

WE'RE ON A ROLL

CATALYST PAPER | 2011 | SECOND QUARTER REPORT



COMPANY PROFILE

Catalyst Paper manufactures diverse specialty printing papers, newsprint and pulp. Our customers include retailers, publishers and commercial printers in North America, Latin America, the Pacific Rim and Europe. With four mills located in British Columbia and Arizona, Catalyst has a combined annual production capacity of 1.9 million tonnes. Headquartered in Richmond, British Columbia, Canada, Catalyst's common shares trade on the Toronto Stock Exchange under the symbol CTL.

MANAGEMENT'S DISCUSSION AND ANALYSIS

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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, 2011 and June 30, 2010, and our audited annual consolidated financial statements for the year ended December 31, 2010 and the notes thereto, which have been prepared in accordance with generally accepted accounting principles (GAAP) in the United States (U.S.). Additional information about the company, including our most recent Annual Information Form is available on our website at www.catalystpaper.com, or the Canadian Securities Administrator's electronic filing website at 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 restructuring costs, 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. We believe that these non-GAAP measures are useful in evaluating our performance. These non-GAAP measures are defined and reconciled to their nearest GAAP measure in section 6, 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 tonne. Use of these symbols is in accordance with industry practice.

The information in this report is as of August 1, 2011, which is the date of filing in conjunction with our press release announcing our results for the second quarter of 2011. Disclosure contained in this document is current to August 1, 2011, unless otherwise stated.

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

Certain statements and information in this MD&A are not based on historical facts and constitute forward-looking statements or forward-looking information within the meaning of Canadian securities laws and the U.S. Private Securities Litigation Reform Act of 1995 (forward-looking statements), including but not limited to, statements about our strategy, plans, future operating performance, contingent liabilities 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
- can be identified by the use of words such as “believe”, “expect”, “anticipate”, “intend”, “plan”, “likely”, “predicts”, “estimates”, “forecasts”, and similar words or phrases or the negative of such words or phrases
- reflect our current beliefs, intentions or expectations based on certain assumptions and estimates, including those identified below, which could prove to be significantly incorrect:
 - our ability to develop, manufacture and sell new products and services that meet the needs of our customers and gain commercial acceptance
 - our ability to continue to sell our products and services in the expected quantities at the expected prices and expected times
 - our ability to successfully obtain cost savings from our cost reduction initiatives
 - our ability to implement business strategies and pursue opportunities
 - expected cost of goods sold
 - expected component supply costs and constraints
 - expected foreign exchange and tax rates
- while considered reasonable by management, are inherently subject to known and unknown risks and uncertainties and other factors that could cause actual results or events to differ from historical or anticipated results or events. These risk factors and others are discussed in this MD&A. Certain of these risks are:
 - the impact of general economic conditions in the countries in which we do business
 - conditions in the capital markets and our ability to obtain financing and refinance existing debt
 - market conditions and demand for our products (including declines in advertising and circulation)
 - the implementation of trade restrictions in jurisdictions where our products are marketed
 - fluctuations in foreign exchange or interest rates
 - raw material prices (including wood fibre, chemicals and energy)
 - the effect of, or change in, environmental and other governmental regulations
 - uncertainty relating to labour relations
 - the availability of qualified personnel
 - legal proceedings
 - the effects of competition from domestic and foreign producers
 - the risk of natural disaster and other factors many of which are beyond our control

As a result, no assurance can be given that any of the events or results anticipated by such forward-looking statements will occur or, if they do occur, what benefit they will have on our operations or financial condition. Readers are cautioned not to place undue reliance on these forward-looking statements. 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.

1. OVERVIEW AND HIGHLIGHTS

BUSINESS OVERVIEW

We are the largest producer of mechanical printing papers in western North America. We also produce NBSK pulp which is marketed primarily in Asia. Our business is comprised of three business segments: specialty printing papers, newsprint, and pulp. Specialty printing papers include coated mechanical, uncoated mechanical, and directory paper. We are the only producer of coated mechanical paper and soft calender (SC) paper in western North America. We operate four paper mills, three of which are located in British Columbia (B.C.) in Crofton, Port Alberni, and Powell River and one in Snowflake, Arizona, which produces 100% recycled-content paper. Our Crofton mill includes a two-line kraft pulp operation.

More information about our business segments, product profile, and our geographic sales distribution is provided on pages 7 to 9 of our 2010 Annual Report. Our production capacity by mill and product line is summarized in the following chart:

2011 Capacity by Mill Location and Product Line ¹

Mill location	Number of paper machines	Specialty printing papers ¹			Newsprint ¹	Pulp	Total
		Uncoated mechanical	Coated mechanical	Directory	Newsprint	NBSK pulp	
Crofton, B.C. ²	3	–	–	145,000	291,000	310,000 ³	746,000
Port Alberni, B.C.	2	–	223,000	115,000	–	–	338,000
Powell River, B.C.	3	449,000	–	–	30,000	–	479,000
Snowflake, Arizona	2	48,000	–	–	289,000	–	337,000
Total capacity (tonnes)	10	497,000	223,000	260,000	610,000	310,000	1,900,000
% of total capacity		26%	12%	14%	32%	16%	100%

¹ Capacities expressed in the above table can vary as we are able to switch production between products, particularly newsprint, directory and machine-finished uncoated grades.

² 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.

³ Total pulp capacity at Crofton is 370,000 tonnes, of which 310,000 tonnes are designated as market pulp with the remainder of 60,000 tonnes being consumed internally.

SECOND QUARTER OVERVIEW

Operating earnings for the quarter were down from the previous quarter due to lower sales, higher maintenance spending, lower production, higher fibre prices, and higher electric power. Sales in the second quarter were heavily impacted by lower production volumes and currency exchange. Lower production and higher maintenance spending were due to our annual maintenance outages at our Snowflake and Powell River mills, and fires at both of these mills.

Demand for mechanical paper products was down in the second quarter compared to the first quarter. Prices for most paper grades were higher compared to the previous quarter, but were more than offset by the stronger Canadian dollar. NBSK pulp continued its strong run, with solid demand and higher prices during the second quarter.

Chip prices are tied to the pulp market, and higher NBSK pulp transaction prices combined with a tightening in chip supply led to higher fibre prices which negatively impacted our results for the quarter.

The focus on financial restructuring continued with the successful renegotiation of the company's asset based loan facility (ABL Facility) with amended terms and an extended maturity date from 2013 to 2016.

Financial Performance

We recorded a net loss attributable to the company of \$47.4 million and a net loss attributable to the company before specific items of \$46.9 million in Q2. This compared to a net loss of \$12.9 million and \$23.6 million, respectively, in Q1. Significant specific items in Q2 included a foreign exchange gain on the translation of U.S. dollar denominated debt, losses sustained due to fires at our Snowflake mill in April and our Powell River mill in May and an impairment recovery associated with the permanent closure of the Coquitlam paper recycling facility. Significant specific items in the prior quarter included a foreign exchange gain on the translation of U.S. dollar denominated debt.

EBITDA was negative \$3.9 million in Q2 compared to positive \$15.9 million in Q1. Refer to section 6, *Non-GAAP measures*, for additional information on specific items in the reported financial results.

SELECTED FINANCIAL INFORMATION

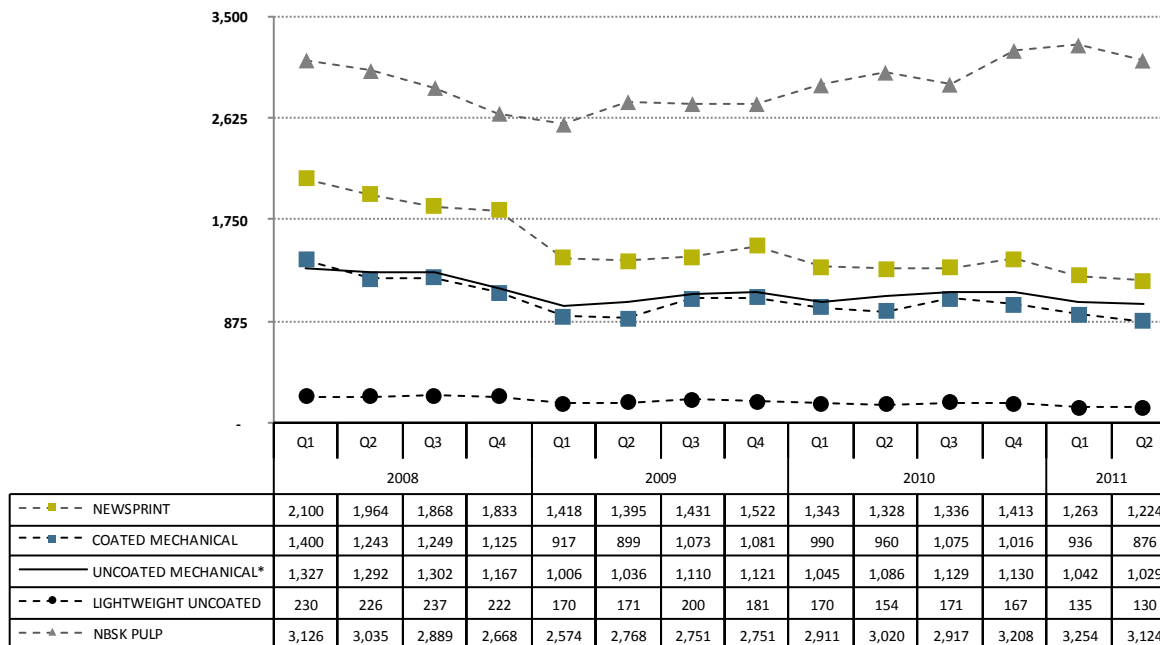
(In millions of Canadian dollars, except where otherwise stated)	2011			2010				
	YTD	Q2	Q1	Total	Q4	Q3	Q2	Q1
Sales	\$ 601.4	\$ 297.8	\$ 303.6	\$ 1,228.6	\$ 333.6	\$ 322.3	\$ 299.4	\$ 273.3
Operating earnings (loss)	(41.5)	(30.6)	(10.9)	(367.5)	0.2	5.1	(323.9)	(48.9)
Depreciation and amortization	53.8	27.0	26.8	119.3	27.2	28.2	31.2	32.7
EBITDA ¹	12.0	(3.9)	15.9	46.3	28.7	34.2	(0.4)	(16.2)
– before restructuring costs ¹	12.0	(3.9)	15.9	71.6	28.7	34.5	10.5	(2.1)
Net earnings (loss) attributable to the company	(60.3)	(47.4)	(12.9)	(396.9)	9.6	6.0	(368.4)	(44.1)
– before specific items ¹	(70.5)	(46.9)	(23.6)	(87.0)	4.1	(9.6)	(43.9)	(37.6)
EBITDA margin ¹	2.0%	(1.3%)	5.2%	3.8%	8.6%	10.6%	(0.1%)	(5.9%)
– before restructuring costs ¹	2.0%	(1.3%)	5.2%	5.8%	8.6%	10.7%	3.5%	(0.8%)
Net earnings (loss) per share attributable to the company's common shareholders (in dollars)								
– basic and diluted	\$ (0.16)	\$ (0.13)	\$ (0.03)	\$ (1.04)	\$ 0.02	\$ 0.02	\$ (0.96)	\$ (0.12)
– before specific items ¹	(0.18)	(0.12)	(0.06)	(0.23)	0.01	(0.03)	(0.11)	(0.10)
(In thousands of tonnes)								
Sales	792.4	393.0	399.4	1,634.9	434.1	412.1	404.5	384.2
Production	806.5	396.1	410.4	1,625.7	429.8	417.7	403.0	375.2

¹ Refer to section 6, *Non-GAAP measures*.

Market Overview

North American Paper Demand and NBSK Pulp Shipments (in thousands of metric tonnes)

Source: PPPC



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

Overall, market conditions remained challenging in the quarter compared to the same quarter last year. Demand for all paper grades decreased, days of inventory rose and operating rates remained at similar levels. Yet despite these less-than-stellar market conditions, prices generally improved compared to the first quarter. North American demand for coated and uncoated mechanical grades was down compared to levels of a year ago while demand decreases for directory paper and newsprint were more substantial. Coated and uncoated mechanical benchmark prices increased during the quarter while benchmark prices for directory and newsprint were flat and down slightly, respectively.

Global pulp shipments increased 4.3% for the quarter compared to last year as pulp demand in China increased during the quarter. NBSK pulp shipments increased 7.5% year-over-year and 3.4% from the same quarter last year led by very strong demand from China. NBSK pulp benchmark prices for China increased during the quarter and were above the record high levels achieved in 2010.

Maintenance Outages and Fires

At the Snowflake mill, a storage yard fire, downtime due to limited availability of affordable waste paper, and a five-day planned annual mill maintenance outage, which was extended to 10 days, resulted in production downtime of 15 days or 8,400 tonnes of lost production. The fire at Snowflake destroyed approximately 11,000 tonnes of recovered ONP and resulted in losses of \$4.1 million. At Powell River the total mill outage was increased from five days to 10 days, representing 14,000 tonnes of lost production, to enable additional repairs and testing in the main steam line serving the mill's operations as well as the necessary tie-ins for the G12 energy project that will become operational later in the year. A cable equipment tray fire at Powell River shortly after start-up idled the mill's No. 9 paper machine for five days and the No. 10 paper machine for 14 days and resulted in losses of \$1.6 million and 8,700 tonnes of lost production. The losses incurred on the fires to date were not covered by insurance as the losses were below our policy deductible of \$2 million per occurrence and our annual aggregate of \$6 million with a per occurrence contribution not to exceed \$3 million.

The financial impact of the maintenance outages, curtailment, and fires had a significant impact on our Q2 results. The following table provides the difference in production volume, maintenance costs, estimated EBITDA impact of lost production tonnes, and other expense from fires between Q2, 2011 and Q1, 2011 at the Snowflake and Powell River mills:

Q2 2011 vs. Q1 2011						
(In millions of Canadian dollars, except where otherwise stated)						
Mill	Machine (Days Lost)	Production volume loss	Additional maintenance cost¹	Estimated EBITDA impact of lost tonnes²	Other expense from fires not included in EBITDA	Estimated total EBITDA and non-EBITDA impact
Snowflake	S1 (15), S3 (15)	10,200	0.6	1.4	4.1	6.1
Powell River	P9 (15), P10 (24), P11 (10)	20,400	6.7	5.5	1.6	13.8

¹ Maintenance cost includes regular and major maintenance materials, services and labour.

² Estimated based on finished goods value less variable cost multiplied by lost tonnes.

Property Tax Dispute

Municipal and provincial property taxes totalling \$18.1 million for 2011 were levied on our properties by the B.C. municipalities where our mills are located. On July 4, 2011 we paid \$22.2 million of property taxes that includes the full amount of property taxes for 2011 levied by these B.C. municipalities and also the payment to North Cowichan for 2010 property taxes and interest. Pursuant to statutory requirements, the payment to North Cowichan was applied firstly to pay outstanding 2010 property taxes, penalties and interest in full and secondly to 2011 property taxes. As a result there are unpaid property taxes owing to North Cowichan for 2011, together with the 10% penalty for late payment, of \$0.4 million at August 1, 2011. Our property tax expense and liability has been recorded based on the full amount of property taxes levied for 2011.

We continue to press for a fair and sustainable level of municipal property taxes for major industry in the B.C. communities in which we operate. We are proceeding with our appeal to the Supreme Court of Canada regarding North Cowichan's 2009 property taxes that is scheduled to be heard in October, 2011. In addition to that appeal and our petition to the Supreme Court of B.C. regarding North Cowichan's 2010 property taxes, we filed a petition with the Supreme Court of B.C. disputing the 2011 property taxes levied by the District of North Cowichan. On February 14, 2011, we filed an appeal to the B.C. Court of Appeal of the decision of the B.C. Supreme Court on January 14, 2011 that dismissed our petition regarding the Strathcona Regional District portion of the property taxes levied by the City of Campbell River for 2010.

Amendment and Extension of Asset Based Loan (ABL) Facility

On May 31, 2011 we amended our ABL Facility, reducing the amount of the facility from \$330.0 million to \$175.0 million and extended the maturity date from August 13, 2013 to May 31, 2016. For further details on the ABL Facility amendment, refer to our interim consolidated financial statements for the three and six months ended June 30, 2011 in note 11, *Long-term debt*.

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 16 to 21 of our 2010 Annual Report.

2011 Key Objectives

The following is an update on our second quarter progress towards our 2011 key objectives:

Social:

❖ Significantly improve safety performance

- Continued to focus on workplace and work practice audits. Our lost-time injury frequency in Q2 of 1.38 was an improvement from Q1 levels of 3.29 and was below our target of 1.57. As well, our medical incident rate improved from 5.65 in Q1 to 4.37 in Q2 but was above our target of 3.20.

❖ Enhance employee communication

- A multi-faceted safety awareness program began in February and a semi-annual employee engagement tracking survey has been introduced.

❖ Continue to seek competitive business conditions in B.C., including joint municipal infrastructure agreements

- Discussions continued with B.C. municipalities and the provincial government.
- Continued to implement the agreement in principle with the City of Powell River to reduce the annual major industry property taxes we pay and settle services arrangements under which we would use our effluent system to treat the City's liquid waste and dispose of the City's bio-solids in the mill's wood waste boiler.

Financial:

❖ Continue to focus on cash flows, liquidity and cost reductions

- Free cash flow for the quarter was negative \$28.3 million and total liquidity decreased by \$31.0 million from Q1. This was due to a change in the terms of the modified ABL Facility and a reduction in cash on hand primarily due to interest payments on our 11.0% senior secured notes of US\$21.5 million.
- Capital expenditures in the current quarter of \$5.6 million were primarily invested in profit adding and maintenance of business projects.
- The Company and the International Brotherhood of Electrical Workers (IBEW) representing 34 hourly employees at the company's Snowflake mill have ratified renewal of the labour agreement through to April 30, 2014.
- On track to realize annual fixed cost savings of approximately \$13 million in 2011 in connection with the permanent closure of the Elk Falls mill and the Coquitlam paper recycling facility.
- In May 2011, a plan was approved to expand pulp capacity by up to 35,000 tonnes by 2012.

❖ Improve capital structure

- The reduction in the ABL Facility from \$330.0 million to \$175.0 million is in line with reduced working capital levels which resulted primarily from the permanent closure of the Elk Falls mill in 2010 as well as the removal of Snowflake's fixed assets from the borrowing base.
- On June 20, 2011 we announced that we are reviewing alternatives for our US\$250 million of 7.375% senior unsecured notes which mature March 1, 2014.

Commercial:

❖ Continue to innovate and diversify product line

- Completed the development of our uncoated book grades to provide a full range of caliper-controlled paper for book publishers, including initial trials of recycled book paper from our Snowflake mill.

❖ Grow market share

- Despite a declining coated market, Catalyst has continued to gain market share. New products such as Pacificote, our coated four grade, have contributed to this growth.

Environmental:

- ❖ **Capital upgrade of \$5 million at Port Alberni mill to improve combustion efficiency and environmental performance of its biomass boiler and a \$13 million upgrade at Powell River mill to increase the electrical generation from the existing generator and biomass boiler.**
 - Each of these projects is in process and scheduled to complete in advance of the March 31, 2012 spending deadline for the Pulp and Paper Green Transformation Program. Completion of these projects is expected to result in annual EBITDA improvement of \$5.0 million.
- ❖ **Implement Forest Stewardship Council chain-of-custody certification at all Canadian mills**
 - The Forest Stewardship Council (FSC) chain of custody system was implemented at the company's B.C. coastal mills. This provides a parallel system to the existing Programme for the Endorsement of Forest Certification systems (PEFC). The Snowflake mill was FSC chain of custody certified in 2009.
- ❖ **Achieve conservation targets in water and energy**
 - Water and energy usage, mill-specific reduction metrics and trend analysis are underway.

CONSOLIDATED RESULTS OF OPERATIONS

Sales

Q2 2011 vs. Q1 2011

Sales revenues decreased by 1.9% as a result of lower paper sales volumes and the negative impact of the stronger Canadian dollar. This was partially offset by higher transaction prices across most grades and higher pulp prices and shipments. The reduction in sales of newsprint and uncoated mechanical paper was mostly due to the maintenance outages at our Snowflake and Powell River mills in Q2.

Q2 2011 vs. Q2 2010

Sales revenues decreased by 0.5% due to lower newsprint and uncoated mechanical paper sales volumes and the negative impact of the stronger Canadian dollar. These factors were partially offset by higher pulp, coated and directory sales volumes and higher transaction prices. The decrease in newsprint and uncoated mechanical sales volumes was due in large part to the maintenance outages in the quarter at our Snowflake and Powell River mills.

2011 YTD vs. 2010 YTD

Sales revenues increased by 5.0% as a result of increased sales volumes and higher transaction prices, partially offset by the negative impact of the stronger Canadian dollar. Pulp sales volumes increased while paper sales volumes were lower in newsprint and uncoated mechanical, due in large part to the maintenance outages in the current year at our Snowflake and Powell River mills.

EBITDA and EBITDA before Restructuring Costs

The following table provides variances between periods for EBITDA and EBITDA before restructuring costs:

(In millions of Canadian dollars)	Q1 2011	Q2 2010	2010 YTD
EBITDA in comparative period ¹	\$ 15.9	\$ (0.4)	\$ (16.6)
Restructuring costs	–	10.9	25.0
EBITDA before restructuring costs in comparative period ¹	15.9	10.5	8.4
Paper prices	0.1	22.5	50.9
Pulp prices	4.0	5.0	14.4
Impact of Canadian dollar	(3.0)	(15.6)	(30.0)
Volume and mix	(4.6)	1.1	16.7
Distribution costs	(3.1)	(2.8)	(4.1)
Furnish mix and costs	(3.9)	(9.5)	(20.5)
Power and fuel costs	(4.0)	1.2	4.6
Maintenance costs	(3.2)	(9.8)	(17.4)
Selling, general and administrative	1.0	0.7	1.1
Lower of cost or market impact on inventory, net of inventory change	(1.6)	(3.4)	(6.7)
Other, net	(1.5)	(3.8)	(5.4)
EBITDA before restructuring costs in the current period ¹	(3.9)	(3.9)	12.0
Restructuring costs	–	–	–
EBITDA in the current period ¹	\$ (3.9)	\$ (3.9)	\$ 12.0

¹ Refer to section 6, *Non-GAAP measures*.

Operating Earnings (Loss)

Q2 2011 vs. Q1 2011

Operating earnings decreased by \$19.7 million primarily due to lower EBITDA of \$19.8 million.

Q2 2011 vs. Q2 2010

Operating earnings improved by \$293.3 million due to lower depreciation and amortization expense of \$4.2 million and an asset impairment charge of \$292.3 million in Q2 2010, partially offset by lower EBITDA of \$3.5 million.

2011 YTD vs. 2010 YTD

Operating earnings improved by \$331.3 million due to higher EBITDA of \$28.6 million, lower depreciation and amortization expense of \$10.1 million and an asset impairment charge of \$292.3 million in 2010 YTD.

Net Earnings (Loss) Attributable to the Company

Q2 2011 vs. Q1 2011

Net earnings attributable to the company decreased by \$34.5 million. This was primarily due to a decline in after-tax operating earnings of \$20.3 million, a lower after-tax foreign exchange gain on the translation of long-term debt of \$6.2 million, higher after-tax interest expense of \$2.6 million and after-tax losses incurred in the current quarter on fires at our Snowflake mill of \$4.1 million and our Powell River mill of \$1.2 million.

Q2 2011 vs. Q2 2010

Net earnings attributable to the company improved by \$321.0 million primarily due to increased after-tax operating earnings of \$293.3 million and an after-tax foreign exchange gain on the translation of U.S. dollar denominated debt of \$4.5 million compared to an after-tax foreign exchange loss of \$21.3 million in Q2 2010.

2011 YTD vs. 2010 YTD

Net earnings attributable to the company improved by \$352.2 million primarily due to increased after-tax operating earnings of \$318.0 million and an after-tax foreign exchange gain on the translation of U.S. dollar denominated debt of \$15.2 million compared to an after-tax foreign exchange loss of \$9.6 million in 2010.

2. SEGMENTED RESULTS

SPECIALTY PRINTING PAPERS

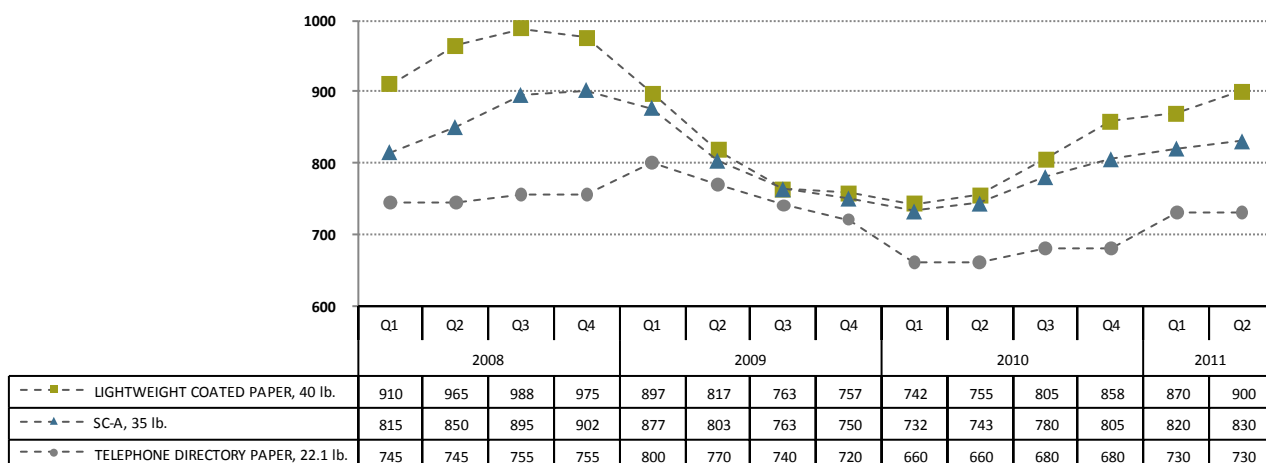
(In millions of Canadian dollars, except where otherwise stated)	Three months ended June 30			Six months ended June 30		
	2011	2010	Change	2011	2010	Change
Sales	\$ 160.9	\$ 165.1	\$ (4.2)	\$ 328.0	\$ 329.2	\$ (1.2)
Operating earnings (loss)	(29.3)	(120.1)	90.8	(36.5)	(140.4)	103.9
Depreciation and amortization	18.8	19.0	(0.2)	37.3	40.3	(3.0)
EBITDA ¹	(10.6)	2.2	(12.8)	0.7	3.2	(2.5)
– before restructuring costs ¹	(10.6)	5.5	(16.1)	0.7	11.3	(10.6)
EBITDA margin ¹	(6.6%)	1.3%	(7.9%)	0.2%	1.0%	(0.8%)
– before restructuring costs ¹	(6.6%)	3.3%	(9.9%)	0.2%	3.4%	(3.2%)
(In thousands of tonnes)						
Sales	202.8	208.9	(6.1)	409.5	415.1	(5.6)
Production	200.9	209.1	(8.2)	415.2	421.3	(6.1)

¹ Refer to section 6, *Non-GAAP measures*.

Specialty Printing Papers Benchmark Price Trend

Average delivered to U.S. benchmark transaction price (US\$/short ton)

(Source: RISI)



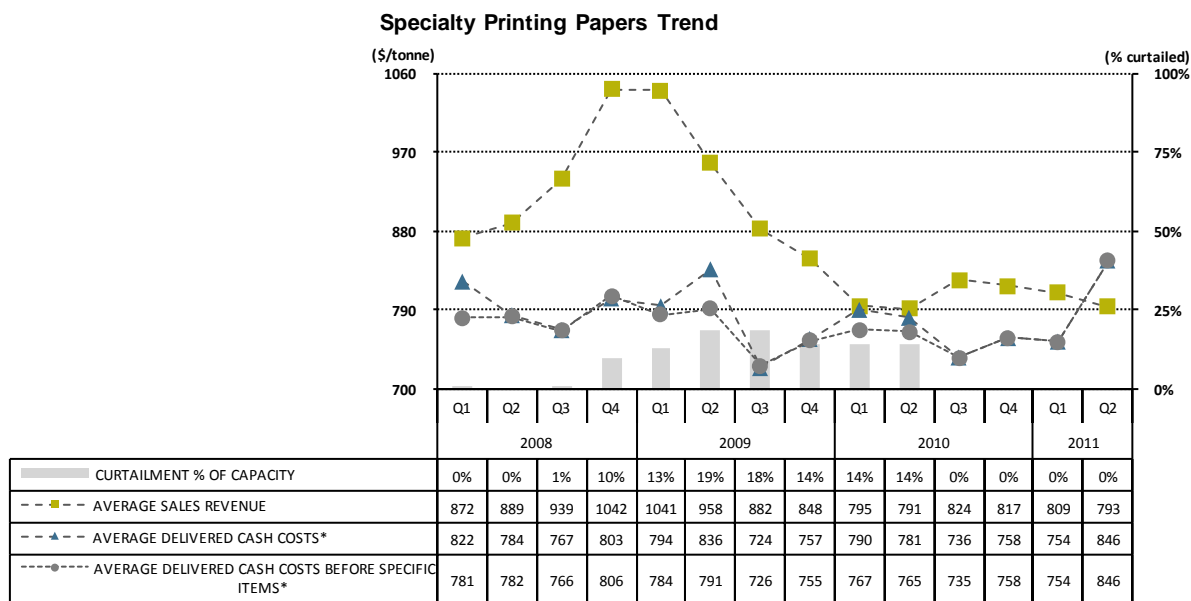
Segment Overview

North American demand for coated mechanical and uncoated mechanical (high-gloss and standard grades) decreased 8.7% and 5.2% respectively, from the same quarter last year due to continued weakness in print advertising. Although inventories increased, adjusted operating rates continued to remain steady due to mill and machine closures. Our sales volumes fell predominantly due to the extended maintenance outage and fire at Powell River. During the quarter, we partially implemented the April 1, 2011 US\$40 per short ton price increase for our coated mechanical and SC grades and the June 1, 2011 US\$40 per short ton price increase on our high bright and super bright paper grades. In addition, we announced a further US\$30 per short ton price increase for our coated mechanical grades and a US\$30 per short ton price increase for our SC grades effective July 1, 2011. During the quarter the benchmark prices for these grades improved modestly from Q1. The average lightweight coated benchmark price increased 3.4% to US\$900 per ton while the average soft-calendered A grade (SC-A) increased 1.2% to US\$830 per ton compared to the previous quarter.

North American directory demand fell 15.5% in Q2 compared to the prior year due to ongoing pressure to reduce or eliminate white pages, smaller books, lower circulation, and the continued migration from printed books to the Internet. Market conditions improved during the quarter compared to the previous quarter as operating rates increased due to a mill closure. On April 27, 2011 we announced a US\$70 per short ton directory price increase for all our non-contract customers effective July 1, 2011. The majority of our directory pricing is largely fixed for the year based on 2011 contract pricing. The average Q2 directory benchmark price was unchanged at US\$730 per ton compared to the previous quarter.

Operational Performance

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



* Average delivered cash costs per tonne consist of cost of sales, excluding depreciation and amortization, and including the impact of SG&A and restructuring costs. 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.

Q2 2011 vs. Q2 2010

- Sales volume decreased by 6,100 tonnes due to lower sales volumes in uncoated mechanical, partially offset by higher sales volumes in directory and lightweight coated. Production of uncoated mechanical was lower due to the maintenance outage and fire at the Powell River mill.
- Average sales revenue increased \$2 per tonne, as higher average transaction prices were partially offset by the negative impact of the stronger Canadian dollar. Our grade mix deteriorated due to a reduction in SC production by Powell River's No. 10 paper machine as a result of the fire.
- Average delivered cash costs increased \$65 per tonne due to reduced production and increased maintenance costs resulting from a 10 day maintenance outage at the Powell River mill as well as the cable tray fire shortly after start-up which idled the mill's No. 9 paper machine for five days and the No. 10 paper machine for 14 days. In addition, coating costs were also higher in the current quarter.

2011 YTD vs. 2010 YTD

- Sales volume decreased by 5,600 tonnes due to lower sales volumes in uncoated mechanical paper primarily due to the maintenance outage and fire at our Powell River mill. This was partially offset by higher sales volumes in directory and coated mechanical paper.
- Average sales revenue increased \$8 per tonne, as higher average transaction prices were partially offset by the negative impact of the stronger Canadian dollar.
- Average delivered cash costs increased \$14 per tonne due to reduced production and maintenance costs resulting from the 10 day maintenance outage at the Powell River mill as well as the cable tray fire shortly after start-up which idled the mill's No. 9 paper machine for five days and the No. 10 paper machine for 14 days. In addition, coating costs were also higher in the current year. These negative factors were partially offset by the absence of restructuring costs in 2011.

NEWSPRINT

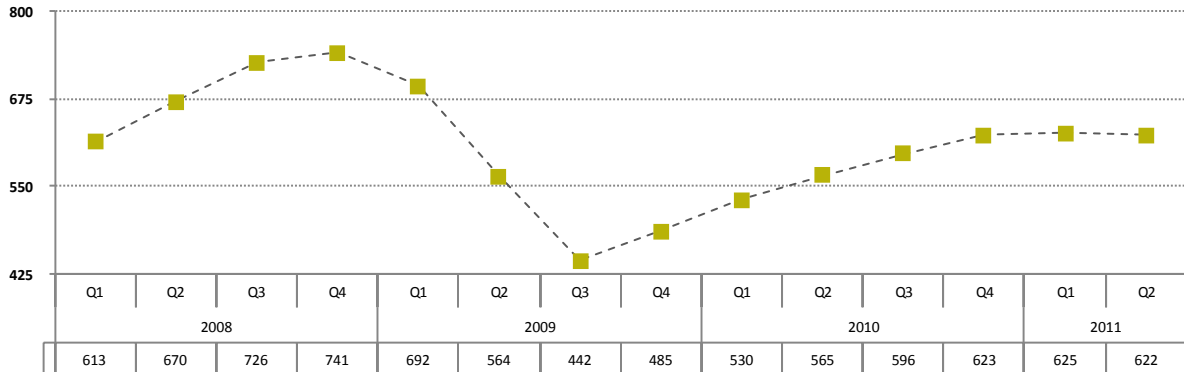
(In millions of Canadian dollars, except where otherwise stated)	Three months ended June 30			Six months ended June 30		
	2011	2010	Change	2011	2010	Change
Sales	\$ 71.5	\$ 73.1	\$ (1.6)	\$ 146.9	\$ 142.6	\$ 4.3
Operating earnings (loss)	(11.9)	(211.8)	199.9	(17.2)	(238.1)	220.9
Depreciation and amortization	4.5	8.6	(4.1)	9.2	16.7	(7.5)
EBITDA ¹	(7.6)	(14.2)	6.6	(8.2)	(32.4)	24.2
– before restructuring costs ¹	(7.6)	(6.7)	(0.9)	(8.2)	(16.4)	8.2
EBITDA margin ¹	(10.6%)	(19.4%)	8.8%	(5.6%)	(22.7%)	17.1%
– before restructuring costs ¹	(10.6%)	(9.2%)	(1.4%)	(5.6%)	(11.5%)	5.9%
(In thousands of tonnes)						
Sales	111.8	123.1	(11.3)	228.2	246.2	(18.0)
Production	111.7	124.5	(12.8)	236.5	238.2	(1.7)

¹ Refer to section 6, *Non-GAAP measures*.

Standard Newsprint Price Trend

Average delivered to U.S. West Coast benchmark transaction price (US\$/tonne)

(Source: RISI)

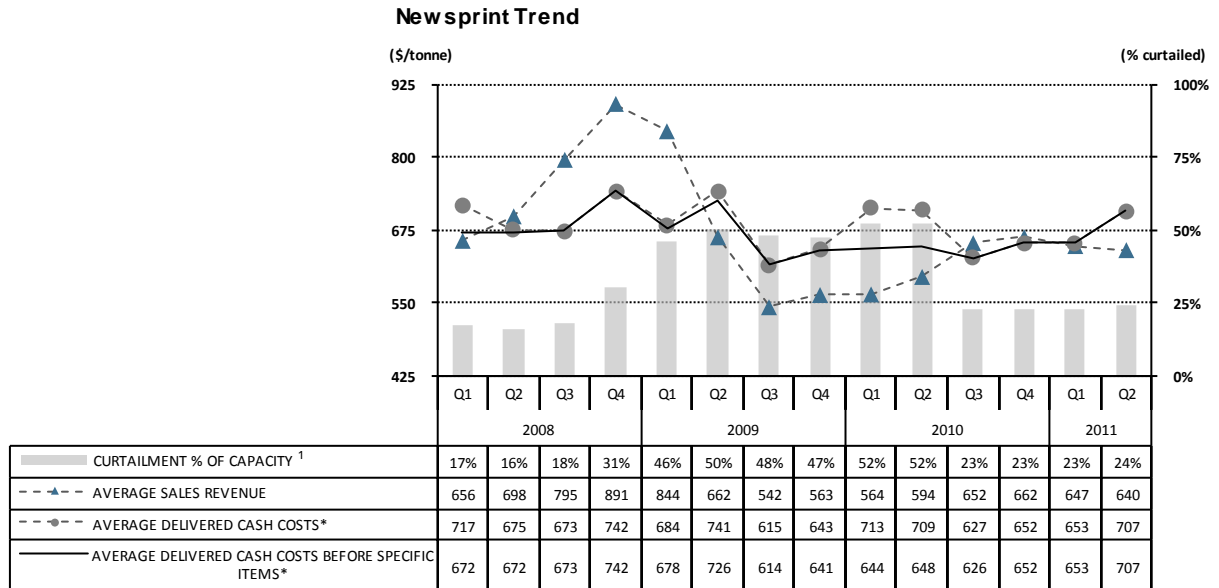


Segment Overview

Total North American demand for newsprint was down 7.9% in Q2, year-over-year in part due to lower newspaper print advertising. In Q2, year-over-year, North American shipments were down 5.8% due to weak North American demand and a 4.1% decrease in exports during the quarter. Operating rates were similar to the previous year. The average Q2 North American Newsprint benchmark price decreased slightly by 0.5% to US\$622 per tonne compared to the previous quarter. Our sales volume fell due to the extended maintenance outage, fire and market curtailment at Snowflake. The Crofton No. 1 paper machine remained indefinitely curtailed throughout the quarter, resulting in a reduction of 34,900 tonnes, or 23% of newsprint production capacity in Q2, based on our 2011 annualized production capacity.

Operational Performance

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



¹ Q2 2011 curtailment consists of 34,900 tonnes at our Crofton mill and 1,400 tonnes at our Snowflake mill.

* Average delivered cash costs per tonne consist of cost of sales, excluding depreciation and amortization, and including the impact of SG&A and restructuring costs. 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.

Q2 2011 vs. Q2 2010

- Sales volume decreased by 11,300 tonnes due to lower demand and lower production largely resulting from the maintenance outage, fire and market curtailment at our Snowflake mill during the quarter.
- Average sales revenue increased \$46 per tonne due to higher average transaction prices, offset in part by the negative impact of the stronger Canadian dollar.
- Average delivered cash costs improved \$2 per tonne due to the absence of restructuring costs in the current quarter partially offset by higher ONP prices and increased maintenance costs due to the planned maintenance outage at Snowflake.

2011 YTD vs. 2010 YTD

- Sales volume decreased by 18,000 tonnes due to lower demand and lower production largely resulting from the maintenance outage at our Snowflake mill.
- Average sales revenue increased \$65 per tonne due to higher average transaction prices, offset in part by the negative impact of the stronger Canadian dollar.
- Average delivered cash costs decreased \$31 per tonne due to the absence of restructuring costs in the current year as well as lower chemical, electric power and steam costs in 2011. This was partially offset by higher ONP prices and increased maintenance costs due to the planned maintenance outage at Snowflake.

PULP

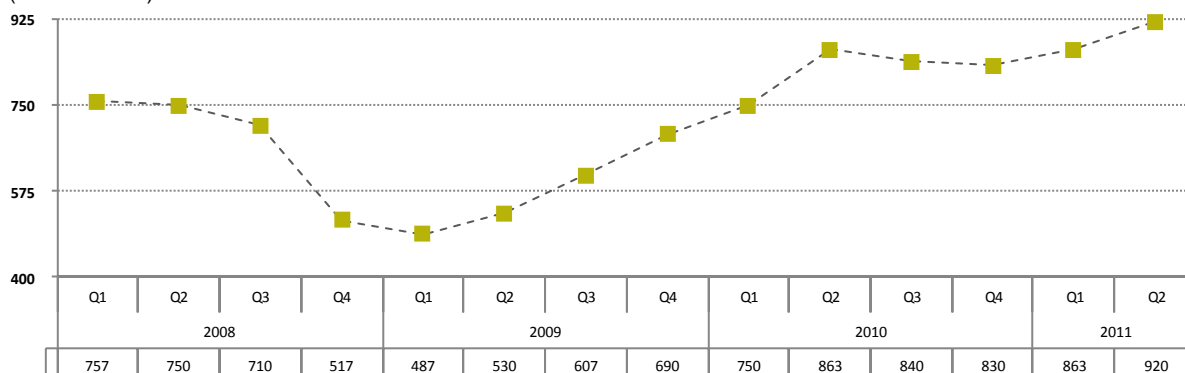
(In millions of Canadian dollars, except where otherwise stated)	Three months ended June 30			Six months ended June 30		
	2011	2010	Change	2011	2010	Change
Sales	\$ 65.4	\$ 61.2	\$ 4.2	\$ 126.5	\$ 100.9	\$ 25.6
Operating earnings (loss)	10.6	8.0	2.6	12.2	5.7	6.5
Depreciation and amortization	3.7	3.6	0.1	7.3	6.9	0.4
EBITDA ¹	14.3	11.6	2.7	19.5	12.6	6.9
– before restructuring costs ¹	14.3	11.7	2.6	19.5	13.5	6.0
EBITDA margin ¹	21.9%	19.0%	2.9%	15.4%	12.5%	2.9%
– before restructuring costs ¹	21.9%	19.1%	2.8%	15.4%	13.4%	2.0%
(In thousands of tonnes)						
Sales	78.4	72.5	5.9	154.7	127.4	27.3
Production	83.5	69.4	14.1	154.8	118.7	36.1

¹ Refer to section 6, *Non-GAAP measures*.

Northern Bleached Softwood Kraft Price Trend

Average delivered to China benchmark transaction price (US\$/tonne)

(Source: RISI)

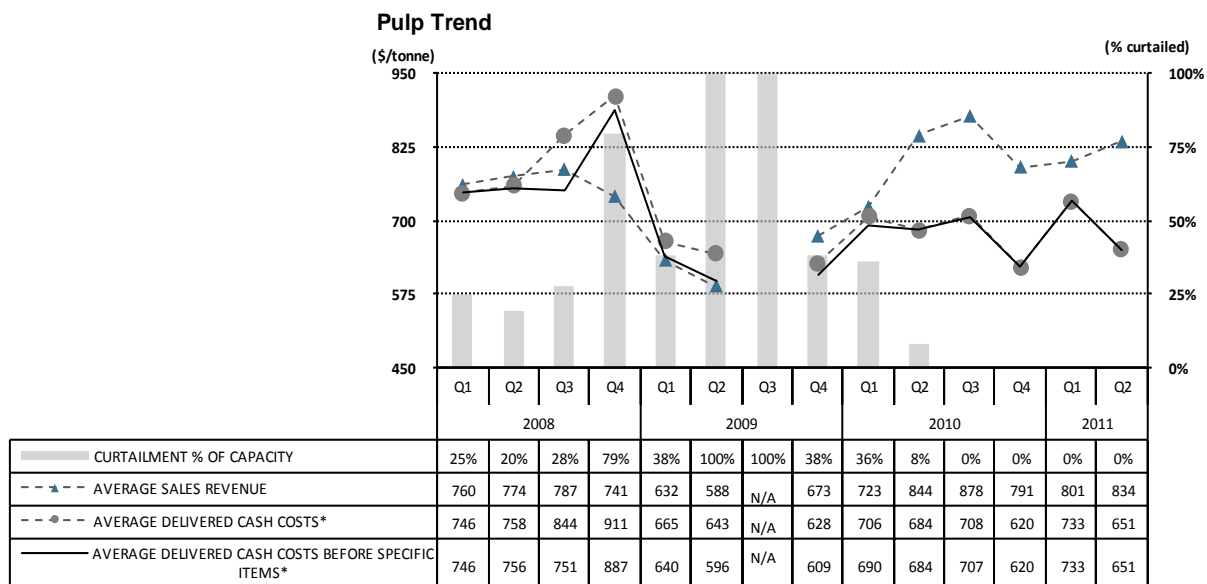


Segment Overview

NBSK pulp markets remained strong in Q2, as global shipments increased 3.4% from the same quarter last year due to demand from China which was up 50.3%. The average NBSK benchmark pulp price for China increased 6.6% to US\$920 per tonne compared to the previous quarter.

Operational Performance

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



* Average delivered cash costs per tonne consist of cost of sales, excluding depreciation and amortization, and including the impact of SG&A and restructuring costs. 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.

Q2 2011 vs. Q2 2010

- Sales volume increased by 5,900 tonnes in Q2 as pulp production was fully operational throughout the current quarter, compared to being partially curtailed throughout the same quarter of 2010.
- Average sales revenue decreased \$10 per tonne due to the negative impact of the stronger Canadian dollar, partially offset by higher average transaction prices in the current quarter.
- Average delivered cash costs period-over-period decreased by \$33 per tonne due to lower fuel and maintenance costs partially offset by higher prices for chips driving up furnish costs and an increase in the cost of chemicals.

2011 YTD vs. 2010 YTD

- Sales volume increased by 27,300 tonnes as pulp production was fully operational throughout the first six months of 2011, compared to being partially curtailed throughout the same period of 2010.
- Average sales revenue increased \$26 per tonne due to higher average transaction prices, offset in part by the negative impact of the stronger Canadian dollar.
- Average delivered cash costs period-over-period decreased by \$2 per tonne due to lower fuel and maintenance costs offset in part by increases in the cost of chips and chemicals.

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		
	2011	2010	Change	2011	2010	Change
Cash flows provided (used) by operations before changes in non-cash working capital	\$ (30.1)	\$ (20.5)	\$ (9.6)	\$ (35.9)	\$ (55.0)	\$ 19.1
Changes in non-cash working capital	14.4	(4.4)	18.8	7.2	0.3	6.9
Cash flows provided (used) by						
Operations	(15.7)	(24.9)	9.2	(28.7)	(54.7)	26.0
Investing activities	(5.2)	(1.8)	(3.4)	(7.8)	1.6	(9.4)
Financing activities	(2.7)	68.8	(71.5)	(28.7)	70.8	(99.5)
Capital spending	5.6	2.8	2.8	7.9	6.0	1.9
Depreciation and amortization	27.0	31.2	(4.2)	53.8	63.9	(10.1)
Impairment (recovery) and other closure costs	(0.3)	292.3	(292.6)	(0.3)	292.3	(292.6)
Capital spending as % of depreciation and amortization	21%	9%	12%	15%	9%	6%
Net debt to net capitalization at June 30 ¹	67%	65%	2%	67%	65%	2%

¹ Net debt ratio equals net debt (total debt less cash) divided by net capitalization (shareholder's equity attributable to the company and total debt less cash).

Refer to page 38 of our 2010 Annual Report for a discussion of the nature and sources of funding for our principal cash requirements.

OPERATING ACTIVITIES

Cash flows from operating activities increased by \$9.2 million in Q2 from the same quarter in the previous year, primarily due to a favourable change in non-cash working capital of \$14.4 million compared to negative \$4.4 million during the second quarter of 2010. This was partially offset by a decrease in EBITDA of \$3.5 million and losses on fires of \$5.7 million in the second quarter of 2011. The reduction in working capital in 2011 was due primarily to collections on trade accounts receivable of \$15.0 million.

INVESTING ACTIVITIES

Cash used by investing activities was \$5.2 million in Q2 compared to cash used of \$1.8 million in the same quarter last year. The increase in cash used was largely due to an increase in fixed asset additions in the current quarter. Capital spending in both periods related primarily to profit adding and maintenance of business projects.

FINANCING ACTIVITIES

Cash used by financing activities in Q2 was \$2.7 million compared to cash provided of \$68.8 million in the same quarter last year. This was primarily due to the issuance of Class B 11% senior secured notes in Q2 2010 for net proceeds of \$93.4 million, partially offset by repayments to the ABL Facility of \$25.0 million in the same quarter.

CAPITAL RESOURCES

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

(In millions of Canadian dollars)	2011		2010			
	Q2	Q1	Q4	Q3	Q2	Q1
Borrowing base ¹	\$ 134.3	\$ 174.1	\$ 152.4	\$ 161.7	\$ 167.8	\$ 144.8
Letters of credit	(28.1)	(25.5)	(23.4)	(25.1)	(25.3)	(24.0)
Amount drawn, net	—	—	—	—	—	(25.0)
Minimum excess availability	—	(35.0)	(35.0)	(35.0)	(35.0)	(35.0)
Availability ²	106.2	113.6	94.0	101.6	107.5	60.8
Cash on hand	30.2	53.8	95.4	82.3	100.8	58.7
Total liquidity	\$ 136.4	\$ 167.4	\$ 189.4	\$ 183.9	\$ 208.3	\$ 119.5

¹ The borrowing base at June 30, 2011 includes a reserve of \$4.5 million for unpaid property taxes and associated penalties (Q1 2011 - \$4.4 million, Q4 2010 - \$4.4 million).

² Our 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, 2011 in note 11, *Long-term debt*.

On May 31, 2011 the company amended its ABL Facility. For additional information on the ABL Facility, refer to our interim consolidated financial statements for the three and six months ended June 30, 2011 in note 11, *Long-term debt*.

Our total liquidity decreased by \$71.9 million from the same quarter last year primarily due to the lower borrowing base associated with the amended ABL Facility, a decrease in cash on hand and an increase in letters of credit. Liquidity decreased by \$31.0 million compared to the previous quarter largely due to the lower borrowing base associated with the amended ABL Facility, a decrease in cash on hand due to the interest payments made on our 11% senior secured notes, and an increase in letters of credit.

At August 1, 2011, the company had 381,900,450 common shares issued and outstanding and 2,159,691 stock options for 2,159,691 common shares that, at August 1, 2011, were exercisable.

FINANCIAL INSTRUMENTS

Our financial instruments consist primarily of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities, long-term debt, and derivatives. Derivatives are used primarily to reduce exposure to currency risk on revenues, or occasionally debt, as well as price risk associated with revenue and energy costs.

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 annual consolidated financial statements for the year ended December 31, 2010, note 26, *Financial instruments*. For the methods and assumptions we use to determine the fair value of financial instruments, refer to note 25, *Fair value measurement*, of those statements. Our methods and assumptions for determining the 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, 2010.

At June 30, 2011, we had foreign currency options and forward contracts with a notional principal of US\$198.7 million with major financial institutions. At June 30, 2011 period-end exchange rates, these instruments were reported at their fair value of \$8.9 million.

The following table reconciles the average spot exchange rate to our effective exchange rate and provides the impact to EBITDA related to the cash flow hedges that were in place as at June 30, 2010 and were designated as hedging instruments at that time:

US\$/CDN\$ FOREIGN EXCHANGE

	2011		2010			
	Q2	Q1	Q4	Q3	Q2	Q1
Average Bank of Canada noon spot rate	1.033	1.015	0.987	0.962	0.973	0.961
(Favourable)/unfavourable impact of derivatives designated as effective hedges for accounting purposes ¹	(0.001)	(0.004)	(0.005)	(0.014)	(0.024)	(0.023)
Average effective rate included in EBITDA	1.032	1.011	0.982	0.948	0.949	0.938
(Favourable)/unfavourable impact of derivatives, other than those designated as effective hedges for accounting purposes, included in other expenses ²	(0.002)	(0.011)	(0.016)	(0.019)	0.051	0.004
Foreign exchange (gain)/loss, on working capital balances, included in other expenses ³	0.006	0.007	0.010	0.008	(0.029)	0.000
Average effective rate in net earnings/(loss) before income taxes ⁴	1.036	1.007	0.976	0.937	0.971	0.942

(In millions of dollars)

1 Favourable/(unfavourable) impact of derivatives designated as effective hedges for accounting purposes included in EBITDA	\$	0.3	\$	1.0	\$	1.3	\$	3.8	\$	5.2	\$	4.9
2 Favourable/(unfavourable) impact of derivatives other than those designated as effective hedges for accounting purposes included in other expenses		0.3		2.5		4.2		4.9		(11.3)		(0.8)
3 Foreign exchange gain/(loss) on working capital balances included in other expenses		(1.2)		(1.6)		(2.5)		(2.1)		6.2		(0.1)
4 Excludes foreign exchange gain/(loss) on long term debt and \$US interest expense												

4. CONTINGENT LIABILITIES

The company's contingent liabilities at December 31, 2010 are described on page 43 of our 2010 Annual Report. For additional and updated information regarding the company's contingent liabilities, refer to our interim consolidated financial statements for the three and six months ended June 30, 2011 note 20, *Contingent liabilities*. There were no significant changes in Q2 2011.

5. SUMMARY OF QUARTERLY RESULTS

The following table highlights selected financial information for the eight consecutive quarters ending June 30, 2011:

(In millions of Canadian dollars, except per share amounts)	2011		2010				2009 ¹	
	Q2	Q1	Q4	Q3	Q2	Q1	Q4	Q3
Sales	\$ 297.8	\$ 303.6	\$ 333.6	\$ 322.3	\$ 299.4	\$ 273.3	\$ 295.0	\$ 266.9
EBITDA ²	(3.9)	15.9	28.7	34.2	(0.4)	(16.2)	14.1	25.9
Net earnings (loss) attributable to the company	(47.4)	(12.9)	9.6	6.0	(368.4)	(44.1)	(35.8)	13.2
Net earnings (loss) per share attributable to the company's common shareholders								
– basic and diluted	\$ (0.13)	\$ (0.03)	\$ 0.02	\$ 0.02	\$ (0.96)	\$ (0.12)	\$ (0.09)	\$ 0.03

¹ Refer to section 8, *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 6, *Non-GAAP measures*.

Refer to section 1, *Overview and highlights*, and the discussion on *Consolidated results of operations*, for details of Q2 results compared to Q1 2011.

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, 2011.

6. NON-GAAP MEASURES

Management uses certain measures that are not defined by U.S. GAAP to evaluate our performance 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. Our 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 restructuring costs, EBITDA margin, EBITDA margin before restructuring costs, 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 or loss on cancellation of long-term debt, asset-impairment and other closure costs, restructuring costs, unusual non-recurring items, and certain income tax adjustments.

EBITDA AND EBITDA BEFORE RESTRUCTURING COSTS

EBITDA as defined equates to operating earnings (loss) plus depreciation and amortization and impairment and other closure costs. EBITDA margin and EBITDA margin before restructuring costs are defined as EBITDA and EBITDA before restructuring costs 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)	2011			2010				
	YTD	Q2	Q1	Total	Q4	Q3	Q2	Q1
Net earnings (loss) attributable to the company	\$ (60.3)	\$ (47.4)	\$ (12.9)	\$ (396.9)	\$ 9.6	\$ 6.0	\$ (368.4)	\$ (44.1)
Net earnings (loss) attributable to non-controlling interest	(0.3)	(0.3)	–	(1.3)	(0.6)	(0.4)	0.3	(0.6)
Net earnings (loss)	(60.6)	(47.7)	(12.9)	(398.2)	9.0	5.6	(368.1)	(44.7)
Depreciation and amortization	53.8	27.0	26.8	119.3	27.2	28.2	31.2	32.7
Impairment (recovery) and other closure costs	(0.3)	(0.3)	–	294.5	1.3	0.9	292.3	–
Gain on cancellation of long-term debt	–	–	–	(0.6)	–	(0.6)	–	–
Foreign exchange (gain) loss on long-term debt	(17.3)	(5.1)	(12.2)	(27.6)	(19.0)	(16.3)	21.3	(13.6)
Loss on Snowflake fire	4.1	4.1	–	–	–	–	–	–
Loss on Powell River fire	1.6	1.6	–	–	–	–	–	–
Other (income) expense	1.2	0.7	0.5	3.2	(2.4)	(2.8)	4.9	3.5
Interest expense, net	36.0	18.7	17.3	72.0	18.2	19.0	18.0	16.8
Income tax expense (recovery)	(6.5)	(2.9)	(3.6)	(16.3)	(5.6)	0.2	–	(10.9)
EBITDA	\$ 12.0	\$ (3.9)	\$ 15.9	\$ 46.3	\$ 28.7	\$ 34.2	\$ (0.4)	\$ (16.2)
Restructuring costs								
Specialty printing papers	–	–	–	8.2	–	0.1	3.3	4.8
Newsprint	–	–	–	16.1	–	0.1	7.5	8.5
Pulp	–	–	–	1.0	–	0.1	0.1	0.8
Total restructuring costs	–	–	–	25.3	–	0.3	10.9	14.1
EBITDA before restructuring costs	\$ 12.0	\$ (3.9)	\$ 15.9	\$ 71.6	\$ 28.7	\$ 34.5	\$ 10.5	\$ (2.1)

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

Specific items are defined previously, 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)	2011			2010				
	YTD	Q2	Q1	Total	Q4	Q3	Q2	Q1
Net earnings (loss) attributable to the company	\$ (60.3)	\$ (47.4)	\$ (12.9)	\$ (396.9)	\$ 9.6	\$ 6.0	\$ (368.4)	\$ (44.1)
Specific items:								
Gain on cancellation of long-term debt	–	–	–	(0.5)	–	(0.5)	–	–
Foreign exchange loss (gain) on long-term debt	(15.2)	(4.5)	(10.7)	(24.2)	(17.5)	(16.3)	21.3	(11.7)
Loss on Snowflake fire	4.1	4.1	–	–	–	–	–	–
Loss on Powell River fire	1.2	1.2	–	–	–	–	–	–
Impairment (recovery) and other closure costs	(0.3)	(0.3)	–	291.4	(1.8)	0.9	292.3	–
Restructuring costs	–	–	–	21.3	–	0.3	10.9	10.1
Notes exchange costs	–	–	–	5.9	–	–	–	5.9
Income tax adjustments	–	–	–	16.0	13.8	–	–	2.2
Net earnings (loss) attributable to the company before specific items	\$ (70.5)	\$ (46.9)	\$ (23.6)	\$ (87.0)	\$ 4.1	\$ (9.6)	\$ (43.9)	\$ (37.6)
Net earnings (loss) per share attributable to the company's common shareholders in dollars:								
As reported	\$ (0.16)	\$ (0.13)	\$ (0.03)	\$ (1.04)	\$ 0.02	\$ 0.02	\$ (0.96)	\$ (0.12)
Before specific items	(0.18)	(0.12)	(0.06)	(0.23)	0.01	(0.03)	(0.11)	(0.10)

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 and assists in cash flow forecasting.

Reconciliation to Cash Provided by Operating Activities less Cash Used by Investing Activities:

(In millions of Canadian dollars)	2011			2010				
	YTD	Q2	Q1	Total	Q4	Q3	Q2	Q1
Cash provided (used) by operating activities	\$ (28.7)	\$ (15.7)	\$ (13.0)	\$ (44.1)	\$ 16.0	\$ (5.4)	\$ (24.9)	\$ (29.8)
Cash provided (used) by investing activities	(7.8)	(5.2)	(2.6)	(4.5)	(2.7)	(3.4)	(1.8)	3.4
Proceeds from the sale of property, plant and equipment and other assets	(0.1)	(0.1)	–	(7.9)	(0.7)	(0.2)	(0.2)	(6.8)
Other investing activities	–	(0.3)	0.3	1.2	0.6	1.2	(0.8)	0.2
Non-cash working capital changes except change in taxes and interest	(7.1)	(18.7)	11.6	12.9	(9.5)	21.8	10.1	(9.5)
Other	9.9	11.7	(1.8)	2.0	3.4	(3.0)	(4.3)	5.9
Free cash flow	\$ (33.8)	\$ (28.3)	\$ (5.5)	\$ (40.4)	\$ 7.1	\$ 11.0	\$ (21.9)	\$ (36.6)

Management's Calculation of Free Cash Flow:

(In millions of Canadian dollars)	2011			2010				
	YTD	Q2	Q1	Total	Q4	Q3	Q2	Q1
EBITDA	\$ 12.0	\$ (3.9)	\$ 15.9	\$ 46.3	\$ 28.7	\$ 34.2	\$ (0.4)	\$ (16.2)
Interest expense, excluding amortization	(35.2)	(17.6)	(17.6)	(72.7)	(18.5)	(19.2)	(18.5)	(16.5)
Capital expenditures	(7.9)	(5.6)	(2.3)	(11.2)	(2.8)	(2.4)	(2.8)	(3.2)
Income taxes received (paid)	(0.4)	(0.1)	(0.3)	(0.4)	(0.2)	(0.4)	0.1	0.1
Employee future benefits, expense over (under) cash contributions ¹	(2.3)	(1.1)	(1.2)	(2.4)	(0.1)	(1.2)	(0.3)	(0.8)
Free cash flow	\$ (33.8)	\$ (28.3)	\$ (5.5)	\$ (40.4)	\$ 7.1	\$ 11.0	\$ (21.9)	\$ (36.6)

¹ Free cash flow is adjusted to reflect the cash impact of employee future benefits rather than the accounting expense which is included in EBITDA.

7. CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of financial statements in conformity with U.S. GAAP 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 51 to 54 of the company's 2010 Annual Report. There were no significant changes in Q2 2011.

8. CHANGES IN ACCOUNTING POLICIES

There were no new pronouncements issued by the Financial Accounting Standards Board (FASB) that impacted our consolidated financial statements in Q2 2011.

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 income (expense)*. 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 in which the hedged item is classified.

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 income (expense)*.

9. 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.

10. RISKS AND UNCERTAINTIES

We face 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 interrelationship risks we 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 55 to 61 of our 2010 Annual Report. Our update as of August 1, 2011 can be found below:

Long-term debt

The company's debt of \$762.1 million at June 30, 2011 as compared to \$783.9 million at December 31, 2010 is summarized in note 11, *Long-term debt*, of our interim consolidated financial statements for the three and six months ended June 30, 2011. A description of our risks and uncertainties at December 31, 2010 referenced our total debt or our individual debt instruments as of that date and are summarized in our consolidated financial statements for the year ended December 31, 2010 in note 14, *Long-term debt*. These risks and uncertainties also apply to the total debt and the individual debt instruments outstanding at June 30, 2011. These risks and uncertainties include those under the following headings in our 2010 Annual Report: *Our substantial debt may impair our financial and operating flexibility*, *We are subject to exchange rate fluctuations*, and, *A change in our legal control could be materially adverse*.

The company has withheld payment of a portion of the assessed property taxes

With the payment of all of our outstanding 2010 property taxes and applicable penalties and interest to North Cowichan, the risk and uncertainties associated with the non-payment of the 2010 property taxes to North Cowichan identified under this heading in the Risks and Uncertainties section of our 2010 Annual Report are no longer applicable.

We do however owe \$0.4 million, including the 10% penalty for late payment, for unpaid 2011 property taxes in dispute related to North Cowichan as at August 1, 2011. Therefore the risks and uncertainties associated with non-payment of 2011 property taxes are the same as those identified in the Risk and Uncertainties section of our 2010 Annual Report with respect to the non-payment of 2010 property taxes. If any 2011 taxes remain unpaid on September 26, 2013, the municipality must proceed to a tax sale but, in that event, we would have until September 26, 2014 to redeem the property by paying all outstanding taxes, penalties, and interest to the date of redemption.

Our substantial debt may impair our financial and operating flexibility

As of June 30, 2011, we had \$649.3 million of outstanding recourse debt on a consolidated basis, excluding non-recourse debt of \$113.8 million owed by PREI.

With the amendment to our ABL Facility described in note 11, *Long-term debt*, of our interim consolidated financial statements for the three and six months ended June 30, 2011, the three financial covenants in the prior ABL Facility referred to under this heading in the Risks and Uncertainties section of our 2010 Annual Report have been replaced with a single financial covenant to maintain a minimum fixed charge coverage ratio of 1.1/1.0, which comes into effect only if excess availability under the amended ABL Facility falls below \$22 million.

Labour disruptions could have a negative impact on our business

On April 28, 2011 the company and the International Brotherhood of Electrical Workers ratified their tentative agreement to replace the collective agreement that expired May 1, 2011 covering 34 hourly employees at the Snowflake mill with a replacement collective agreement for the period May 1, 2011 to April 30, 2014. The collective agreements with the United Transportation Union and Carpenters Union covering 11 hourly employees at Apache Railway, expires at the end of 2011. We do not anticipate labour disruptions in our operations in 2011.

The company is subject to significant environmental regulation

It was expected that the Province of B.C. would issue regulations in Q2, 2011 for its previously announced cap and trade program for greenhouse gases (GHGs). These regulations were not issued in Q2, 2011 and it is now expected that implementation of cap and trade will be delayed until 2012, as has been announced in California. It is too early to determine the impact on the company under the cap and trade program. Under a worst case scenario, the increased costs to the company could be approximately \$2 million per year beginning in 2012 and increasing to \$9 million per year in 2020.

The U.S. Environmental Protection Agency (EPA) published the Maximum Achievable Control Technology (MACT) rules for industrial boilers on March 20, 2011. This is a program that sets emission limits for stationary industrial boilers and process heaters. The standards address numerous pollutants and have suggested considerable reductions in emission limits. The EPA has asked the Federal Courts for additional time to further evaluate the standards which are required in order to meet legal obligations under the Clean Air Act. The current timetable allows for comments to be submitted by October 31, 2011 and the final standards to be issued by April 2012. A preliminary impact assessment of these rules and potential future changes to Snowflake's emission control requirements has been completed with estimated costs in the \$8 million to \$10 million range.

Change in the British Columbia Harmonized Sales Tax could affect our financial results

In September 2010, the B.C. government announced a public referendum on the Harmonized Sales Tax (HST) to be held in September 2011. Mail-in ballots for the referendum have been distributed and the referendum process is now expected to be completed in August, 2011. Should the referendum result in the elimination of the HST and a return to the previous provincial sales tax regime, the additional annualized cost to our business would be in the range of \$9 million to \$15 million.

11. SENSITIVITY ANALYSIS

Our earnings are sensitive to fluctuations in product prices, foreign exchange, energy and fibre costs as described on pages 62 to 63 of our 2010 Annual Report and summarized in the following table:

(In millions of Canadian dollars, except per share amounts)	EBITDA ¹	Net Earnings ²	Earnings per Share
Product prices ³			
A US\$10 per tonne change in the sales price of:			
Specialty printing papers	\$ 8	\$ 6	\$ 0.02
Newsprint	4	3	0.01
Pulp	3	2	0.01
Foreign exchange ⁴			
A US\$0.01 change in the U.S. dollar relative to the Canadian dollar	6	4	0.01
Energy cost sensitivity ⁵			
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
Freight cost sensitivity			
A US\$5/bbl change in the price of West Texas Int. (WTI) Oil	3	2	0.01
Fibre sensitivity ⁵			
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 6, *Non-GAAP measures*.

2 Based on an expected tax rate of 25%.

3 Based on annualized sales of Q2 2011 and foreign exchange rate of US\$1.03

4 Based on Q2 2011 annualized net cash flows and a movement to US\$1.04 from US\$1.03 and excluding our hedging program and the impact of the translation of U.S. dollar-denominated debt.

5 Based on Q2 2011 annualized consumption levels and an exchange rate of US\$1.03.

12. OUTLOOK

Economy

Global growth is expected to continue to be driven by emerging markets particularly China and India. The U.S. economy is expected to continue its slow recovery in Q3 although the rate of growth will depend on consumer spending, consumer confidence and employment recovery. U.S. housing markets and inflation driven commodity prices remain risks to the U.S. economy. The strong Canadian dollar will continue to put pressure on our operating and net earnings, as well as cash flow and liquidity in Q3.

Markets

Underlying demand for print advertising continues to be challenging. Newsprint and directory demand will continue to be negatively affected by declining circulation, ongoing conservation and migration to electronic media. Demand for coated and uncoated mechanical is expected to be higher in the seasonally stronger Q3 and Q4 periods. We announced a US\$30 per short ton price increase for our coated mechanical grades and SC grades effective July 1, 2011. The success of the price increase will depend on the supply demand balance in Q3. In addition, we announced a US\$70 per short ton directory price increase for all our non-contract customers effective July 1, 2011. The majority of our directory pricing is largely fixed for the year based on 2011 contract pricing. Newsprint pricing will depend on the supply and demand balance in Q3, but clearly there is more downside risk than upside at the present time.

Demand for NBSK pulp is expected to slow in Q3 and prices are expected to be under significant pressure during the quarter due to a slowdown in Chinese buying and an increase in global pulp inventories.

Operations

Continued demand from China for recycled paper will continue to place significant supply and price pressure on ONP in Q3. Price pressure is also expected on commodity inputs, including fossil fuel, power, fibre and some chemicals.

We expect specialties and newsprint maintenance costs to be lower in Q3 compared to Q2 as we will have a boiler and turbine generator outage at our Crofton mill in Q3 compared to the total mill outages at our Powell River and Snowflake mill in Q2. Pulp costs in Q3 should be similar to Q2 with the absence of a shutdown in either Q2 or Q3.

The Crofton No. 1 paper machine will continue to be indefinitely curtailed in Q3 representing approximately 35,300 tonnes of newsprint at our Crofton mill, or 23% of our newsprint capacity.

Capital spending in 2011, net of credits received through the Pulp and Paper Green Transformation Program, is forecasted to be approximately \$20 million, compared to a previously announced forecast of \$25 million. Capital projects that qualified for funding through the utilization of the Green Transformation Program were approved by the federal government in Q1, and we expect that the majority of the expenditures will be incurred in 2011 and are expected to result in annual EBITDA of \$5.0 million.

Liquidity, Debt Maturities and Covenants

We currently do not anticipate any significant use of cash in Q3 other than for our operations and working capital fluctuations, which will include an annual payment of property taxes for 2011 of \$18 million, the payment of outstanding property taxes from a prior year of \$4 million which remain under appeal and a one-time pension contribution of US\$5 million on the wind-up of a US defined benefit pension plan.

The Company has applied for a further extension for funding relief in respect of the solvency deficit under the company sponsored defined benefit pension plans. The funding relief would extend the time period required in order to fund the solvency deficit under these plans. If the company's request for funding relief is not accepted, an incremental contribution of up to \$9 million will be required in Q4 2011 for the first three quarters of 2011 in respect of the solvency deficit under these pension plans.

2011 Key Objectives

We remain focused on reducing our cost base, conserving cash, and improving our product mix. Our progress to-date on our key priorities for 2011 is provided in section 1, *Overview and highlights*, and these remain the main focus moving forward.

13. DISCLOSURE CONTROLS AND INTERNAL CONTROL OVER FINANCIAL REPORTING

A summary of our regulatory requirements for the evaluation of internal controls and subsequent reporting of the results of that evaluation can be found on page 65 of our 2010 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, our 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, 2010.

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, 2011 that have materially affected, or are reasonably likely to materially affect, our 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, 2011 (unaudited)	December 31, 2010
Assets		
Current assets		
Cash and cash equivalents	\$ 30.2	\$ 95.4
Accounts receivable (note 5)	118.5	120.6
Inventories (note 6)	154.2	139.9
Prepays and other (note 7)	24.1	27.7
	327.0	383.6
Property, plant and equipment (note 8)	1,235.0	1,285.6
Other assets (note 9)	28.5	27.0
	\$ 1,590.5	\$ 1,696.2
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities (note 10)	\$ 187.7	\$ 171.6
Current portion of long-term debt (note 11)	1.0	27.0
	188.7	198.6
Long-term debt (note 11)	762.1	783.9
Employee future benefits (note 12)	265.8	269.1
Other long-term obligations	18.3	20.2
Future income taxes	5.1	11.4
Deferred credits	9.6	9.6
	1,249.6	1,292.8
Equity		
Shareholders' equity		
Common stock: no par value; unlimited shares authorized; issued and outstanding: 381,820,290 shares (December 31, 2010 – 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	16.6	16.6
Deficit	(642.3)	(582.0)
Accumulated other comprehensive loss (note 13)	(47.6)	(46.1)
	361.7	423.5
Non-controlling interest (deficit) (note 4)	(20.8)	(20.1)
	340.9	403.4
	\$ 1,590.5	\$ 1,696.2

Contingent liabilities (note 20)

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,	
	2011	2010	2011	2010
Sales	\$ 297.8	\$ 299.4	\$ 601.4	\$ 572.7
Operating expenses				
Cost of sales, excluding depreciation and amortization	292.5	278.8	570.0	543.5
Depreciation and amortization	27.0	31.2	53.8	63.9
Selling, general and administrative	9.2	10.1	19.4	20.8
Restructuring (note 14)	—	10.9	—	25.0
Impairment (recovery) and other closure costs (note 15)	(0.3)	292.3	(0.3)	292.3
	328.4	623.3	642.9	945.5
Operating earnings (loss)	(30.6)	(323.9)	(41.5)	(372.8)
Interest expense, net	(18.7)	(18.0)	(36.0)	(34.8)
Foreign exchange gain (loss) on long-term debt	5.1	(21.3)	17.3	(7.7)
Other income (expense) (note 16)	(6.4)	(4.9)	(6.9)	(8.4)
Earnings (loss) before income taxes	(50.6)	(368.1)	(67.1)	(423.7)
Income tax recovery (note 17)	(2.9)	—	(6.5)	(10.9)
Net earnings (loss)	(47.7)	(368.1)	(60.6)	(412.8)
Net (earnings) loss attributable to non-controlling interest	0.3	(0.3)	0.3	0.3
Net earnings (loss) attributable to the company	\$ (47.4)	\$ (368.4)	\$ (60.3)	\$ (412.5)
Basic and diluted net earnings (loss) per share attributable to the company's common shareholders (in dollars)	\$ (0.13)	\$ (0.96)	\$ (0.16)	\$ (1.08)
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,	
	2011	2010	2011	2010
Net earnings (loss)	\$ (47.7)	\$ (368.1)	\$ (60.6)	\$ (412.8)
Other comprehensive income (loss), net of tax (expense) recovery:				
Employee future benefits liability adjustment				
Gross amount	–	9.7	–	31.0
Tax (expense) recovery	–	(2.8)	–	(7.7)
Net amount	–	6.9	–	23.3
Reclassification of amortization of employee future benefits				
Gross amount	0.6	0.3	1.2	1.5
Tax (expense) recovery	(0.1)	0.2	(0.3)	(0.5)
Net amount	0.5	0.5	0.9	1.0
Unrealized net gain on cash flow revenue hedges				
Gross amount	–	–	–	5.8
Tax (expense) recovery	–	–	–	(1.6)
Net amount	–	–	–	4.2
Reclassification of net (gain) loss on cash flow revenue hedges				
Gross amount	(0.3)	(5.2)	(1.2)	(10.1)
Tax (expense) recovery	0.1	1.5	0.3	2.9
Net amount	(0.2)	(3.7)	(0.9)	(7.2)
Foreign currency translation adjustments				
Gross amount	(1.1)	–	(1.1)	0.1
Tax (expense) recovery	–	0.7	(0.4)	(0.1)
Net amount	(1.1)	0.7	(1.5)	–
Unrealized gain (loss) on interest rate hedges				
Gross amount	–	–	–	0.1
Tax (expense) recovery	–	–	–	–
Net amount	–	–	–	0.1
Other comprehensive income (loss), net of taxes	(0.8)	4.4	(1.5)	21.4
Total comprehensive income (loss)	(48.5)	(363.7)	(62.1)	(391.4)
Comprehensive (income) loss attributable to non-controlling interest:				
Net (earnings) loss	0.3	(0.3)	0.3	0.3
Other comprehensive (income) loss, net of taxes	–	–	–	(0.1)
Comprehensive (income) loss attributable to non-controlling interest	0.3	(0.3)	0.3	0.2
Comprehensive income (loss) attributable to the company	\$ (48.2)	\$ (364.0)	\$ (61.8)	\$ (391.2)

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

CONSOLIDATED STATEMENTS OF EQUITY

Equity attributable to the Company							
(in millions of Canadian dollars)	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, 2009	381,753,490	\$ 1,035.0	\$ 16.4	\$ (185.1)	\$ (52.7)	\$ (18.0)	\$ 795.6
Stock option compensation expense	–	–	0.2	–	–	–	0.2
Net earnings (loss)	–	–	–	(396.9)	–	(1.3)	(398.2)
Distributions to non-controlling interest	–	–	–	–	–	(0.9)	(0.9)
Other comprehensive income (loss), net of tax	–	–	–	–	6.6	0.1	6.7
Balance as at December 31, 2010	381,753,490	\$ 1,035.0	\$ 16.6	\$ (582.0)	\$ (46.1)	\$ (20.1)	\$ 403.4
Common shares issued	66,800	–	–	–	–	–	–
Stock option compensation expense	–	–	–	–	–	–	–
Net earnings (loss)	–	–	–	(60.3)	–	(0.3)	(60.6)
Distributions to non-controlling interest	–	–	–	–	–	(0.4)	(0.4)
Other comprehensive income (loss), net of tax	–	–	–	–	(1.5)	–	(1.5)
Balance as at June 30, 2011 (unaudited)	381,820,290	\$ 1,035.0	\$ 16.6	\$ (642.3)	\$ (47.6)	\$ (20.8)	\$ 340.9

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,	
	2011	2010	2011	2010
Cash flows provided (used) by:				
Operations				
Net earnings (loss)	\$ (47.7)	\$ (368.1)	\$ (60.6)	\$ (412.8)
Items not requiring (providing) cash				
Depreciation and amortization	27.0	31.2	53.8	63.9
Impairment (recovery) and other closure costs (note 15)	(0.3)	292.3	(0.3)	292.3
Future income taxes	(2.9)	0.1	(6.4)	(10.9)
Foreign exchange (gain) loss on long-term debt	(5.1)	21.3	(17.3)	7.7
Employee future benefits, expense over (under) cash contributions	(1.1)	(0.3)	(2.3)	(1.1)
Decrease in other long-term obligations	–	(0.4)	(1.3)	(2.1)
(Gain) loss on disposal of property, plant and equipment	–	(0.2)	0.1	(6.0)
Other	–	3.6	(1.6)	14.0
Changes in non-cash working capital				
Accounts receivable	14.5	(10.9)	2.1	(12.9)
Inventories	(6.2)	(1.2)	(14.3)	12.0
Prepays and other	2.8	5.2	3.4	2.5
Accounts payable and accrued liabilities	3.3	2.5	16.0	(1.3)
Cash flows used by operations	(15.7)	(24.9)	(28.7)	(54.7)
Investing				
Additions to property, plant and equipment	(5.6)	(2.8)	(7.9)	(6.0)
Proceeds from sale of property, plant and equipment	0.1	0.2	0.1	7.0
Decrease in other assets	0.3	0.8	–	0.6
Cash flows provided (used) by investing activities	(5.2)	(1.8)	(7.8)	1.6
Financing				
Decrease in revolving loan and loan payable	–	(25.0)	–	(14.5)
Redemption of senior notes (note 11)	–	–	(25.8)	–
Proceeds on issuance of Class B senior secured notes (note 11)	–	98.4	–	98.4
Deferred financing costs	(2.5)	(4.3)	(2.5)	(4.3)
Note exchange costs	–	–	–	(8.3)
Decrease in other long-term debt	(0.2)	(0.3)	(0.4)	(0.5)
Cash flows provided (used) by financing activities	\$ (2.7)	\$ 68.8	\$ (28.7)	\$ 70.8
Cash and cash equivalents, increase (decrease) in the period	(23.6)	42.1	(65.2)	17.7
Cash and cash equivalents, beginning of the period	53.8	58.7	95.4	83.1
Cash and cash equivalents, end of the period	\$ 30.2	\$ 100.8	\$ 30.2	\$ 100.8
Supplemental disclosures:				
Income taxes paid (received)	\$ 0.1	\$ (0.1)	\$ 0.4	\$ (0.2)
Net interest paid	17.6	12.9	35.2	35.2
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, 2011	Specialty Printing Papers	Newsprint	Pulp	Corporate Adjustments	Total
Sales to external customers	\$ 160.9	\$ 71.5	\$ 65.4	\$ –	\$ 297.8
Inter-segment sales	–	–	8.0	(8.0)	–
Depreciation and amortization	18.8	4.5	3.7	–	27.0
Impairment (recovery) and other closure costs (note 15)	(0.1)	(0.2)	–	–	(0.3)
Operating earnings (loss)	(29.3)	(11.9)	10.6	–	(30.6)
Additions to property, plant and equipment	2.7	2.6	0.3	–	5.6

Three months ended June 30, 2010

Sales to external customers	\$ 165.1	\$ 73.1	\$ 61.2	\$ –	\$ 299.4
Inter-segment sales	–	–	5.7	(5.7)	–
Depreciation and amortization	19.0	8.6	3.6	–	31.2
Restructuring	3.3	7.5	0.1	–	10.9
Impairment (recovery) and other closure costs (note 15)	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

Six months ended June 30, 2011	Specialty Printing Papers	Newsprint	Pulp	Corporate Adjustments	Total
Sales to external customers	\$ 328.0	\$ 146.9	\$ 126.5	\$ –	\$ 601.4
Inter-segment sales	–	–	18.8	(18.8)	–
Depreciation and amortization	37.3	9.2	7.3	–	53.8
Impairment (recovery) and other closure costs (note 15)	(0.1)	(0.2)	–	–	(0.3)
Operating earnings (loss)	(36.5)	(17.2)	12.2	–	(41.5)
Additions to property, plant and equipment	4.1	3.5	0.3	–	7.9

Six months ended June 30, 2010

Sales to external customers	\$ 329.2	\$ 142.6	\$ 100.9	\$ –	\$ 572.7
Inter-segment sales	–	–	7.1	(7.1)	–
Depreciation and amortization	40.3	16.7	6.9	–	63.9
Restructuring	8.1	16.0	0.9	–	25.0
Impairment (recovery) and other closure costs (note 15)	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

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

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NOTES TO THE 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.

The accompanying unaudited interim consolidated financial statements have been prepared in accordance with United States generally accepted accounting principles (U.S. GAAP), on a basis consistent with those followed in the December 31, 2010 audited annual consolidated financial statements. 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, 2010 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

Catalyst Paper Corporation, together with its subsidiaries and partnerships (collectively, the company) is a significant specialty mechanical printing papers and newsprint producer in North America. 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 (NBSK) pulp

The company owns and operates four manufacturing facilities, three of which are located in the province of British Columbia (B.C.), Canada and one in Arizona, U.S.A. Two other facilities, including a paper recycling facility, were permanently shut down during 2010 (note 5 on page 82 of the company's 2010 Annual Report). Inter-segment sales consist of pulp transfers at market prices.

The primary market for the company's paper products is North America. The primary markets for the company's pulp products are Asia and Australasia.

3. SIGNIFICANT ACCOUNTING POLICIES

Recently implemented accounting changes

There were no recent amendments by the Financial Accounting Standards Board (FASB) to the Accounting Standards Codification that materially impacted the company's consolidated financial statements or disclosures.

Changes in future accounting standards

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

4. VARIABLE INTEREST ENTITIES

The company has a 50.001% 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 83 Megawatts. The company purchases 100% of the power generated by PREI.

The company has limited access to PREI's financial 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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

Effective January 1, 2011, PREI changed their financial reporting framework from Canadian generally accepted accounting principles (Canadian GAAP) to International Financial Reporting Standards (IFRS). The condensed financial information presented below has been prepared in accordance with U.S. GAAP.

Condensed financial information with respect to PREI is as follows:

	Three months ended June 30,		Six months ended June 30,	
	2011	2010	2011	2010
Condensed statements of earnings (loss)				
Sales – affiliate ¹	\$ 5.5	\$ 5.5	\$ 11.1	\$ 10.9
Cost of sales, excluding depreciation and amortization	2.1	1.5	3.3	2.7
Depreciation and amortization	1.9	0.8	3.7	3.7
	4.0	2.3	7.0	6.4
Operating earnings	1.5	3.2	4.1	4.5
Interest expense	(2.3)	(2.1)	(4.5)	(4.4)
Interest expense – affiliate ¹	(0.6)	(0.5)	(1.2)	(1.2)
Income tax recovery	0.8	–	1.0	0.5
Net earnings (loss)	(0.6)	0.6	(0.6)	(0.6)
Other comprehensive income (loss)	–	–	–	0.2
Total comprehensive income (loss) ²	\$ (0.6)	\$ 0.6	\$ (0.6)	\$ (0.4)

¹ Balances with Catalyst Paper Corporation.

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

	June 30, 2011	December 31, 2010
Condensed balance sheets		
Current assets		
Cash and cash equivalents	\$ 6.1	\$ 3.4
Other	3.1	2.6
Property, plant and equipment	104.6	108.1
	\$ 113.8	\$ 114.1
Current liabilities		
Accounts payable and accrued liabilities	\$ 6.1	\$ 4.1
Long-term debt (note 11)	113.8	113.8
Long-term debt – affiliate ¹	20.8	20.8
Future income taxes	14.7	15.7
Equity ²	(41.6)	(40.3)
	\$ 113.8	\$ 114.1

¹ Balances with Catalyst Paper Corporation.

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

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, 2011, the principal amount of the mortgage was \$5.6 million (December 31, 2010 - \$6.4 million). This agreement does not increase the company's liability beyond the obligation under the building lease.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

5. ACCOUNTS RECEIVABLE

The components of accounts receivable were as follows:

	June 30, 2011	December 31, 2010
Trade receivables	\$ 105.1	\$ 112.7
Less allowance for doubtful accounts	(2.9)	(3.0)
Trade receivables, net	102.2	109.7
Sales tax receivable	6.8	5.7
Other receivables	9.5	5.2
	\$ 118.5	\$ 120.6

6. INVENTORIES

The components of inventories were as follows:

	June 30, 2011	December 31, 2010
Finished goods		
Specialty printing papers	\$ 28.7	\$ 24.4
Newsprint	10.4	5.7
Pulp	4.9	4.6
Total finished goods	44.0	34.7
Work-in-progress	1.0	0.9
Raw materials – wood chips, pulp logs and other	28.0	23.7
Operating and maintenance supplies and spare parts	81.2	80.6
	\$ 154.2	\$ 139.9

At June 30, 2011, the company had applied write-downs of \$1.7 million to finished goods inventory (December 31, 2010 – \$0.2 million) and \$3.7 million to raw materials inventory (December 31, 2010 – \$0.4 million).

7. PREPAIDS AND OTHER

The components of prepaids and other were as follows:

	June 30, 2011	December 31, 2010
Property taxes, insurance and licences	\$ 1.4	\$ 2.3
Derivative financial instruments	3.3	8.0
Future income tax assets	14.4	14.3
Other	5.0	3.1
	\$ 24.1	\$ 27.7

8. PROPERTY, PLANT AND EQUIPMENT

The components of property, plant and equipment were as follows:

	June 30, 2011	December 31, 2010
Cost	\$ 4,219.1	\$ 4,217.7
Accumulated depreciation, amortization and impairment	2,984.1	2,932.1
Net book value	\$ 1,235.0	\$ 1,285.6

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

9. OTHER ASSETS

The components of other assets were as follows:

	June 30, 2011	December 31, 2010
Deferred financing costs	\$ 13.2	\$ 13.0
Deferred charges and other	10.6	10.7
Derivative financial instruments	4.5	3.1
Accrued benefit asset – pension plan	0.2	0.2
	\$ 28.5	\$ 27.0

10. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

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

	June 30, 2011	December 31, 2010
Trade payables	\$ 100.4	\$ 87.3
Accrued payroll and related liabilities	31.2	35.4
Accrued interest	11.6	11.1
Accrued benefit obligation – pension plan	11.9	11.7
Accrued benefit obligation – other employee future benefit plans	6.9	6.9
Restructuring (note 14)	0.5	3.1
Property taxes	9.3	0.2
Property taxes in arrears, interest and related penalties	4.5	4.4
Lease obligation – paper recycling – current portion	2.9	2.7
Payables related to capital projects	2.6	1.5
Other	5.9	7.3
	\$ 187.7	\$ 171.6

11. LONG-TERM DEBT

	June 30, 2011	December 31, 2010
Recourse		
Senior notes, 8.625% due June 2011 (US\$ nil; December 31, 2010 – US\$26.0 million)	\$ –	\$ 25.9
Senior notes, 7.375% due March 2014 (US\$250.0 million)	243.6	251.6
Senior secured notes, 11.0% due December 2016 (US\$280.4 million)	270.4	278.9
Modification – difference in carrying value of 8.625% and 11.0% senior secured notes (US\$38.3 million) on exchange	33.8	36.2
Class B senior secured notes, 11.0% due December 2016 (US\$110.0 million)	91.8	94.3
	639.6	686.9
Revolving asset based loan facility of up to \$175.0 million due May 2016	–	–
Capital lease obligations	9.7	10.2
	649.3	697.1
Non-recourse		
First mortgage bonds, 6.447% due July 2016	95.0	95.0
Subordinated promissory notes	18.8	18.8
	113.8	113.8
Total debt	763.1	810.9
Less: current portion	(1.0)	(27.0)
Total long-term debt	\$ 762.1	\$ 783.9

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

On February 11, 2011, the company redeemed the outstanding 8.625% senior unsecured notes of US\$26.0 million, due June 2011.

The indentures governing the 7.375% senior notes, due March 2014, (2014 Notes) and both the 11.0% senior secured notes, due December 2016 and the 11.0% Class B senior secured notes due December 15, 2016 (collectively, 2016 Notes), limit the ability of the company to incur debt, other than *permitted debt*, while the company cannot meet a fixed charge coverage ratio of 2.0:1. The company's fixed charge coverage ratio under its senior and senior secured notes, calculated on a 12-month trailing average, was 0.8:1 at June 30, 2011 (December 31, 2010 – 0.4:1). The company cannot make any restricted payments, including paying 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 \$369.9 million and negative \$129.5 million, respectively, as at June 30, 2011, as a result of accumulated losses in recent years (December 31, 2010 – negative \$302.2 million and negative \$86.2 million, respectively).

On May 31, 2011, the company amended its revolving asset based loan facility (the ABL Facility) reducing the size of the Facility to \$175 million, from \$330 million, in part due to working capital levels which have been lower since the closure of the Elk Falls mill. The maturity date was extended to May 31, 2016, from August 13, 2013. In addition the fixed assets of the Snowflake mill are no longer part of the borrowing base and become first lien security under the company's 2016 notes thereby increasing the first lien basket under those notes by \$60 million. A financial covenant requires the company to maintain a minimum fixed charge coverage ratio of 1.1/1.0 if excess availability under the Facility is below \$22 million; at June 30, 2011 the fixed charge coverage ratio was 0.5/1.0 for purposes of this covenant. This springing fixed charge financial covenant replaces the previous three financial covenants on (a) minimum shareholders' equity; (b) minimum excess availability; and (c) maximum capital expenditure in a fiscal year.

Availability under the amended ABL Facility is determined by a borrowing base calculated primarily on eligible accounts receivable and eligible inventory less certain reserves. The borrowing base at June 30, 2011 includes a reserve of \$4.5 million for unpaid property taxes and associated penalties. A reserve of \$3.5 million may also be imposed for vacation pay obligations if availability (as defined in the ABL Facility) is below \$50.0 million. As at June 30, 2011, the borrowing base under the ABL Facility was \$134.3 million. After deducting outstanding drawings of \$nil and outstanding letters of credit of \$28.1 million, \$106.2 million was available under the ABL Facility, before potential application of the springing fixed charge coverage ratio. The company also had an additional \$30.2 million of cash on hand at June 30, 2011.

At June 30, 2011, the company was in compliance with its covenants under the ABL Facility and under each of the indentures governing its outstanding senior notes.

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, 2011		December 31, 2010	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Recourse	\$ 649.3	\$ 479.8	\$ 697.1	\$ 585.5
Non-recourse	113.8	121.0	113.8	120.1

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 reflect its own non-performance risk, where applicable.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

12. 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. Unionized employees of the company are members of multi-employer industry-wide pension plans to which the company contributes a predetermined amount per hour worked by an employee.

The company provides other benefit plans consisting of provincial medical plan premiums, extended health care and dental benefits to employees. A description of changes to pension and other benefit plans can be found on page 91 of the company's 2010 Annual Report.

For the three and six months ended June 30, 2011, the company incurred total post-retirement benefit costs of \$7.6 million and \$14.2 million, respectively (three and six months ended June 30, 2010 – \$8.6 million and \$17.2 million).

In December 2009, the Company announced changes to its pension and post-retirement benefit plans to active employees. In July 2011, the final true up contribution for the closure of our U.S. sales company's benefit pension plan was made. At June 30, 2011 the company was fully accrued based on the July 2011 payment of US\$5.1 million.

For the three and six months ended June 30, 2011, the company contributed \$8.5 million and \$16.3 million, respectively (three and six months ended June 30, 2010 - \$7.6 million and \$13.9 million) for employee future benefits which include cash contributed to the company's funded pension plans, cash payments directly to beneficiaries for its unfunded benefit plans, cash contributions to its defined contribution plans and cash contributed to its multi-employer industry-wide pension plans.

Components of net periodic benefit cost recognized in the period were as follows:

Pension benefit plans	Three months ended June 30,		Six months ended June 30,	
	2011	2010	2011	2010
Defined benefit plan				
Service cost for the period	\$ 0.3	\$ 0.5	\$ 0.6	\$ 0.9
Interest cost	4.6	5.2	9.0	10.4
Expected return on assets	(4.1)	(4.1)	(8.2)	(8.2)
Amortization of unrecognized items:				
Actuarial losses	1.3	1.5	2.6	3.1
Prior service costs	0.1	0.1	0.2	0.2
	2.2	3.2	4.2	6.4
Defined contribution plan				
Service cost for the period	1.0	0.8	1.8	1.8
Multi-employer industry-wide pension plan service cost for the period	3.0	2.4	5.4	4.7
Net periodic benefit cost for pension benefit plans	\$ 6.2	\$ 6.4	\$ 11.4	\$ 12.9

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

Other post-retirement benefit plans	Three months ended June 30,		Six months ended June 30,	
	2011	2010	2011	2010
Service cost for the period	\$ 0.4	\$ 0.5	\$ 0.7	\$ 1.0
Interest cost	1.9	2.5	3.8	5.0
Amortization of unrecognized items:				
Actuarial losses	0.1	0.1	0.2	0.1
Prior service credits	(1.0)	(0.9)	(1.9)	(1.8)
Net periodic benefit cost for other benefit plans	\$ 1.4	\$ 2.2	\$ 2.8	\$ 4.3

13. ACCUMULATED OTHER COMPREHENSIVE LOSS

The following table contains information about the accumulated other comprehensive loss (AOCI) of the company, net of taxes:

	June 30, 2011	December 31, 2010
Unrecognized pension and other post-retirement benefits costs	\$ (45.5)	\$ (46.4)
Unrecognized gains on cash flow revenue hedges	0.1	1.0
Foreign currency translation adjustments, net of related hedging activities ¹	(1.7)	(0.2)
Unrecognized loss on interest rate hedges	(0.5)	(0.5)
	\$ (47.6)	\$ (46.1)

¹ The accumulated net adjustment is comprised of non-taxable translation loss of \$5.9 million (2010 – \$2.6 million loss), and a net revaluation of long-term debt designated as a net investment hedge of \$4.2 million gain (2010 – \$2.4 million gain), net of tax of \$1.0 million expense (2010 – \$0.6 million expense).

14. RESTRUCTURING

The following table provides the activity in the restructuring liability:

	As at June 30, 2011	As at December 31, 2010
Balance, beginning of period	\$ 3.3	\$ 6.8
Expensed in period	–	25.3
Disbursements	(2.5)	(28.8)
Balance, end of period	\$ 0.8	\$ 3.3
Classification:		
Accounts payable and accrued liabilities (note 10)	\$ 0.5	\$ 3.1
Other long-term obligations	0.3	0.2
	\$ 0.8	\$ 3.3

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

The following table provides restructuring liability by year of initiative:

	June 30, 2011	December 31, 2010
2008 and prior initiatives	\$ 0.5	\$ 0.6
2009 initiatives	–	0.7
2010 initiatives	0.3	2.0
	\$ 0.8	\$ 3.3

During the three and six months ended June 30, 2011, the company did not record any restructuring costs.

15. IMPAIRMENT (RECOVERY) AND OTHER CLOSURE COSTS

During the quarter, the company recorded a \$0.3 million impairment recovery associated with the permanent closure of the paper recycling operation. The recovery represents a change in estimated property tax and water lot tax in future years from what was originally anticipated in 2010. A detailed account of the company's 2010 impairment and closure costs can be found on page 82 of the company's 2010 Annual Report.

16. OTHER INCOME (EXPENSE)

The components of other income (expense) were as follows:

	Three months ended June 30,		Six months ended June 30,	
	2011	2010	2011	2010
Gain (loss) on derivative financial instruments	\$ 0.4	\$ (11.2)	\$ 1.2	\$ (12.1)
Foreign exchange gain (loss) on working capital balances	(1.2)	6.2	(2.8)	6.1
Fees related to bond exchange	–	–	–	(8.3)
Gain (loss) on disposal of property, plant and equipment	–	0.2	(0.1)	6.0
Loss on fires	(5.7)	–	(5.7)	–
Other	0.1	(0.1)	0.5	(0.1)
	\$ (6.4)	\$ (4.9)	\$ (6.9)	\$ (8.4)

17. INCOME TAXES

As at June 30, 2011, the company has provided for a cumulative valuation allowance on its future tax assets of \$117.7 million (\$103.0 million at December 31, 2010). The effective rate for the three months ended June 30, 2011 was 5.8%. The effective rate is less than the statutory rate primarily due to non-recognition of the tax benefit of a portion of the losses. A description of the company's income taxes can be found on pages 97 to 100 of the company's 2010 Annual Report.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

18. FAIR VALUE MEASUREMENT

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, 2011, the company did not have any currency or commodity contracts which have been designated as hedging instruments.

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, 2011	Fair value hierarchy	Balance sheet classification
Assets			
Currency contracts	\$ 4.4	2 ⁽¹⁾	Prepays and other
Currency contracts	4.5	2 ⁽¹⁾	Other assets
	\$ 8.9		
Liabilities			
Commodity contracts	\$ 1.1	2 ⁽²⁾	Prepays and other

Fair value of the company's derivatives are classified under Level 2 as they are measured as follows:

- (1) 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.
- (2) 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 Company no longer designates its U.S. dollar revenue risk management instruments as cash flow hedges for accounting purposes effective April 1, 2010. 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 loss*. When the hedge item is recorded in earnings, the corresponding gain or loss on the hedge will be reclassified from *Accumulated other comprehensive loss* to *Sales*.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

The following table presents information about the effects of the company's derivative instruments previously designated as cash flow hedges until April 1, 2010 when hedge accounting was discontinued. It also presents the effect of long-term debt designated as a hedge of the company's net investment in the Snowflake mill on the company's consolidated financial statements:

	Gain (loss) recognized in AOCI ⁽¹⁾		(Gain) loss reclassified from AOCI ⁽¹⁾		Classification on statement of earnings (loss) reclassified from AOCI ⁽¹⁾	Gain (loss) recognized in income ⁽²⁾	
	2011	2010	2011	2010		2011	2010
Three months ended June 30							
Derivatives designated as cash flow hedges							
Currency contracts	\$ -	\$ -	\$ (0.2)	\$ (3.7)	Other income (expense)	\$ -	\$ -
Long-term debt designated as hedges of net investment	\$ 0.6	\$ (5.7)	\$ (0.9)	\$ -	Foreign exchange gain (loss) on long-term debt	\$ -	\$ -
Six months ended June 30							
Derivatives designated as cash flow hedges							
Currency contracts	\$ -	\$ 4.2	\$ (0.9)	\$ (7.2)	Other income (expense)	\$ -	\$ (1.8)
Long-term debt designated as hedges of net investment	\$ 5.5	\$ (2.5)	\$ (1.0)	\$ 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, 2011, the company estimates that a net gain of \$0.2 million, or an after-tax net gain of \$0.1 million, will be reclassified from *Accumulated other comprehensive 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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

19. 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.

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 108 to 110 of the company's 2010 Annual Report.

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 were as follows:

	June 30, 2011	December 31, 2010
Trade receivables		
Current	\$ 95.1	\$ 106.0
Past due 1-30 days	7.7	4.7
Past due 31-90 days	0.9	1.4
Past due over 90 days	1.4	0.6
	105.1	112.7
Less allowance for doubtful accounts	(2.9)	(3.0)
Trade receivables, net	\$ 102.2	\$ 109.7

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

	June 30, 2011	December 31, 2010
Balance, beginning of period	\$ 3.0	\$ 3.7
Increase (decrease) in provision	(0.1)	(0.7)
Balance, end of period	\$ 2.9	\$ 3.0

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

(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, 2011						
0 to 12 months	\$ 100	0.9987	\$ 81	0.9077	\$ 11	1.0160
13 to 24 months	88	1.0099	–	–	–	–
	\$ 188	1.0039	\$ 81	0.9077	\$ 11	1.0160
As at December 31, 2010						
0 to 12 months	\$ 253	0.9878	\$ 249	0.8953	\$ 13	0.9761
13 to 24 months	55	0.9898	5	0.8786	–	–
	\$ 308	0.9882	\$ 254	0.8949	\$ 13	0.9761

At period-end exchange rates, the net amount the company would receive to settle the above contracts and options is \$8.9 million (December 31, 2010 – \$11.0 million).

At June 30, 2011, instruments having a notional principal of US\$198.7 million are marked to market, where the related gains and losses are recognized as *Other income (expense)*, except for the portion still deferred in *Accumulated other comprehensive loss*.

At June 30, 2011, commodity swap agreements are outstanding to fix the sales price of 17,000 metric tonnes of NBSK pulp within the next nine months. These contracts are not designated as hedging instruments for accounting purposes and are reported at their fair value, which was negative \$1.1 million at June 30, 2011 (December 31, 2010 – negative \$0.1 million), with related gains and losses recognized in *Other income (expense)*.

(c) Cost Risk Management Instruments

At June 30, 2011, the company was party to commodity options to hedge the purchase price of natural gas for 0.8 million gigajoules (GJ) (December 31, 2010 – 0.7 million GJ) within the next 21 months at rates averaging \$4.65 per GJ. These instruments were not designated as hedging instruments for accounting purposes and were reported at fair value, with related gains and losses recognized in *Other income (expense)*. At period-end contract rates, the fair value of these contracts was \$0.0 million (December 31, 2010 - \$0.1 million).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

20. CONTINGENT LIABILITIES

A description of the company's contingent liabilities as at December 31, 2010 can be found on page 113 of the company's 2010 Annual Report. An update as at June 30, 2011 is outlined below:

(a) Claim for Return of Payments Made to Quebecor World (USA)

No changes since December 31, 2010 Annual Report disclosure.

(b) Claim for Certain Post-Retirement Benefits

The Communications, Energy and Paperworkers Union of Canada Locals 1, 76, 592 and 686 (the "Locals"), representing hourly employees at the company's Powell River and Port Alberni mills, 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 ("MB"), now doing business as Weyerhaeuser Company Ltd. ("Weyerhaeuser"). Pacifica Papers Inc. ("Pacifica") acquired the Powell River and Port Alberni mills from MB in 1998, and it was agreed as part of that transaction that MB would remain responsible for any benefits for eligible employees who retired prior to the acquisition by Pacifica of the mills. The company subsequently amalgamated with Pacifica in 2001. The Locals claim that the contractual relationships between the company, Pacifica and MB do not absolve the company (as successor to Pacifica) from any obligations which may exist in respect of certain post-retirement benefits and that the successorship provisions of the Labour Relations Code imposed any such possible obligations on Pacifica at the time Pacifica acquired the mills. 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. All four Locals filed grievances claiming that the company is responsible for these post-retirement benefits. The company does not agree with the Locals' positions and has contested or will be contesting the grievances. Local 76's claim was dismissed by an arbitrator on December 23, 2010. Local 686 advised the company on March 29, 2011 that Local 686 was withdrawing its claim. The other two grievances are at a preliminary stage and, as at August 1, 2011, have not been scheduled. Although the extent of the company's liability for the remaining two claims remains unknown at this time, the company estimates that it would incur costs of between \$1.0 million and \$2.0 million annually to provide these additional benefits. In that case, it would seek indemnification from Weyerhaeuser.

(c) Short-term Incentive Plan and Benefits 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 announced in November 2009 and certification of the action as a class proceeding on behalf of all salaried employees who were entitled to Short-term Incentive Plan payments and affected by the reduction in benefits. The action was certified as a class proceeding on March 21, 2011 but only on behalf of those employees and former employees who have not provided the company with releases of the claims. The company intends to vigorously defend this action. Most of the company's employees and applicable former employees have provided the company with written releases of these claims, leaving only a small number of employees and former employees who have not done so. Although it is not possible to determine the likelihood and extent of any potential liability for the remaining claims, the company does not expect to incur any additional material liability in connection with this claim.

21. COMPARATIVE FIGURES

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

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