



PRIMARY ENERGY RECYCLING CORPORATION

**Management's Discussion and
Analysis of Financial Condition and Results of Operations
(In US Dollars)**

Three Months and Six Months Ended June 30, 2011 and 2010

Primary Energy Recycling Corporation
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL
CONDITION AND RESULTS OF OPERATIONS

The following management's discussion and analysis of the financial condition and results of operations ("MD&A") of Primary Energy Recycling Corporation (the "Company") dated August 3, 2011 should be read in conjunction with the unaudited interim consolidated financial statements of the Company for the three months and six months ended June 30, 2011 and 2010. The Company's financial statements are presented to comply with International Financial Reporting Standards ("IFRS"). The comparative periods for 2010 that were previously reported in accordance with Canadian generally accepted accounting principles ("Canadian GAAP") have been presented to comply with IFRS for comparative purposes. See note 4 to the Company's interim consolidated financial statements for a reconciliation of the comparative periods from Canadian GAAP to IFRS. All amounts in this MD&A are in U.S. dollars, unless otherwise stated. Rounding adjustments have been made to certain financial information in this MD&A. As a result, numerical figures shown as totals may not be exact arithmetic aggregations of their component parts.

Forward-Looking Statements

Certain statements in this MD&A, including statements regarding the expected completion date of the North Lake upgrade and the repayment of debt under the Company's Credit Facility (as defined below), may constitute "forward-looking statements", which reflect the expectations of management regarding future growth, results of operations, performance and business prospects and opportunities of the Company. Such forward-looking statements reflect current expectations regarding future events and operating performance and speak only as of the date hereof. These forward-looking statements involve significant risks and uncertainties, and should not be read as guarantees of future performance or results, and will not necessarily be accurate indications of whether or not or the times at or by which such performance or results will be achieved.

A number of factors could cause actual results to differ materially from the results discussed in the forward-looking statements, including, but not limited to, the factors discussed under "Risk Factors" in this MD&A and in the Company's most recent annual information form. Additional information relating to the Company, including its annual information form, is available on SEDAR at www.sedar.com. Although the forward-looking statements contained in this MD&A are based on what are believed to be reasonable assumptions, investors cannot be assured that actual results will be consistent with these forward-looking statements, and the differences may be material. These forward-looking statements are made as of the date of this MD&A and, except as required by applicable securities laws, the Company assumes no obligation to update or revise them to reflect new events or circumstances.

Non-IFRS Measures

Definition of EBITDA and Free Cash Flow

References to "EBITDA" are to earnings before interest, taxes, depreciation and amortization and certain other adjustments listed in the reconciliation table provided herein.

References to "Free Cash Flow" are to cash provided by operating activities as adjusted for capital expenditures.

EBITDA and Free Cash Flow are not recognized measures under IFRS and do not have standardized meanings prescribed by IFRS. Therefore, EBITDA and Free Cash Flow may not be comparable to similar measures presented by other issuers. Management believes that EBITDA and Free Cash Flow are important measures in evaluating the Company's performance and allow for comparison of operating performance on a consistent basis. However, EBITDA should not be construed as an

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alternative to net earnings or loss determined in accordance with IFRS and Free Cash Flow should not be construed as an alternative to net cash provided by operating activities determined in accordance with IFRS as indicators of the Company's performance or cash flows from operating, investing and financing activities or as measures of liquidity and cash flows.

Overview

General

The Company owns a majority interest in Primary Energy Recycling Holdings LLC ("PERH") which is headquartered in Oak Brook, Illinois. PERH indirectly owns and operates three recycled energy projects, one clean heat and power project and a 50% interest in a pulverized coal facility ("Harbor Coal") (collectively, the "Projects"). The Projects have a combined electrical generating capacity of 283 megawatts and a combined steam generating capacity of 1.8 MMBtu/hour. PERH creates value for its customers by recycling recoverable heat and byproduct fuels from industrial and electric generation processes and converting it into reliable and economical electricity and thermal energy for resale back to its customers.

The Company owns 85.7% of the common membership interests of PERH. CPI USA Ventures LLC (the "Manager") indirectly holds the remaining 14.3% of the common membership interests of PERH.

Review of Facility Operations

The Company's facilities had an average availability of 94.3%, during the three months ended June 30, 2011, with no facility experiencing any significant unplanned outage. Production of electricity and pulverized coal during the quarter were both at the highest quarterly levels in the past five years. The outage at North Lake for Phase I of the plant upgrade project was completed at the beginning of the quarter. During the second quarter the plant had availability of nearly 100% after the outage and tests demonstrated thermal performance at original design specification levels. Work on Phase II of the North Lake plant upgrade continues as planned with expected completion in the second or third quarter of 2012, depending on the site host's outage plans for its blast furnace. Work at Cokenergy continued with the planned outage of one boiler for major retubing work with expenditures in the second quarter of 2011 totaling \$0.7 million. Periodic repairs to the baghouse and scrubber modules were also completed as planned. No material discussions with the United States Environmental Protection Agency regarding Cokenergy's notice of violation were held during the quarter. Cokenergy's Title V permit renewal remains in process with no material update. Harbor Coal had high pulverized coal deliveries in response to blast furnace demand. The Portside facility performed a planned outage to replace worn tubing in the heat recovery boiler associated with the combustion turbine. During this work both the heat recovery boiler and combustion turbine were unavailable for service, but the two auxiliary boilers and the steam turbine operated to meet steam demand and provide electricity. Ironside operated during the quarter with 100% availability, and the site host continued operating two blast furnaces during the quarter.

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Results of Operations

(in 000's of US\$, except share and per share data)

	Three Months Ended June 30,	
	2011	2010
Revenue:		
Capacity	\$ 9,018	\$ 9,018
Energy service	4,295	4,223
	<u>13,313</u>	<u>13,241</u>
Expenses:		
Operations and maintenance	4,123	3,297
General and administrative	2,148	2,312
Employee benefits	606	357
Depreciation and amortization	6,246	7,566
	<u>13,123</u>	<u>13,532</u>
Equity in earnings of joint venture	1,093	966
Operating income	1,283	675
Other expense:		
Interest expense	(1,692)	(2,564)
Realized and unrealized loss on derivative contracts	-	(29)
	<u>(1,692)</u>	<u>(2,593)</u>
Loss before income taxes	(409)	(1,918)
Income tax expense	(384)	(910)
Net loss and comprehensive loss	<u>\$ (793)</u>	<u>\$ (2,828)</u>
Net loss and comprehensive loss attributable to:		
Owners of the Company	\$ -	\$ (1,820)
Non-controlling interest	(793)	(1,008)
	<u>\$ (793)</u>	<u>\$ (2,828)</u>
Net loss per share attributable to owners of the Company:		
Weighted average number of shares outstanding - basic and diluted	44,706,187	44,706,187
Basic and diluted net loss per share attributable to owners of the Company	<u>\$ -</u>	<u>\$ (0.04)</u>

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Three Months Ended June 30, 2011 compared to Three Months Ended June 30, 2010

The Company's revenue of \$13.3 million in the second quarter of 2011 increased \$0.1 million, or 0.6%, compared with revenue of \$13.2 million for the second quarter of 2010. The increase is related to the variable portion of Energy Service revenue. Market conditions in the steel industry improved in the second quarter of 2011 compared to the same period in 2010 and resulted in increased steel production at the Company's site hosts. North Lake's revenue decreased by \$0.3 million during the second quarter primarily due to reduced host operations resulting in lower host steam delivery to the North Lake facility. The Ironside facility operated during the second quarter of 2011, but was out of service during the same period in 2010 which positively impacted revenue by \$0.4 million.

Operations and maintenance expense for the second quarter of 2011 was \$4.1 million compared to \$3.3 million for the second quarter of 2010, an increase of \$0.8 million or 25.1%. The increase is primarily due to additional expenses associated with boiler repairs, cooling tower system work, environmental control system repairs and general maintenance and labor.

General and administrative expense for the second quarter of 2011 was \$2.2 million compared to \$2.3 million for the second quarter of 2010, a decrease of \$0.1 million or 7.1%. The decrease is primarily due to reductions to accrued property taxes of \$0.3 million offset by additional professional fees of \$0.1 million and plant and liability insurance of \$0.1 million.

Employee benefits for the second quarter of 2011 were \$0.6 million compared to \$0.4 million for the second quarter of 2010, an increase of \$0.2 million.

Depreciation and amortization expense for the second quarter of 2011 was \$6.2 million compared to \$7.6 million for the second quarter of 2010, a decrease of \$1.4 million. During the second quarter of 2011, the North Lake contract intangible was fully amortized resulting in a reduced amount of amortization expense compared to the prior period.

Equity in earnings of joint venture for the second quarter of 2011 was \$1.1 million compared to \$1.0 million for the second quarter of 2010, an increase of \$0.1 million. The net increase is the result of reduced operating expenses of \$0.2 million offset by reduced revenue of \$0.1 million in the period from the Company's investment in PCI Associates.

Operating income for the second quarter of 2011 was \$1.3 million compared to \$0.7 million for the second quarter of 2010, an increase of \$0.6 million. The increase is driven by the net effect of the items discussed above.

Interest expense for the second quarter of 2011 was \$1.7 million compared to \$2.6 million for the second quarter of 2010, a decrease of \$0.9 million. This decrease is primarily due to the reduced level of debt outstanding under the Company's Credit Facility (as defined below) partially offset by increased amortization of deferred finance fees during the second quarter of 2011.

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Realized and unrealized loss on derivative contracts for the second quarter of 2011 and 2010 were de minimis amounts.

Income tax expense for the second quarter of 2011 was \$0.4 million compared to \$0.9 million for the second quarter of 2010, a decrease of \$0.5 million. The amount of expense recorded in each period is primarily due to the change in value of future tax assets and liabilities.

Net loss and comprehensive loss for the second quarter of 2011 was \$0.8 million compared to \$2.8 million for the second quarter of 2010, an improvement of \$2.0 million. The improvement is the result of the net effect of the items discussed above.

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Results of Operations

(in 000's of US\$, except share and per share data)

	Six Months Ended June 30,	
	2011	2010
Revenue:		
Capacity	\$ 18,036	\$ 18,036
Energy service	8,059	8,465
	26,095	26,501
Expenses:		
Operations and maintenance	6,866	5,354
General and administrative	4,479	4,636
Employee benefits	1,166	923
Depreciation and amortization	13,804	15,132
	26,315	26,045
Equity in earnings of joint venture	2,104	1,801
Operating income	1,884	2,257
Other expense:		
Interest expense	(3,535)	(5,372)
Realized and unrealized loss on derivative contracts	(4)	(176)
Loss on derecognition	(500)	-
	(2,155)	(3,291)
Loss before income taxes	(2,155)	(3,291)
Income tax expense	(896)	(1,225)
Net loss and comprehensive loss	\$ (3,051)	\$ (4,516)
Net loss and comprehensive loss attributable to:		
Owners of the Company	\$ (1,281)	\$ (2,590)
Non-controlling interest	(1,770)	(1,926)
	\$ (3,051)	\$ (4,516)
Net loss per share attributable to owners of the Company:		
Weighted average number of shares outstanding - basic and diluted	44,706,187	44,706,187
Basic and diluted net loss per share attributable to owners of the Company	\$ (0.03)	\$ (0.06)

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Six Months Ended June 30, 2011 compared to Six Months Ended June 30, 2010

The Company's revenue of \$26.1 million in the first six months of 2011 decreased \$0.4 million, or 1.5%, compared with revenue of \$26.5 million for the first six months of 2010. The decrease is related to the variable portion of Energy Service revenue. Market conditions in the steel industry improved in the first six months of 2011 compared to the same period in 2010 and resulted in increased steel production at the Company's site hosts. The North Lake facility experienced reduced operations due to the planned upgrade and overhaul and lower host steam delivery which negatively impacted revenue by \$1.1 million. The Ironside facility operated during the first six months of 2011, but was out of service during the same period in 2010 which positively impacted revenue by \$0.6 million.

Operations and maintenance expense for the first six months of 2011 was \$6.8 million compared to \$5.4 million for the first six months of 2010, an increase of \$1.4 million or 28.2%. The increase is primarily due to additional expenses associated with boiler repairs, cooling tower system work, environmental control system repairs, general maintenance and labor.

General and administrative expense for the first six months of 2011 was \$4.5 million compared to \$4.6 million for the first six months of 2010, a decrease of \$0.1 million or 3.4%. The decrease is primarily due to reductions to accrued property taxes of \$0.4 million offset by additional professional fees of \$0.1 million, management fees of \$0.1 million and plant and liability insurance of \$0.1 million.

Employee benefits for the first six months of 2011 were \$1.1 million compared to \$0.9 million for the first six months of 2010, an increase of \$0.2 million.

Depreciation and amortization expense for the first six months of 2011 was \$13.8 million compared to \$15.1 million for the first six months of 2010, a decrease of \$1.3 million. During the second quarter of 2011, the North Lake contract intangible was fully amortized resulting in a reduced amount of amortization expense compared to the prior period.

Equity in earnings of joint venture for the first six months of 2011 was \$2.1 million compared to \$1.8 million for the first six months of 2010, an increase of \$0.3 million. The net increase is the result of reduced operating expenses of \$0.4 million offset by reduced revenue of \$0.1 million in the current year from the Company's investment in PCI Associates.

Operating income for the first six months of 2011 was \$1.9 million compared to \$2.3 million for the first six months of 2010, a decrease of \$0.4 million. The decrease is driven by the net effect of the items discussed above.

Interest expense for the first six months of 2011 was \$3.5 million compared to \$5.4 million for the first six months of 2010, a decrease of \$1.9 million. This decrease is primarily due to the reduced level of debt outstanding under the Company's Credit Facility partially offset by increased amortization of deferred finance fees during the first six months of 2011.

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Realized and unrealized loss on derivative contracts for the first six months of 2011 was a de minimis amount and was \$0.2 million for the first six months of 2010.

Loss on derecognition for the first six months of 2011 was \$0.5 million and represents the write-off of the undepreciated costs associated with the prior overhaul at North Lake.

Income tax expense for the first six months of 2011 was \$0.9 million compared to \$1.2 million for the first six months of 2010, a decrease of \$0.3 million. The amount of expense recorded in each period is primarily due to the change in value of future tax assets and liabilities.

Net loss and comprehensive loss for the first six months of 2011 was \$3.1 million compared to \$4.5 million for the first six months of 2010, an improvement of \$1.4 million. The improvement is the result of the net effect of the items discussed above.

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EBITDA and Free Cash Flow

The Company believes that EBITDA is an important measure as it allows for the assessment of the operating performance of the business on a consistent basis from period to period. For the three months ended June 30, 2011 and 2010 the Company generated EBITDA of \$8.5 million and \$9.2 million, respectively. For the six months ended June 30, 2011 and 2010 the Company generated EBITDA of \$17.7 million and \$19.4 million, respectively. EBITDA is reconciled to net loss and comprehensive loss in the table below.

Reconciliation of Net Loss and Comprehensive Loss to EBITDA
(in 000's of US\$)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Net loss and comprehensive loss	\$ (793)	\$ (2,828)	\$ (3,051)	\$ (4,516)
Adjustment to net loss and comprehensive loss:				
Depreciation and amortization	6,246	7,566	13,804	15,132
Depreciation and amortization included in equity in earnings of joint venture	1,009	1,009	2,018	2,018
Interest expense	1,692	2,564	3,535	5,372
Realized and unrealized loss on derivative contracts	-	29	4	176
Loss on derecognition	-	-	500	-
Income tax expense	384	910	896	1,225
EBITDA	\$ 8,538	\$ 9,250	\$ 17,706	\$ 19,407

The Company believes that Free Cash Flow is an important measure as it allows for the evaluation of the amount of cash generated by the business on a consistent basis from period to period. For the three months ended June 30, 2011 and 2010 the Company generated Free Cash Flow of \$3.4 million and \$6.3 million, respectively. For the six months ended June 30, 2011 and 2010 the Company generated Free Cash Flow of \$12.5 million and \$15.7 million, respectively. Free Cash Flow is reconciled to net cash provided by operating activities in the table below.

Reconciliation of Net Cash Provided By Operating Activities to Free Cash Flow

(in 000's of US\$)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Net cash provided by operating activities	\$ 6,891	\$ 6,858	\$ 16,598	\$ 16,221
Less: capital expenditures	(3,534)	(490)	(4,128)	(490)
Free Cash Flow	\$ 3,357	\$ 6,368	\$ 12,470	\$ 15,731

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Summary of Quarterly Results

(In 000's of US\$, except per share data)

	3rd Quarter 2009 (1), (2)	4th Quarter 2009 (1), (2)	1st Quarter 2010 (2)	2nd Quarter 2010 (2)	3rd Quarter 2010 (2)	4th Quarter 2010 (2)	1st Quarter 2011 (2)	2nd Quarter 2011
Revenues	\$ 14,449	\$ 15,329	\$ 13,260	\$ 13,241	\$ 12,748	\$ 13,534	\$ 12,782	\$ 13,313
Operating income (loss)	\$ 1,250	\$ 2,290	\$ 1,582	\$ 675	\$ (3,259)	\$ 1,414	\$ 601	\$ 1,283
Net income (loss) and comprehensive income (loss) attributable to the owners of the Company	\$ 21,035	\$ (2,824)	\$ (770)	\$ (1,820)	\$ (3,649)	\$ 19,111	\$ (1,281)	\$ -
Net income (loss) per share (basic and diluted) attributable to the owners of the Company	\$ 0.47	\$ (0.06)	\$ (0.02)	\$ (0.04)	\$ (0.08)	\$ 0.44	\$ (0.03)	\$ -

(1) Results for 2009 have been prepared using Canadian GAAP. Results for 2010 and 2011 have been prepared using IFRS.

(2) All per share amounts have been retrospectively restated to give effect to the Share Consolidation in the consolidated financial statements.

Outstanding Share Data

On May 5, 2011, the Company announced a three-to-one Common Share consolidation (the "Share Consolidation"). Under the Share Consolidation, the Company consolidated all of its outstanding Common Shares on the basis of one post-consolidation Common Share for three existing Common Shares and all resulting fractional Common Shares were cancelled. Accordingly, the 134,118,561 Common Shares previously issued and outstanding were consolidated into 44,706,187 Common Shares, all of which are outstanding as of the date of this MD&A. All Common Share and per share amounts have been retrospectively restated to give effect to the Share Consolidation in the consolidated financial statements. The post-consolidation Common Shares began trading on the Toronto Stock Exchange (the "TSX") on May 19, 2011. The number of Common Shares reserved for issuance under the Company's stock option plan and the number of Common Shares into which the outstanding options will be exercisable has been proportionally reduced to reflect the three-to-one consolidation ratio and the applicable exercise price has been proportionally increased. On August 24, 2010, the Board of Directors awarded a total of 5,500,000 options to Mr. John Prunkl, the President and Chief Executive Officer of the Company, subject to approval of the Stock Option Plan by the Company's shareholders. The Company's shareholders approved the plan on October 15, 2010. All of the options granted to Mr. Prunkl vested immediately and are defined as incentive stock options for U.S. tax purposes. The stock price at date of award was Cdn\$0.94 (Cdn\$2.82 after applying the effects of the Share Consolidation). The exercise price of the first option to acquire 5,000,000 Common Shares was Cdn\$1.00 with a fair value at the date of measurement of \$0.61. The exercise price of the second option to acquire 500,000 Common Shares was Cdn\$1.20 with a fair value at the date of measurement of \$0.56. For the year ended December 31, 2010, the Company recognized a total of \$3.3 million in non-cash stock based compensation expense associated with the grants issued under the Stock Option Plan, based on the estimated fair value of the options on the grant date. Upon completion of the Share Consolidation, Mr. Prunkl's 5,500,000 options have been consolidated into 1,833,332 options with the respective exercise price increasing by three times. As a result, the first option is to acquire 1,666,666 Common Shares at an exercise price of Cdn\$3.00. The second option is to acquire 166,666 Common Shares at an exercise price of Cdn\$3.60. At June 30, 2011 there were 1,833,332 options currently exercisable with a weighted average exercise price of \$3.03.

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As of the grant date, the options had a weighted average fair value measurement of \$0.61. The fair value of the respective options was determined by the Black-Scholes option pricing model using the assumptions noted in the following table.

Stock price at date of fair value measurement	Cdn\$1.09
Volatility	40%
Risk-free rate	2.79%
Expected term (in years)	10
Dividend yield	0%

Basic and Diluted Net Loss Per Share

Basic loss per share is computed by dividing the net loss for the period attributable to the owners of the Company by the weighted average number of Common Shares outstanding during the period. Diluted net loss per share is computed by dividing the net loss for the period, by the weighted average number of Common Shares outstanding and, when dilutive, adjusted for the effect of all potentially dilutive shares, including stock options, on an as-if-converted basis.

The following table sets forth the computation for basic and diluted net loss per share:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Numerator:				
Net loss attributable to owners of the Company	\$ -	\$ (1,820)	\$ (1,281)	\$ (2,590)
Denominator:				
Denominator for basic and diluted - weighted average number of Common Shares outstanding	44,706,187	44,706,187	44,706,187	44,706,187
Basic and diluted loss per share:				
Basic and diluted net loss per share	\$ -	\$ (0.04)	\$ (0.03)	\$ (0.06)

(i) All Common Share and per share amounts have been retrospectively restated to give effect to the Share Consolidation in the consolidated financial statements.

Options to purchase 1,833,332 Common Shares were outstanding at the end of the period ending June 30, 2011. For the three months and six months ended June 30, 2011 and 2010, there were no differences in the weighted average number of Common Shares outstanding used for basic and diluted net loss per share as the effect of all potentially dilutive Common Shares outstanding was anti-dilutive.

Liquidity and Capital Resources

For the three months ended June 30, 2011, the Company recorded a decrease in cash and cash equivalents of \$2.1 million. As of June 30, 2011, the Company's cash balance was \$22.5 million. The Company's primary source of capital has historically been cash flows from operations. Available capital is now primarily used for repayment of debt principal, capital expenditures, payment of interest and operating expenses. The Company believes that available cash funds, in addition to cash flows to be generated from future operations, will be sufficient to finance the Company's anticipated operating and maintenance requirements associated with the Company's facilities in the near term, its planned capital expenditures and its debt service requirements under its Credit Facility (as defined below). The Company expects to spend approximately \$11.0 - 12.0 million on capital improvements for its North Lake facility to meet the upgrade requirements specified under the new Tolling Agreement. Approximately \$6.0 million will be spent during 2011 with the balance in 2012. The upgrade is expected to be completed in mid 2012. For the first six months of 2011, the Company incurred \$3.2 million of capital expenditures for equipment and services in support of the North Lake upgrade. Additionally, the Company expects to pay off its outstanding debt balance early in 2013, if

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the Company does not re-finance prior thereto. The Company is exploring re-financing at the present time but no decisions have been made to proceed at this time.

Cash Flows for the Three Months and Six Months Ended June 30, 2011

Net cash provided by operating activities for the three months ended June 30, 2011 was \$6.9 million, which resulted from net loss and comprehensive loss of \$0.8 million, plus \$6.1 million of net non-cash items charged to the Consolidated Statement of Comprehensive Income, plus \$2.1 million of distributions received from the Company's investment in joint venture, less \$0.5 million representing the net change in the Company's operating assets and liabilities. The net non-cash items consisted primarily of depreciation of property, plant and equipment and amortization of intangible assets, equity in earnings of joint venture, interest expense and income tax expense. The net change in operating assets and liabilities resulted primarily from increases in accounts payable, accrued expenses, amounts due to affiliates and a decrease in inventory and other assets offset by decreases in accrued property taxes and increases in accounts receivable. Net cash used in investing activities for the three months ended June 30, 2011 was \$3.3 million comprised of \$3.5 million of capital expenditures offset by a \$0.2 million change in restricted cash. Net cash used in financing activities for the three months ended June 30, 2011 was \$5.7 million and represents repayment of debt outstanding under the Credit Facility.

Net cash provided by operating activities for the six months ended June 30, 2011 was \$16.6 million, which resulted from net loss and comprehensive loss of \$3.1 million, plus \$14.4 million of net non-cash items charged to the Consolidated Statement of Comprehensive Income, plus \$3.6 million of distributions received from the Company's investment in joint venture, plus \$1.7 million representing the net change in the Company's operating assets and liabilities. The net non-cash items consisted primarily of depreciation of property, plant and equipment and amortization of intangible assets, loss on derecognition, equity in earnings of joint venture, interest expense and income tax expense. The net change in operating assets and liabilities resulted primarily from increases in accounts payable, accrued expenses, amounts due to affiliates and a decrease in accounts receivable and inventory and other assets offset by decreases in accrued property taxes. Net cash used in investing activities for the six months ended June 30, 2011 was \$3.6 million comprised of \$4.1 million of capital expenditures offset by a \$0.5 million change in restricted cash. Net cash used in financing activities for the six months ended June 30, 2011 was \$12.9 million and represents repayment of debt outstanding under the Credit Facility.

Cash Flows for the Three Months and Six Months Ended June 30, 2010

Net cash provided by operating activities for the three months ended June 30, 2010 was \$6.8 million, which resulted from a net loss and comprehensive loss of \$2.8 million, plus \$8.5 million of net non-cash items charged to the Consolidated Statement of Operations, plus \$2.0 million of distributions received from the Company's investment in joint venture, less \$0.9 million representing the net change in the Company's operating assets and liabilities. The net non-cash items consisted primarily of depreciation of property, plant and equipment and amortization of intangible assets, losses associated with the valuation of derivative hedge contracts, equity in earnings of joint venture, income tax expense and amounts allocated to the non-controlling interest. The net change in operating assets and liabilities resulted primarily from increases in accrued expenses, accounts payable, amounts due to affiliates offset by decreases in accrued property taxes and increases in inventory and other assets and accounts receivable. Net cash used in investing activities for the three months ended June 30, 2010 was \$0.4 million comprised of \$0.5 million of capital expenditures offset by a \$0.1 million change in restricted cash. Net cash used in financing activities for the three months

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ended June 30, 2010 was \$6.9 million and represents repayment of debt outstanding under the Credit Facility.

Net cash provided by operating activities for the six months ended June 30, 2010 was \$16.2 million, which resulted from a net loss and comprehensive loss of \$4.5 million, plus \$16.8 million of net non-cash items charged to the Consolidated Statement of Operations, plus \$4.1 million of distributions received from the Company's investment in joint venture, less \$0.2 million representing the net change in the Company's operating assets and liabilities. The net non-cash items consisted primarily of depreciation of property, plant and equipment and amortization of intangible assets, losses associated with the valuation of derivative hedge contracts, equity in earnings of joint venture, income tax expense and amounts allocated to the non-controlling interest. The net change in operating assets and liabilities resulted primarily from increases in accrued expenses and accounts payable, offset by decreases in accrued property taxes and amounts due to affiliates and increases in accounts receivable and inventory and other assets. Net cash used in investing activities for the six months ended June 30, 2010 was \$0.4 million comprised of \$0.5 million of capital expenditures offset by a \$0.1 million change in restricted cash. Net cash used in financing activities for the six months ended June 30, 2010 was \$17.7 million comprised of \$17.1 million of repayment of debt outstanding under the Credit Facility, \$0.3 million paid in financing costs and \$0.3 million of payments for stock issuance costs incurred in 2009.

Long-Term Debt and Credit Facility
Credit Facility

On October 23, 2009, PERH, through its subsidiary Primary Energy Operations LLC ("PEO"), entered into a \$105.0 million secured term loan facility (the "Credit Facility"). On November 13, 2009, the Company borrowed the \$105.0 million available under the Credit Facility. As of June 30, 2011, \$58.4 million remains outstanding.

The Credit Facility has a five-year term and accrues interest at an interest rate equal to, at PEO's option, an adjusted LIBOR rate (subject to a 2.0% minimum) plus 4.5% or an alternate base rate (subject to a 3.0% minimum) plus 3.5%. The loan is subject to 0.25% quarterly mandatory amortization payments and quarterly mandatory prepayments of principal equal to 100% of PEO's excess cash flow (as defined in the Credit Facility) for the period. The Company has classified approximately \$35.8 million, exclusive of \$1.7 million of deferred finance fees, of borrowings under the Credit Facility as short-term debt at June 30, 2011. This amount represents approximately \$0.5 million of required principal repayments and approximately \$35.3 million of estimated principal prepayments based upon anticipated excess cash flow (as defined in the Credit Facility). To the extent the Company's excess cash flow is more or less than anticipated, the amount of quarterly prepayment of principal under the terms of the Credit Facility may be different than the amount currently classified as short term debt. The debt outstanding under the Credit Facility is guaranteed by PERH and PEO's wholly-owned subsidiaries (collectively, the "Guarantors") and secured by a pledge of substantially all of PEO's and the Guarantors' real and personal property. The Credit Facility also contains financial covenants requiring PEO to meet certain maximum leverage and minimum fixed charge coverage ratios, as well as other covenants. These covenants may limit the Company's ability to, among other things, incur additional secured or unsecured debt, pay dividends, make acquisitions or other investments, make capital expenditures, sell or otherwise dispose of certain assets, enter into sale and leaseback transactions and enter into mergers or consolidations. The cost of borrowing (including fees) for the Company is approximately 6.9% based on current LIBOR. As of June 30, 2011, the Company was in compliance with all covenants under the Credit Facility.

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Net Operating Loss Carryforward

As of June 30, 2011, the Company has recorded a deferred tax asset relating to its U.S. net operating loss carryforward of approximately \$49.1 million that will start to expire in 2026. As of December 31, 2010 the Company increased the value of its deferred tax asset related to its U.S. net operating losses as it is more likely than not that the tax benefit of the net operating loss carryforward will be utilized. The increase was primarily based on the expectation of future taxable income due to the reduction in interest expense as a result of the Company's recapitalization in 2009.

Additionally, during 2010, the Company determined that \$32.6 million of income recognized upon the cancellation of debt in 2009 is not taxable for U.S. purposes. This determination served to increase the Company's net operating loss carryforward by \$32.6 million. However, the Company has not recorded a corresponding deferred tax asset as it is not probable that the asset would be realized.

In addition, the Company has net operating losses of approximately Cdn\$47.0 million for Canadian tax purposes that will begin to expire in 2028. A deferred tax asset associated with these net operating losses has not been recognized as the Company does not anticipate realizing a benefit. At June 30, 2011 and December 31, 2010, the net long-term deferred tax asset balance was \$4.1 million and \$4.9 million, respectively.

Interest Rate Cap Contract

On November 12, 2009 the Company entered into an interest rate cap contract for \$0.3 million pursuant to provisions of the Credit Facility. The interest rate cap contract has a three-year term. The interest rate cap contract establishes a series of quarterly interest rate caps with the notional amount of each quarterly cap based upon the amount of anticipated debt outstanding under the Credit Facility. The quarterly interest rate increases from 2.25% to 5.00% during the last year of the three-year term of the contract. The notional amounts reduce over time based upon anticipated debt reductions. The contract does not qualify as a cash flow hedge for accounting purposes and the change in fair value is recorded in income. As of June 30, 2011 and December 31, 2010, the fair value of the interest rate cap contract was a de minimis amount.

Commitments and Contractual Obligations

The following table reflects the Company's contractual obligations and commitments related to outstanding indebtedness as of June 30, 2011, including payments due for each of the next five years and thereafter. The Credit Facility requires the Company to make mandatory quarterly prepayments of principal equal to 100% of PEO's excess cash flow (as determined in accordance with the terms of the Credit Facility) for the period. The figures included in the table below reflect management's current estimates of its excess cash flow during the term of the Credit Facility. Based on management's current estimates, the Company expects to repay all indebtedness under the Credit Facility in 2013. However, there can be no assurance that management's current estimates of the Company's excess cash flow will be met or that the Credit Facility will be repaid in advance of its maturity as set forth below.

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Maturities of debt are based upon quarterly mandatory payments and projections of excess cash flow, which are subject to change based on results of operations and other factors, including those identified under "Risk Factors". The estimated principal prepayments are as follows (in 000's):

	June 30, 2011						
	Balance	2011	2012	2013	2014	2015	Thereafter
Credit Facility	\$ 58,403	\$ 17,882	\$ 35,613	\$ 4,908	\$ -	\$ -	\$ -
Total	<u>\$ 58,403</u>	<u>\$ 17,882</u>	<u>\$ 35,613</u>	<u>\$ 4,908</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

The Company pays a management fee under a management agreement with the Manager dated August 24, 2009 ("the Management Agreement") which continues through August 2025. See "Transactions with Related Parties".

As of June 30, 2011, the Company has outstanding commitments of \$8.3 million to purchase equipment/services in support of the North Lake upgrade.

The Company has no off-financial position debt or similar obligations.

Transactions with Related Parties

The Manager provides accounting, tax, administrative and operational services to the Company and its subsidiaries pursuant to the terms of the Management Agreement for which it earns a fixed fee that is adjusted annually for inflation. The Management Agreement has an initial term ending in 2025.

For 2011 the annual management fee is \$3.2 million, subject to annual adjustment for inflation and any incremental additional costs incurred by the Manager as a result of any acquisitions or investments made by PERH or its subsidiaries. In addition, there are certain costs paid by the Manager that the Company manages. If the amount of these costs exceeds \$1.3 million, subject to annual adjustment for inflation, the excess costs will be incurred by the Company. A copy of the Management Agreement is available for review on SEDAR at www.sedar.com.

Critical Accounting Estimates

The preparation of financial statements requires the Company to make estimates and assumptions concerning the future that affect the reported amounts of assets and liabilities and by definition will seldom equal actual results. The estimates and judgments that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are discussed below.

Property plant and equipment

Estimated useful lives

Management estimates the useful lives of property, plant and equipment based on the period during which the assets are expected to be available for use. The amounts and timing of recorded expenses for amortization of property, plant and equipment for any period are affected by these estimated useful lives. The estimates are reviewed at least annually and are updated if expectations change as a result of physical wear and tear, technical or commercial obsolescence and legal or other limits to use. It is possible that changes in these factors may cause significant changes in the estimated useful lives of the Company's property, plant and equipment in the future.

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Asset retirement obligations

Provisions for asset retirement obligations require the assessment of the amounts that the Company will have to pay and assumptions in terms of timing and discount rate.

Income Taxes

Estimation of income taxes included an evaluation of the recoverability of deferred tax assets based on an assessment of the Company's ability to utilize the underlying future tax deductions against future taxable income before they expire. The Company's assessment is based upon existing tax laws and estimates of future taxable income. If the assessment of the Company's ability to utilize the underlying future tax deductions changes, the Company would be required to recognize more or fewer of the tax deductions as assets, which would decrease or increase the income tax expense in the period in which the determination is made.

Risk Factors

The Company's future performance and financial condition involves a number of risks and uncertainties. Any of these risks and uncertainties could have a material adverse effect on the results of operations, business prospects and financial condition of the Company or on the market price or value of the Common Shares. The following is a list of some of the risks facing the Company. Additional risks are discussed in the Company's most recent annual information form which is available for review on SEDAR at www.sedar.com.

Primary Energy Derives its Revenues From Only Two Steel Industry Customers

All of PERH's revenues are generated from providing services to entities controlled by only two underlying customers. The percentage of PERH's revenues generated by each major customer for the year ended December 31, 2010 was approximately 86% and 14%, respectively. In addition, both of PERH's customers are participants in the U.S. steel industry and, as such, their businesses are affected by risks relating to the steel industry. In particular, the steel industry is cyclical in nature and may be affected by prevailing economic conditions in major world economies. A recession in the United States, Canada or globally (or concerns that a recession could continue for a prolonged period) could substantially decrease the demand for steel products and adversely affect the financial condition, production and business of our customers. The steel industry is particularly sensitive to trends in cyclical industries such as non-residential construction, appliance, machinery and equipment, and transportation industries. A disruption or downturn in any of these industries or markets could materially adversely impact the financial condition, production and business of PERH's customers. A material adverse impact to the business of either of our customers may adversely affect the Projects and the financial condition of PERH.

Projects May Not Operate as Planned

The revenue produced by the Projects is dependent, in whole or in part, on the amount of electric energy and thermal energy generated by them. With respect to each of the Projects, there is a risk of equipment failure (of both Project equipment and equipment operated by the host) for various reasons including, without limitation, component failures, latent defect, design error, operator error, weather conditions or force majeure which could adversely affect revenues or operating and maintenance expenses. For Project equipment, it is possible that annual major maintenance expenditures may increase above historical spending levels as equipment ages and it is expected that these costs will be funded from cash generated from operations. To the extent that maintenance spending exceeds historical requirements, there may be a negative impact on net income. To the extent that such equipment requires either longer than anticipated down times for maintenance and

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repair, or suffers disruptions of energy generation for other reasons, the amount of revenue may be adversely affected.

Neither PERH nor its subsidiaries control, or have contractual rights in respect of, the operations of its customers. The host steel mills have the ability to run their plants at their discretion. Since some of the Projects are affected by the level of production at these host steel mills, a Project's performance may be impacted by its host's operational decisions. Such operational decisions include, without limitation, production levels and which blast furnaces the host steel mills choose to run.

Dependence on the Manager, Dedicated Employees, CEO and the Management Agreement

PERH and the Company are currently dependent on the Manager and Capital Power Operations (US) Inc. ("Capital Power US") to provide accounting, tax, administrative and operational services. On August 24, 2009, amendments were made to the Management Agreement so that the Company will have the right to terminate the Management Agreement for an initial termination fee of \$8.0 million, which fee shall decline on a pro rata monthly basis over a four year period to \$5.0 million provided that the Manager agrees to the sale, transfer, assignment or redemption of its interests in PERH. Upon termination of the Management Agreement, PERH and the Company will be required to establish replacement management arrangements. If PERH and the Company are not able to obtain or internally replace such management arrangements with a similar cost structure, the financial condition of the Company may be negatively affected.

Following the amendments to the Management Agreement, certain Capital Power US employees became dedicated employees required to devote their full-time efforts to managing the business of PERH. In addition, PERH hired John D. Prunkl as its President and Chief Executive Officer. These dedicated employees or the CEO may terminate their employment and the loss of any of their services could materially harm PERH's business and financial condition. The Manager or PERH may also not be able to locate or employ on acceptable terms qualified replacements for such dedicated employees or the CEO if their services were no longer available.

Transition to International Financial Reporting Standards

Effective January 1, 2011, IFRS replaced Canadian GAAP for all Canadian publicly traded companies for annual and interim financial statements. IFRS is premised on a conceptual framework similar to Canadian GAAP; however, significant differences exist in certain matters of recognition, measurement and disclosure. The transition required the conversion, for comparative purposes, of previously reported balance sheets as at December 31, 2009 and December 31, 2010 and interim and annual consolidated statements of income and cash flow for 2010 from Canadian GAAP to IFRS.

New Accounting Standards Issued but not yet Effective

Certain new accounting standards and IFRS Interpretation Committee (IFRIC) interpretations have been published that are mandatory for accounting periods beginning on or after January 1, 2011. The Company's assessment of the impact of these new standards and interpretations is set out below.

IFRS 7, *Financial Instruments – Disclosures* (IFRS 7), has been amended and will be effective for financial periods beginning on or after July 1, 2011. The amendments increase the disclosure requirements for transactions involving transfers of financial assets, for example using receivables, investments or equity to settle transactions. These amendments are intended to provide greater transparency around risk exposures of transactions when a financial asset is transferred and the transferor retains some level of continuing exposure in the asset. The amendments also require

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disclosures where transfers of financial assets are not evenly distributed throughout the period. It is not anticipated that these amendments to IFRS 7 will have a significant effect on the Company's disclosures as it is the Company's practice to settle transactions in cash. However, if the Company enters into other types of transfers of financial assets in the future, disclosure regarding those transfers may be affected.

IFRS 9, *Financial Instruments* (IFRS 9), was issued by the IASB on November 12, 2009 and will replace IAS 39, *Financial Instruments: Recognition and Measurement*. IFRS 9 is effective for annual periods beginning on or after January 1, 2013. The Company is currently evaluating the impact of IFRS 9; however it is not expected to have a material effect on the consolidated financial statements of the Company.

On May 13, 2011, the IASB issued IFRS 10, *Consolidated Financial Statements* (IFRS10), IFRS 11, *Joint Arrangements* (IFRS 11) and IFRS 12, *Disclosure of Interests in Other Entities* (IFRS 12). IFRS 10 establishes principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities. IFRS 10 replaces IAS 27, *Consolidated and Separate Financial Statements* and SIC-12, *Consolidation – Special Purpose Entities*. IFRS 11 establishes principles for the financial reporting by parties to a joint arrangement. IFRS 11 supersedes IAS 31, *Interests in Joint Ventures* and SIC-13, *Jointly Controlled Entities – Non-monetary Contributions by Venturers*. IFRS 12 combines, enhances and replaces the disclosure requirements for subsidiaries, joint arrangements, associates and unconsolidated structured entities. As a consequence of these new standards, the IASB also issued amended and retitled IAS 27, *Separate Financial Statements* and IAS 28, *Investments in Associates and Joint Ventures*. The new requirements are effective for annual periods beginning on or after January 1, 2013, with earlier application permitted. Management anticipates that these standards will be adopted in the Company's consolidated financial statements for the relevant period, however these standards are not expected to have a material effect on the consolidated financial statements of the Company.

In addition to the issuance of new standards as detailed above, there have also been amendments to existing standards, including IAS 1, *Presentation of Financial Statements* (IAS 1) and IAS 19, *Employee Benefits* (IAS 19). The amendments to IAS 1 will require that entities group items presented in other comprehensive income (OCI) based on an assessment of whether such items may, or may not, be reclassified to earnings at a subsequent date. Amendments to IAS 1 are applicable to annual periods beginning on or after July 1, 2012, with early adoption permitted. Amendments to IAS 19 eliminate an entity's option to defer the recognition of certain gains and losses related to postemployment benefits and require remeasurement of associated assets and liabilities in OCI. Amendments to IAS 19 are applicable on a modified retrospective basis to annual periods beginning on or after January 1, 2013, with early adoption permitted. Management anticipates that these amended standards will be adopted in the Company's consolidated financial statements for the relevant period, however these standards are not expected to have a material effect on the consolidated financial statements of the Company.

International Financial Reporting Standards

Effective January 1, 2011 Canadian publicly listed entities were required to prepare their financial statements in accordance with IFRS. Due to the requirement to present comparative financial information, the effective transition date is January 1, 2010. The three months ended March 31, 2011 was the Company's first reporting period under IFRS.

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The Company's IFRS conversion project is comprised of four phases: diagnostic assessment, evaluation and development, implementation and post implementation review. The IFRS conversion project is complete through the implementation phase. The post-implementation review phase will continue in future periods, as outlined below.

Note 4 to the Company's interim consolidated financial statements for the three months and six months ended June 30, 2010 provides more detail on the key differences between Canadian GAAP and IFRS, accounting policy decisions adopted by the Company, the application of IFRS 1 – *First time adoption of IFRS* to the Company for significant or potentially significant areas that have had an impact on the Company's financial statements on transition to IFRS or that may have an impact in future periods.

Transitional Financial Impact

The table below outlines the impact of adjustments to equity upon adoption of IFRS at June 30, 2010 and December 31, 2010 for comparative purposes.

	<u>December 31, 2010</u>	<u>June 30, 2010</u>
Equity as reported under Canadian GAAP	\$ 170,730	\$ 151,280
IFRS adjustments increase (decrease):		
Restatement of property, plant and equipment to reflect impact of IFRS requirements	(338)	(72)
Impact of IFRS conversion on long-term incentive compensation	(35)	-
Impact of recognizing deferred tax in accordance with IAS 12	(399)	14
Pro-rata allocation of IFRS adjustments to non-controlling interest	53	11
Reclassification of non-controlling interests	<u>82,028</u>	<u>83,934</u>
Total equity under IFRS	<u>\$ 252,039</u>	<u>\$ 235,167</u>

Additional disclosure of the IFRS conversion impact on prior period net income and statement of financial position is provided in Note 4 to the Company's financial statements.

Cash Flow Impact

The IFRS transition adjustment that impacted the cash balance in 2010 was due to the accounting policy determination to reflect the Company's investment in the PCI Associates joint venture using the equity method, which resulted in the Company's proportionate share of PCI Associates' assets (including cash) and liabilities being reflected as investment in PCI Associates on the statement of financial position. The change did not have a material impact on cash balances. None of the other IFRS transition adjustments noted had an impact on cash balances during 2010.

Financial Statement Presentation Changes

The transition to IFRS has resulted in numerous presentation changes in the financial statements.

The changes to our cash flow statement are outlined above. The following is a summary of the significant changes to our consolidated statement of comprehensive income:

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- Revenue and expenses of the Company's investment in the PCI Associates joint venture have been reclassified into equity in earnings of joint venture.
- Expenses by function and nature – the consolidated statements of comprehensive income present expenses by nature with a separate expense line for employee benefits that had previously been reflected in operations and maintenance and general and administrative expenses. Depreciation and amortization expense has been adjusted to reflect the changes associated with componentization as required under IFRS.
- Interest expense – under IFRS, interest expense includes interest on debt, accretion expense for asset retirement costs and amortization of deferred financing fees. Accretion expense was previously included in general and administration expense.
- Income tax expense – has been adjusted to reflect the impact of additional IFRS depreciation expense due to componentization, capitalization of overhead related expenditures and the deferred tax impact to stock based compensation as required under IFRS. These changes and the corresponding tax impact serve to change the amount of income or loss reported under IFRS compared to Canadian GAAP for the respective period in 2010.

Other adjustments noted in the reconciliations are reclassifications within the statement of comprehensive income and do not impact net income/loss.

The changes to the statement of financial position primarily relate to the reclassification of the Company's share of PCI Associates' assets and liabilities into investment in joint venture and the reclassification of non controlling interest into equity.

Control Activities

For all changes to policies and procedures that have been identified, the effectiveness of internal controls over financial reporting and disclosure controls and procedures has been assessed and any changes have been implemented. In addition, controls over the IFRS changeover process have been implemented, as necessary. The required accounting process changes that resulted from the application of IFRS accounting policies were not significant. The design, implementation and documentation of the internal controls over accounting process changes resulting from the application of IFRS accounting policies has been completed. The existing control framework was applied to the IFRS changeover process. All accounting policy changes and transitional financial position impacts were subject to review by senior management and the Audit Committee of the Board of Directors.

Business Activities and Key Performance Measures

We have assessed the impact of the IFRS transition project on our financial covenants and key ratios in the Credit Facility. The transition did not impact our covenants as they are based on U.S. GAAP requirements and key ratios that have an equity component.

Information Technology and Systems

The IFRS transition project did not have a significant impact on our information systems for the convergence periods. We also do not expect significant changes in the post-convergence periods.

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Post-Implementation

The post-implementation phase of the IFRS conversion project will involve continuous monitoring of changes in IFRS in future periods. It is noted that the standard-setting bodies that determine IFRS have significant ongoing projects that could impact the IFRS accounting policies that the Company selected. In particular, there may be additional new or revised IFRSs or IFRICs in relation to consolidation, joint ventures, financial instruments, hedge accounting, discontinued operations, leases, employee benefits and revenue recognition. Processes are in place to ensure that potential changes are monitored and evaluated. The impact of any new IFRSs and IFRIC interpretations will be evaluated as they are drafted and published.

Internal Control over Financial Reporting

The objective of the internal control over financial reporting designed by management is to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with IFRS. Other than changes related to our IFRS transition plan, there have been no changes to the Company's internal control over financial reporting that have occurred during the six months ended June 30, 2011, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Additional Information

Additional information relating to the Company, including the unaudited interim consolidated financial statements for the three months and six months ended June 30, 2011 and 2010 and the Company's most recent annual information form, is available on SEDAR at www.sedar.com.