, 2009 – 1.5:1).

Under the indenture for the 2014 Notes and 2016 Notes, "permitted debt" includes (a) the Company's existing 2014 Notes and 2016 Notes (as a permitted refinancing of the 2011 Notes); (b) a credit facility basket in an amount equal to the greater of (i) \$725 million and (ii) the sum of 85% of the book value of the Company's accounts receivable, 60% of the book value of the Company's inventory and \$375 million, against which in either case utilization under the Company's \$330 million ABL Facility is applied; (c) purchase money debt and capitalized lease obligations in an amount equal to 7.5% of the Company's consolidated tangible assets; (d) a \$100 million general basket; and (e) a \$5 million basket for accommodation guarantees, trade or standby letters of credit, performance bonds, bankers' acceptances and surety bonds. In addition, the indenture governing the 2016 Notes includes a limitation of US\$411.7 million on the amount of 2016 Notes and additional debt that can be secured on a pari passu basis with the 2016 Notes, and restricts the ability of the Company to repurchase the 2014 Notes prior to their maturity unless, among other things, the Company has available liquidity under the ABL Facility and cash on hand of at least \$100 million. The Company cannot make any restricted payments, including paying any dividends, except to the extent the balance in its restricted payments baskets is positive. The restricted payments baskets under the 2014 Notes and 2016 Notes were negative \$288.9 million and negative \$72.9 million, respectively, as at June 30, 2010, as a result of accumulated losses in recent years (December 31, 2009 – negative \$176.0 million and \$nil, respectively).

The security for the ABL Facility and the related derivatives facilities consists of a first charge on the accounts receivable, inventory and cash of the Company and on the Snowflake mill property, plant and equipment and related rail operation (collectively, the "ABL First Charge Collateral") and a second charge on the 2016 Notes First Charge Collateral. Availability under the ABL Facility is determined by a borrowing base calculated primarily on eligible accounts receivable, eligible inventory and a value ascribed to the Snowflake mill fixed assets, less certain reserves. A reserve may also be imposed for vacation pay obligations, which as at June 30, 2010 were \$19.1 million, if Excess Availability (as defined in the ABL Facility) is below \$75 million. Excess Availability was \$142.5 million at June 30, 2010. As at June 30, 2010, the borrowing base under the ABL Facility was \$167.8 million. After deducting outstanding drawings of \$nil, outstanding letters of credit of \$25.3 million, and the \$35.0 million minimum Excess Availability covenant, \$107.5 million was available to be drawn by the Company under the ABL Facility. The Company also had an additional \$100.8 million of cash on hand at such date.

The financial covenants applicable under the ABL Credit Agreement must be maintained based upon the Company's financial results prepared under Canadian GAAP and include covenants to (a) maintain shareholders' equity above \$346.2 million as at June 30, 2010; (b) maintain Excess Availability of not less than \$35 million; and (c) not make capital expenditures in any fiscal year in an amount which exceeds 120% of the budgeted capital expenditures for such

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited and in millions of Canadian dollars, except where otherwise stated)

fiscal year. The minimum equity requirement is reduced by the amount of any non-cash write-downs of property, plant and equipment as a result of a permanent discontinuance of operations. At June 30, 2010, as calculated under the ABL Facility under Canadian GAAP, shareholders' equity was \$466.0 million (December 31, 2009 – \$881.4 million).

The ABL Facility also contains a number of covenants that, among other things, place restrictions on matters customarily restricted in such facilities, including indebtedness which encompasses guarantee obligations, liens, fundamental changes, investments, derivative transactions, sales of assets, changes in fiscal periods, environmental activity, negative pledges, subsidiary distributions and changes in lines of business as well as restrictions on voluntary prepayments of certain debt, including the senior notes, unless Excess Availability of at least \$65 million is maintained. The ABL Facility contains customary events of default, including failure to pay principal or interest when due, failure to comply with or observe key covenants, failure to refinance the 2011 notes such that no more than US\$17.7 million remain outstanding on March 15, 2011, adverse judgements, seizures of property, material adverse change, auditors' "going concern" qualification, and change in control.

At June 30, 2010, the Company was in compliance with its covenants under the ABL Facility and under each of the indentures governing its outstanding senior notes.

Non-recourse debt is debt owed by the Company's subsidiary PREI. The Company has a 50% interest in PREI, and consolidates 100% of it as PREI is a VIE in which the Company is the primary beneficiary.

The Company's long-term debt is recorded at amortized cost. The following table contains information about management's best estimate of the fair value of the Company's debt:

	June 30, 2010		December 31, 2009	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Recourse	\$ 753.7	\$ 494.0	\$ 662.7	\$ 472.3
Non-recourse	113.8	120.0	112.9	113.8

The fair value of the Company's long-term recourse debt related to its senior notes is determined based on quoted market prices of identical debt instruments. The fair value of the Company's recourse debt related to the ABL Facility and non-recourse debt related to the first mortgage bonds is measured by discounting the respective cash flows at quoted market rates for similar debt having the same maturity. In measuring fair value, the Company incorporates credit valuation adjustments to appropriately reflect its own non-performance risk, where appropriate.

**10. EMPLOYEE FUTURE BENEFITS**

The Company maintains pension benefit plans for all salaried employees, which include defined benefit and defined contribution segments. Employees hired subsequent to January 1, 1994 enroll in the defined contribution segment. Effective January 1, 2010, employees in the defined benefit plan ceased to accrue benefits under the defined benefit segment of the plan and began to participate in the defined contribution segment of the plan. The Company also maintains pension benefits for former hourly employees that are not covered by union pension plans.

The Company provides other benefit plans consisting of provincial medical plan premiums, extended health care and dental benefits to employees. During the quarter, the Company made the decision to permanently close Elk Falls mill and the reduction in the benefit obligation resulting from the plan curtailment amounting to \$9.7 million was recognized during the quarter with a corresponding increase to other comprehensive income.

For the three and six months ended June 30, 2010, the Company incurred a total post-retirement benefit cost of \$8.6 million and \$17.2 million, respectively (three and six months ended June 30, 2009 – \$10.5 million and \$22.4 million, respectively).

For the three and six months ended June 30, 2010, the Company contributed \$6.0 million and \$10.3 million, respectively, to its pension plans and \$1.6 million and \$3.6 million, respectively, to the other post-retirement benefit plans.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited and in millions of Canadian dollars, except where otherwise stated)

Components of net periodic benefit cost for pension plans and other post-retirement benefit plans

	Three months ended June 30, 2010		Three months ended June 30, 2009	
	Pension plans	Other post-retirement benefit plans	Pension plans	Other post-retirement benefit plans
<b>Defined benefit costs</b>				
Service cost for the period	\$ 0.5	\$ 0.5	\$ 1.0	\$ 0.6
Interest cost	5.2	2.5	5.6	2.8
Actual and expected return on assets	(4.1)	–	(3.8)	–
Actuarial loss	0.6	0.1	0.1	–
Difference between actual and recognized actuarial (gain) loss and other	0.9	–	0.9	(0.2)
Difference between actual and recognized prior service (credits) costs	0.1	(0.9)	0.1	(0.1)
<b>Net periodic benefit cost</b>	<b>\$ 3.2</b>	<b>\$ 2.2</b>	<b>\$ 3.9</b>	<b>\$ 3.1</b>

	Six months ended June 30, 2010		Six months ended June 30, 2009	
	Pension plans	Other post-retirement benefit plans	Pension plans	Other post-retirement benefit plans
<b>Defined benefit costs</b>				
Service cost for the period	\$ 0.9	\$ 1.0	\$ 2.0	\$ 1.2
Interest cost	10.4	5.0	11.2	5.6
Actual and expected return on assets	(8.2)	–	(7.6)	–
Actuarial loss	1.2	0.1	0.2	–
Difference between actual and recognized actuarial (gain) loss and other	1.9	–	1.8	(0.4)
Difference between actual and recognized prior service (credits) costs	0.2	(1.8)	0.2	(0.1)
<b>Net periodic benefit cost</b>	<b>\$ 6.4</b>	<b>\$ 4.3</b>	<b>\$ 7.8</b>	<b>\$ 6.3</b>

## 11. ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following table contains information about the accumulated other comprehensive income (loss) (“AOCI”) of the Company, net of taxes:

	June 30, 2010	December 31, 2009
Unrecognized pension and other post-retirement benefits costs	\$ (36.6)	\$ (60.9)
Unrecognized gain on cash flow revenue hedges	4.7	7.7
Foreign currency translation adjustments, net of related hedging activities <sup>1</sup>	1.1	1.1
Unrecognized loss on interest rate hedges	(0.6)	(0.6)
	<b>\$ (31.4)</b>	<b>\$ (52.7)</b>

<sup>1</sup> The accumulated net adjustment is comprised of non-taxable translation gain of \$6.7 million (2009 – \$5.2 million gain), and a net revaluation of long-term debt designated as a net investment hedge of \$5.6 million loss (2009 – \$4.1 million loss), net of tax of \$0.4 million recovery (2009 – \$0.3 million recovery).

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited and in millions of Canadian dollars, except where otherwise stated)

**12. RESTRUCTURING COSTS**

During the three and six months ended June 30, 2010, the Company recorded restructuring costs of \$10.9 million and \$25.0 million, respectively, primarily related to severances paid to eligible employees at Elk Falls.

The Company's restructuring expenses and related provisions were as follows:

Three months ended June 30, 2010	2007 and 2008 Initiatives	2009 Initiatives	2010 Initiatives	Total
Balance, beginning	\$ 1.8	\$ 2.0	\$ 0.4	\$ 4.2
Expensed in period	–	0.2	10.7	10.9
Disbursements	(0.8)	(0.6)	(1.2)	(2.6)
Balance, end of period	\$ 1.0	\$ 1.6	\$ 9.9	\$ 12.5
<b>Classification:</b>				
Accounts payable and accrued liabilities	\$ 0.6	\$ 1.6	\$ 9.9	\$ 12.1
Other long-term obligations	0.4	–	–	0.4
	\$ 1.0	\$ 1.6	\$ 9.9	\$ 12.5

Three months ended June 30, 2009	2007 and 2008 Initiatives	2009 Initiatives	Total
Balance, beginning	\$ 10.1	\$ 2.2	\$ 12.3
Expensed in period	1.0	11.3	12.3
Disbursements	(4.0)	(1.9)	(5.9)
Other non-cash items	0.4	–	0.4
	7.5	11.6	19.1
Less: portion related to employee future benefits	–	(5.6)	(5.6)
Balance, end of period	\$ 7.5	\$ 6.0	\$ 13.5
<b>Classification:</b>			
Accounts payable and accrued liabilities	\$ 6.3	\$ 3.8	\$ 10.1
Other long-term obligations	1.2	2.2	3.4
	\$ 7.5	\$ 6.0	\$ 13.5

Six months ended June 30, 2010	2007 and 2008 Initiatives	2009 Initiatives	2010 Initiatives	Total
Balance, beginning	\$ 4.1	\$ 2.7	\$ –	\$ 6.8
Expensed in period	0.8	0.3	23.9	25.0
Disbursements	(3.9)	(1.4)	(14.0)	(19.3)
Balance, end of period	\$ 1.0	\$ 1.6	\$ 9.9	\$ 12.5
<b>Classification:</b>				
Accounts payable and accrued liabilities	\$ 0.6	\$ 1.6	\$ 9.9	\$ 12.1
Other long-term obligations	0.4	–	–	0.4
	\$ 1.0	\$ 1.6	\$ 9.9	\$ 12.5

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited and in millions of Canadian dollars, except where otherwise stated)

Six months ended June 30, 2009	2007 and 2008 Initiatives	2009 Initiatives	Total
Balance, beginning	\$ 16.3	\$ –	\$ 16.3
Expensed in period	3.0	13.5	16.5
Disbursements	(12.2)	(1.9)	(14.1)
Other non-cash items	0.4	–	0.4
	7.5	11.6	19.1
Less: portion related to employee future benefits	–	(5.6)	(5.6)
Balance, end of period	\$ 7.5	\$ 6.0	\$ 13.5
<b>Classification:</b>			
Accounts payable and accrued liabilities	\$ 6.3	\$ 3.8	\$ 10.1
Other long-term obligations	1.2	2.2	3.4
	\$ 7.5	\$ 6.0	\$ 13.5

### 13. IMPAIRMENT AND CLOSURE COSTS

During the quarter, as a result of the decision to permanently close the Company's Elk Falls paper mill and paper recycling operation in September 2010, the Company recorded a \$302.0 million charge for related impairment, severances and other closure costs. The Elk Falls mill had been indefinitely curtailed since February 2009 and the paper recycling facility was indefinitely idled in February 2010. The following table provides the components of the impairment, severances and other closure costs:

Property, plant and equipment	\$ 272.5
Operating and maintenance supplies and spare parts inventory (note 5)	20.3
	292.8
Less: impairment previously recorded on paper assets (prior to announcement of permanent closure)	(12.0)
Severances	9.7
Other closure costs – operating lease at paper recycling operation	11.5
<b>Total</b>	<b>\$ 302.0</b>
<b>Classification in consolidated statement of earnings (loss):</b>	
Impairment and other closure costs	\$ 292.3
Restructuring (severances)	9.7
	<b>\$ 302.0</b>

Key assumptions used in calculating the liability associated with the closure of the paper recycling operation include estimates related to the timing and extent of sublease revenues and the estimates of other related closure costs. The closure costs of \$11.5 million relating to the operating lease at the paper recycling operation are comprised of total rental payments over the lease term to 2023 of \$42.4 million, including estimated property taxes and fixed operating costs, reduced by estimated sublease payments and discounted using a discount rate of 16.5%. If the timing and amount of actual net sublease payments, property taxes or fixed operating costs differ from these estimates, or the Company settles the outstanding liability through negotiations with the lessor, the resulting liability could vary from the recorded amount. This liability will be reviewed periodically and adjusted when necessary.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited and in millions of Canadian dollars, except where otherwise stated)

**14. OTHER EXPENSE, NET**

The components of other expense, net, were as follows:

	Three months ended June 30,		Six months ended June 30,	
	2010	2009	2010	2009
Fees related to bond exchange	\$ —	\$ —	\$ (8.3)	\$ —
Loss on derivative financial instruments	(11.2)	7.0	(12.1)	1.3
Foreign exchange gain on working capital balances	6.2	(15.2)	6.1	(17.3)
Gain (loss) on disposal of property, plant and equipment	0.2	(3.9)	6.0	(2.7)
Termination fee on closure of corrugating machine at Snowflake	—	—	—	(0.5)
Other	(0.1)	0.1	(0.1)	0.1
	\$ (4.9)	\$ (12.0)	\$ (8.4)	\$ (19.1)

**15. INCOME TAX EXPENSE (RECOVERY)**

During the quarter, the Company did not provide for any tax benefits associated with the impairment, severances and other closure costs of \$302.0 million. As at June 30, 2010, the Company has provided for a valuation allowance on its future tax assets of \$90.7 million. As a result, the effective tax rate for the quarter was nil.

**16. FAIR VALUE MEASUREMENTS**

An established fair value hierarchy requires the Company to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. A financial instrument's categorization within the fair value hierarchy is based upon the lowest level of input that is available and significant to the fair value measurement. There are three levels of inputs that may be used to measure fair value:

**Level 1**

Quoted prices in active markets for identical assets or liabilities.

**Level 2**

Observable inputs other than quoted prices in active markets for identical assets and liabilities, such as quoted prices for identical or similar assets or liabilities in markets that are not active, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

**Level 3**

Inputs that are generally unobservable and are supported by little or no market activity and that are significant to the fair value determination of the assets or liabilities.

As at June 30, 2010, the Company does not have any derivative and non-derivative instruments which have been designated as hedging instruments.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited and in millions of Canadian dollars, except where otherwise stated)

The following table presents information about the fair value of the Company's derivative and non-derivative financial instruments not designated as hedging instruments and measured at fair value on a recurring basis:

	June 30, 2010	Fair value hierarchy	Balance sheet classification
<b>Assets</b>			
Currency contracts	\$ 5.0	2 <sup>1</sup>	Prepays and other
Commodity swap contracts	0.3	2 <sup>2</sup>	Prepays and other
Currency contracts	0.4	2 <sup>1</sup>	Other assets
	\$ 5.7		
<b>Liabilities</b>			
Commodity swap contracts	\$ —	—	Accounts payable and accrued liabilities

Fair value of the Company's derivatives is classified under Level 2 (inputs that are observable; directly or indirectly) as it is measured as follows:

- The fair value of forward currency contracts is measured using the discounted difference between contractual rates and market future rates. Interest rates, forward market rates and volatility are used as inputs for such valuation techniques. The Company incorporates credit valuation adjustments to appropriately reflect both its own non-performance risk and the counterparty's non-performance risk in the fair value measurements.
- The fair value of commodity swap contracts is measured using the discounted difference between contractual rates and market rates. The fair value of natural gas commodity options is measured using techniques derived from the Black-Scholes pricing model. The Company incorporates credit valuation adjustments to appropriately reflect both its own non-performance risk and the counterparty's non-performance risk in the fair value measurements.

The following table presents information about the six month period ended June 30 effects of the Company's derivative instruments designated previously as hedging instruments until April 1, 2010 when hedge accounting was discontinued (refer to note 3) on the Company's consolidated financial statements:

	Gain (loss) recognized in AOCI <sup>1</sup>		(Gain) loss reclassified from AOCI <sup>1</sup>		Classification on Statement of earnings (loss) reclassified from AOCI <sup>1</sup>	Gain (loss) recognized in income <sup>2</sup>	
	2010	2009	2010	2009		2010	2009
Derivatives designated as cash flow hedges							
Currency contracts	\$ 4.2	\$ 5.1	\$ (7.2)	\$ 7.7	Sales	\$ (1.8)	\$ (1.7)
Derivatives and other instruments designated as net investment hedges							
Long-term debt	\$ (2.5)	\$ 9.0	\$ 1.0	\$ —	Foreign exchange gain (loss) on long-term debt	\$ —	\$ —

1 The gain (loss) recognized, or (gain) loss reclassified from AOCI relates to the effective portion of the hedge.

2 The gain (loss) recognized in income relates to the ineffective portion of the hedge and the amount excluded from effectiveness testing.

As U.S. dollar denominated revenues are recognized over the next 12 months subsequent to June 30, 2010, the Company estimates that net gain of \$6.6 million, or an after-tax net gain of \$4.8 million, will be reclassified from "Accumulated other comprehensive income (loss)" to "Sales".

The carrying value of the Company's other financial instruments, namely cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities approximate their fair values because of the short-term maturity of these instruments.

## 17. FINANCIAL INSTRUMENTS

### (a) Financial Risk Management

Financial instruments of the Company consist primarily of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities and long-term debt. Financial instruments of the Company also include derivatives which the Company uses to reduce its exposure to currency and price risk associated with its revenues, energy costs and long-term debt.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited and in millions of Canadian dollars, except where otherwise stated)

The Company has exposure to risk from its financial instruments, specifically credit risk, market risk (including currency, price and interest rate risk) and liquidity risk. A summary of the Company's financial risk management objectives can be found on pages 121 to 125 of the Company's 2009 Annual Report.

**Accounts receivable**

The Company is exposed to credit risk on accounts receivable from its customers who are mainly in the newspaper publishing and commercial printing businesses. Aging of receivables was as follows:

	June 30, 2010	December 31, 2009
Trade receivables, gross		
Current	\$ 101.7	\$ 89.0
Past due 1-30 days	6.0	7.3
Past due 31-90 days	1.9	1.0
Past due over 90 days	–	1.4
	<b>109.6</b>	<b>98.7</b>
Allowance for doubtful accounts	<b>(3.0)</b>	<b>(3.7)</b>
Trade receivables, net	<b>106.6</b>	<b>95.0</b>
Other receivables, including GST recoverables	<b>7.8</b>	<b>6.5</b>
Accounts receivable	<b>\$ 114.4</b>	<b>\$ 101.5</b>

The movement in the allowance for doubtful accounts in respect of trade receivables was as follows:

	Six months ended June 30, 2010	Year ended December 31, 2009
Balance, beginning of period	\$ 3.7	\$ 3.2
Increase (decrease) in provision	(0.7)	1.2
Utilized	–	(0.7)
Balance, end of period	<b>\$ 3.0</b>	<b>\$ 3.7</b>

**(b) Revenue Risk Management Instruments**

Foreign currency options and forward contracts outstanding to sell U.S. dollars were as follows:

Term	Options					
	Purchased US\$ put		Sold US\$ call		Forward contracts	
	US\$millions	Average rate US\$/CDN\$	US\$millions	Average rate US\$/CDN\$	US\$millions	Average rate US\$/CDN\$
As at June 30, 2010						
0 to 12 months	\$ 286	0.9591	\$ 268	0.8641	\$ 8	0.8905
13 to 24 months	52	0.9855	38	0.8802	–	–
	<b>\$ 338</b>	<b>0.9631</b>	<b>\$ 306</b>	<b>0.8660</b>	<b>\$ 8</b>	<b>0.8905</b>
As at December 31, 2009						
0 to 12 months	\$ 270	0.9319	\$ 241	0.8281	\$ 27	0.8729
13 to 24 months	69	0.9590	53	0.8370	–	–
	<b>\$ 339</b>	<b>0.9373</b>	<b>\$ 294</b>	<b>0.8297</b>	<b>\$ 27</b>	<b>0.8729</b>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited and in millions of Canadian dollars, except where otherwise stated)

At period-end exchange rates, the net amount the Company would receive to settle the above contracts and options is \$5.4 million (December 31, 2009 – \$19.0 million).

The Company no longer designates its U.S. dollar revenue risk management instruments as cash flow hedges for accounting purposes effective April 1, 2010 (note 3). For cash flow hedges that were in place as at March 31, 2010, the effective portion of changes in the fair value accumulated as at March 31, 2010 have been deferred and recorded in "Accumulated other comprehensive income (loss)". When the hedge item is recorded in earnings, the corresponding gain or loss on the hedge will be reclassified from "Accumulated other comprehensive income (loss)" to "Sales". At June 30, 2010, instruments having a notional principal of US\$346 million are marked to market, where the related gains and losses are recognized as "Other expense, net", except for the portion still deferred in AOCI.

### (c) Cost Risk Management Instruments

The Company is party to commodity options to hedge the purchase price of natural gas for 1.1 million gigajoules ("GJ") (December 31, 2009 – 0.4 million GJ) within the next nine months at rates averaging \$4.91 per GJ. These instruments are not designated as hedging instruments for accounting purposes and are reported at fair value. At period-end contract rates, the net amount the Company would receive to settle these commodity contracts is \$0.3 million (December 31, 2009 - \$nil).

## 18. COMPARATIVE FIGURES

Certain comparative figures presented in the interim consolidated financial statements have been reclassified to conform to the current period presentation.

## 19. CONTINGENT LIABILITIES

A description of the Company's contingent liabilities as at December 31, 2009 can be found on pages 49 and 50 of the Company's 2009 Annual Report. An update as at June 30, 2010 is outlined below:

### (a) Severances

The decision to permanently close the Elk Falls mill during the quarter resulted in the Company recording \$9.7 million in severances for approximately 120 employees who are expected to be impacted. The recording of this liability has eliminated the contingent severance obligation with respect to these employees.

With the restart of the second line of pulp production at Crofton, Crofton employees who were on lay-offs as at December 31, 2009 have been recalled. This action has eliminated the contingent severance obligation with respect to these employees.

As a result of restructuring and other initiatives announced in prior quarters, as of June 30, 2010, there were approximately 60 hourly employees at the Powell River and Port Alberni mills that were on lay-offs and have rights of recall ranging from 13 to 24 months. These employees may at any time forfeit their rights of recall in exchange for severance payments. If all affected employees exercise their severance rights at some point and thereby forfeit their recall rights, the total severance payment would be approximately \$3 million. The Company did not record a liability for this contingency as at June 30, 2010 as the likelihood, timing, and extent of any potential liability were not determinable.

### (b) Application to Labour Relations Board for Certain Post-retirement Benefits

The CEP Locals 1, 76, 592 and 686 (the "Locals"), representing hourly employees at the Company's Powell River and Port Alberni mills, have applied to the Labour Relations Board of B.C. for a declaration that the Company is responsible for certain post-retirement medical and extended health benefits for some retired employees who were represented by the Locals and who retired from MacMillan Bloedel Limited, now doing business as Weyerhaeuser Company Ltd. The Labour Relations Board declined to rule on the Locals' application or the Company's defence to the claim on the basis that this matter is a dispute under the collective agreement and accordingly a matter to be determined by arbitration. At this point, Locals 1, 76 and 592 have filed grievances. The grievance proceeding for Local 76 is expected to take place in December 2010. The other two proceedings have not been scheduled. The extent of the Company's liability for this claim remains unknown at this time although the Company estimates that it would incur costs of between \$2 million and \$4 million annually to provide these additional benefits.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited and in millions of Canadian dollars, except where otherwise stated)

**(c) Short-term Incentive Plan Benefit Claim**

In May 2010, a salaried employee of the Company commenced an action against the Company in the B.C. Supreme Court seeking a payment under the Company's 2009 Short-term Incentive Plan and damages in connection with the reduction of certain employee benefits. The employee is proposing to seek certification of the action as a class proceeding on behalf of all salaried employees entitled to Short-term Incentive Plan payments and who were affected by the benefit reduction. The Company disputes the claims made and intends to vigorously defend this action and any certification proceedings which may be brought. Given the early stage of these proceedings, it is not possible to determine the likelihood, timing and extent of any potential liability. As such, the Company has not recorded a liability for this contingency as at June 30, 2010.

**20. RECONCILIATION OF UNITED STATES AND CANADIAN GENERALLY ACCEPTED ACCOUNTING PRINCIPLES**

The Company's consolidated financial statements have been prepared in accordance with U.S. GAAP, which differ in some respects from Canadian GAAP. The following are the significant measurement and disclosure differences between U.S. and Canadian GAAP:

**Net Earnings (Loss) Adjustments**

The following table provides a reconciliation of the net earnings (loss) for the three and six months ended June 30 from U.S. GAAP to Canadian GAAP:

	Three months ended June 30,		Six months ended June 30,	
	2010	2009	2010	2009
<b>Net earnings (loss) as reported under U.S. GAAP</b>	<b>\$ (368.1)</b>	<b>\$ (3.0)</b>	<b>\$ (412.8)</b>	<b>\$ 17.2</b>
Net (earnings) loss attributable to non-controlling interest (a)	(0.3)	1.1	0.3	1.0
Amortization related to hedge of net investment (b)	–	–	0.1	0.2
Income tax effect of rate change on employee future benefits	–	–	–	0.7
<b>Net earnings (loss) in accordance with Canadian GAAP</b>	<b>(368.4)</b>	<b>(1.9)</b>	<b>(412.4)</b>	<b>19.1</b>
Other comprehensive income (loss), net of taxes:				
Other comprehensive income in accordance with U.S. GAAP	4.4	5.6	21.4	11.1
Other comprehensive income (loss) attributable to non-controlling interest (a)	–	–	(0.1)	–
Employee future benefits liability adjustment, net of taxes (c)	(6.9)	–	(23.3)	–
Reclassification of amortization of employee future benefits included in pension cost, net of taxes (c)	(0.5)	(0.6)	(1.0)	(1.3)
<b>Comprehensive income (loss) in accordance with Canadian GAAP</b>	<b>\$ (371.4)</b>	<b>\$ 3.1</b>	<b>\$ (415.4)</b>	<b>\$ 28.9</b>
Basic and diluted net earnings (loss) per share in accordance with Canadian GAAP (in dollars)	<b>\$ (0.96)</b>	<b>\$ (0.01)</b>	<b>\$ (1.08)</b>	<b>\$ 0.05</b>
Basic and diluted weighted average number of shares in accordance with Canadian GAAP (in millions)	<b>381.8</b>	<b>381.8</b>	<b>381.8</b>	<b>381.8</b>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited and in millions of Canadian dollars, except where otherwise stated)

### Balance Sheet Adjustments

The following table provides a reconciliation of the consolidated balance sheet components from U.S. GAAP to Canadian GAAP:

	June 30, 2010	December 31, 2009
<b>Prepays and other – U.S. GAAP</b>	<b>\$ 22.9</b>	<b>\$ 25.2</b>
Deferred financing costs (d)	(0.2)	–
<b>Prepays and other – Canadian GAAP</b>	<b>\$ 22.7</b>	<b>\$ 25.2</b>
<b>Property, plant and equipment – U.S. GAAP</b>	<b>\$ 1,346.1</b>	<b>\$ 1,664.7</b>
Foreign exchange gain on hedge of net investment, net of amortization (b)	(2.1)	(2.2)
<b>Property, plant and equipment – Canadian GAAP</b>	<b>\$ 1,344.0</b>	<b>\$ 1,662.5</b>
<b>Other assets – U.S. GAAP</b>	<b>\$ 38.8</b>	<b>\$ 38.0</b>
Employee future benefits (c)	35.2	35.2
Tax effect of employee future benefits adjustment	(1.5)	(1.9)
Deferred financing costs (d)	(11.3)	(6.6)
Non-controlling interest deficit (a)	18.7	18.0
<b>Other assets – Canadian GAAP</b>	<b>\$ 79.9</b>	<b>\$ 82.7</b>
<b>Long-term debt – U.S. GAAP</b>	<b>\$ 828.7</b>	<b>\$ 774.6</b>
Deferred financing costs (d)	(11.5)	(6.6)
<b>Long-term debt – Canadian GAAP</b>	<b>\$ 817.2</b>	<b>\$ 768.0</b>
<b>Employee future benefits – U.S. GAAP</b>	<b>\$ 260.9</b>	<b>\$ 294.6</b>
Employee future benefits (c)	(26.5)	(59.0)
<b>Employee future benefits – Canadian GAAP</b>	<b>\$ 234.4</b>	<b>\$ 235.6</b>
<b>Future income taxes – U.S. GAAP</b>	<b>\$ 27.1</b>	<b>\$ 22.8</b>
Tax effect of employee future benefits adjustment	23.6	31.4
Tax effect of other adjustments	(9.1)	(9.1)
<b>Future income taxes – Canadian GAAP</b>	<b>\$ 41.6</b>	<b>\$ 45.1</b>
<b>Equity – U.S. GAAP</b>	<b>\$ 403.7</b>	<b>\$ 795.6</b>
Foreign exchange gain on hedge of net investment, net of amortization (b)	(2.1)	(2.2)
Employee future benefits (c)	61.2	94.2
Tax effect of employee future benefits adjustment	(25.1)	(33.3)
Tax effect of other adjustments	9.1	9.1
Non-controlling interest deficit (a)	18.7	18.0
<b>Equity – Canadian GAAP</b>	<b>\$ 466.0</b>	<b>\$ 881.4</b>

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited and in millions of Canadian dollars, except where otherwise stated)

The following table provides a reconciliation of AOCI from U.S. GAAP to Canadian GAAP:

	June 30, 2010	December 31, 2009
<b>Accumulated other comprehensive income (loss) – U.S. GAAP</b>	<b>\$ (31.4)</b>	<b>\$ (52.7)</b>
Employee future benefits (c)	36.6	60.9
<b>Accumulated other comprehensive income (loss) – Canadian GAAP</b>	<b>\$ 5.2</b>	<b>\$ 8.2</b>

**(a) Non-controlling Interest**

Under U.S. GAAP, non-controlling interest's equity or deficit is reported as a separate component within equity of the consolidated balance sheet and consolidated net earnings (loss) and other comprehensive income (loss) attributable to the Company and to the non-controlling interest is clearly identified and presented on the face of the consolidated statements of earnings (loss), comprehensive income (loss), and equity. Under Canadian GAAP, the Company includes non-controlling interest's equity or deficit in "Other assets" and the non-controlling interest's share of earnings or loss is excluded from consolidated net earnings (loss).

**(b) Foreign Exchange on Hedge of Net Investment**

Under U.S. GAAP, the foreign exchange gain on a hedge of a net investment is recognized in earnings, and accordingly, the net investment acquired is not reduced by the amount of the gain. Under Canadian GAAP, the Company designated a forward contract as a hedge of the purchase price on the acquisition of the Snowflake newsprint mill, and accounted for the respective foreign exchange gain as a reduction of the net investment.

**(c) Employee Future Benefits**

U.S. GAAP requires the recognition of the overfunded or underfunded status of a defined benefit post-retirement plan as an asset or liability in the balance sheet and requires that changes in that funded status in the year in which the changes occur be recorded in "Other comprehensive income (loss)". As a result, as amounts that relate to the funded status are recognized in earnings through pension expense, the amounts are reclassified out of AOCI. Canadian GAAP does not require recognition of the overfunded or underfunded status of a defined benefit post-retirement plan. There is no GAAP difference between U.S. and Canada in the determination of pension and other employee future benefits expense.

**(d) Deferred Financing Costs**

Under U.S. GAAP, debt issue costs are reported on the balance sheet as deferred charges in "Other assets." Under Canadian GAAP, debt issue costs related to the Company's senior notes and non-recourse first mortgage bonds are netted against the carrying value of long-term debt on the consolidated balance sheet.

### Investor Relations Contacts

#### **Brian Baarda**

Vice-President, Finance and  
Chief Financial Officer  
Tel: 604-247-4710

#### **Lyn Brown**

Vice-President, Corporate Relations  
and Social Responsibility  
Tel: 604-247-4713

### Transfer Agent and Registrar

CIBC Mellon Trust Company  
at its principal offices in  
Vancouver and Toronto.

### Share Information

Common Shares  
(symbol: CTL)  
The Toronto Stock Exchange

### PRODUCTION NOTES

This report is printed on Pacificote paper with a 66.5 gsm basis weight, produced at Catalyst's Port Alberni mill. A coated grade, Pacificote has excellent opacity, and is one of the brightest coated mechanical papers available in the market today. It is used in book publishing, magazines, catalogues, and for general commercial printing.

In accordance with PEFC chain-of-custody, this paper contains 100 per cent certified wood fibre. It is also Catalyst Cooled(tm), having been manufactured with no net carbon emissions to the atmosphere.

Printed by Blanchette Press, Richmond, British Columbia, using inks that comply with CONEG regulations for heavy metal content and are formulated to contain vegetable-derived raw materials including soya, canola and linseed oils as well as resins derived from pine and fir tree gum.





Catalyst Paper Corporation  
 2nd Floor, 3600 Lysander Lane  
 Richmond, B.C. V7B 1C3  
 604-247-4400  
[www.catalystpaper.com](http://www.catalystpaper.com)

### Paper Facts

per report (99 g)

#### Inputs

Raw Fibre (g)	75
% certified sources	100
Filler (g)	42
Water (L)	7.7
Work (person-secs)	1.0
Energy (Cal)	549
% renewable	88

#### Emissions

Greenhouse gas (g)	13*
Air Particulate (mg)	4
Effluent BOD (mg)	23
Solid waste (cm <sup>3</sup> )	7

This Paper Facts label identifies the weight, inputs and emissions for the inside pages of each paper copy of this report. It demonstrates Catalyst's focus on its operations' environmental footprint as well as its commitment to transparency.

Catalyst produces mechanical printing papers, also referred to as groundwood papers, which do not rely on chemical processes to separate the fibres. Mechanical paper production uses less fibre and energy with fewer emissions than papers made using chemical processes.

While commonly seen in applications such as magazines, catalogues and advertising inserts, Catalyst's annual disclosure reports demonstrate the application of its products in non-traditional uses.

Catalyst customers can use its Paper Facts Calculator at [www.catalystpaper.com/calculator](http://www.catalystpaper.com/calculator) to identify the inputs and emissions of specific weights of Catalyst paper grades, compare them to typical North American sheets, and make informed choices.

\* Catalyst Cooled™ – offset to zero