



PRIMARY ENERGY RECYCLING CORPORATION

**Management's Discussion and
Analysis of Financial Condition and Results of Operations**

Three Months and Six Months Ended June 30, 2006

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 of Primary Energy Recycling Corporation (the "Company") 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, 2006. The Company's financial statements are prepared in accordance with accounting principles generally accepted in Canada ("Canadian GAAP"). All amounts described in the management discussion and analysis of financial condition and results of operations are in thousands of U.S. dollars, unless otherwise stated.

Forward-Looking Statements

Certain statements in this management's discussion and analysis report 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 June 30, 2006. 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 management's discussion and analysis and in the Company's Annual Information Form dated March 30, 2006. 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 management's discussion and analysis are based upon 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 July 31, 2006 and the Company assumes no obligation to update or revise them to reflect new events or circumstances.

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 four recycling energy projects and a 50% interest in a pulverized coal facility (collectively, the "Projects"). The Projects have a combined electrical generating capacity of 283 megawatts and a combined steam generating capacity of 1,851 Mlbs/hour. PERH creates value for its customers by capturing and recycling waste energy from industrial processes and converting it into reliable and economical electricity and thermal energy for its customers' use.

With the completion of its Initial Public Offering (the "Offering") on August 24, 2005 and after the exercise of the underwriter's over-allotment on September 27, 2005, the Company owns an 83.2% financial interest in PERH through its ownership of all of the Class A Preferred and Common shares and Primary Energy Holdings LLC ("PEH") owns a 16.8% interest in PERH through its ownership of all of the Class B Preferred and Common shares.

Matters Affecting Comparability

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

The Company began operations on August 24, 2005, the same day as the Company completed the Offering. There are no financial statements for the 2005 fiscal year for the Company (or its subsidiaries) that can be used on a comprehensive basis for comparing the three months and six months ended June 30, 2006 operating results to the comparative period in the prior period.

The results of the three and six month periods ended June 30, 2006 reflect a \$0.2 million reduction of depreciation and amortization expense to adjust for excess intangible asset amortization recorded in prior periods.

In order to enhance its usefulness, this management discussion and analysis includes a summary of the operating results of the Company for the three month and six month periods ended June 30, 2006 and comparative pro forma operating results for the corresponding three and six month periods in 2005. As the periods, or portions thereof, are prior to the closing of the Offering, this information is provided for reference purposes only, and is not intended as a comprehensive comparison of financial results.

Definition of EBITDA and Distributable Cash

References to "EBITDA" are to earnings before interest, taxes, depreciation, amortization and certain other adjustments listed in the reconciliation table provided herein. References to "Distributable Cash" are to EBITDA, as adjusted for: interest on the New Credit Facility and interest on the Separate Subordinated Notes. EBITDA and Distributable Cash are not recognized measures under Canadian GAAP and do not have standardized meanings prescribed by Canadian GAAP. Therefore, EBITDA and Distributable Cash may not be comparable to similar measures presented by other issuers. The Company intends to distribute substantially all of its cash excluding those amounts required for operation of the business on an ongoing basis. Accordingly, management believes that EBITDA and Distributable Cash are important measures in evaluating the Company's performance. However, EBITDA and Distributable Cash should not be construed as an alternative to net earnings or loss determined in accordance with Canadian GAAP as an indicator of the Company's performance or to cash flows from operating, investing and financing activities, as a measure of liquidity and cash flows.

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

Results of Operations

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

	Three Months Ended June 30,	
	Actual 2006	Predecessor Pro forma 2005 (Note 1)
Revenue:		
Capacity	\$ 9,018	\$ 9,018
Energy Service	12,884	10,113
	21,902	19,131
Expenses:		
Operations and maintenance	8,726	6,533
General and administrative	1,107	2,143
Depreciation and amortization	9,852	3,237
	19,685	11,913
Operating income	\$ 2,217	\$ 7,218
Other income (expense):		
Interest income (expense), net	(5,126)	
Unrealized gain on derivative hedge contracts	7,772	
Unrealized loss on Foreign Currency Translation	(3,844)	
	1,019	
Income before income taxes	1,019	
Income tax benefit	33	
	1,052	
Income before non-controlling interest	1,052	
Non-controlling interest in class B Preferred	(380)	
Non-controlling interest in class B Common	1,202	
	1,874	
Net Income	\$ 1,874	
Weighted average number of shares outstanding	31,000,000	
Basic and Diluted net income per share (Note 2)	\$ 0.06	

Note 1: Proforma financial data has been adjusted to reflect investment in PCI Associates on a proportionate consolidation basis for all periods presented and to remove the financial results of Lakeside Energy LLC from historical predecessor financial results.

Note 2: Basic and Diluted net loss per share has been calculated using a weighted average number of Common Shares outstanding during the period of 31,000,000.

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

Distributable Cash Summary

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

	Three Months Ended June 30, 2006	Six Months Ended June 30, 2006	Inception to June 30, 2006
Reconciliation of net income (loss) to EBITDA:			
Net income (loss)	\$ 1,874	\$ 558	\$ (406)
Plus:			
Depreciation and Amortization	9,852	20,002	34,407
Interest expense	5,126	10,184	17,395
Unrealized loss on foreign currency exchange	3,844	3,759	6,069
Unrealized gain on derivative hedge contracts	(7,772)	(8,427)	(13,039)
Income tax expense (benefit)	(33)	956	2,881
Non-controlling interest	(1,202)	(2,445)	(4,151)
Distributions on Class B preferred interest	380	762	1,299
EBITDA (Note 1)	\$ 12,069	\$ 25,349	\$ 44,455
Less:			
Interest and related charges on new credit facility	2,645	5,126	8,535
Interest on separate subordinated notes	464	928	1,587
Distributable Cash (Note 1)	\$ 8,960	\$ 19,295	\$ 34,333
Per Common and equivalent Common Share (Note 2)	\$ 0.24	\$ 0.52	\$ 0.92
Interest on EIS Subordinated Notes	\$ 1,944	\$ 3,888	\$ 6,647
Distributions on Common Shares	5,573	10,908	18,480
Distributions on non-controlling Class B preferred interest	380	762	1,299
Distributions on non-controlling Class B common interest	1,139	2,230	3,778
Total distributions (Note 3)	\$ 9,036	\$ 17,788	\$ 30,204
Per Common and equivalent Common Share (Note 2)	\$ 0.24	\$ 0.48	\$ 0.81
Hedge rate (Cdn\$ per US\$) (Note 4)	\$ 1.1684	\$ 1.1699	\$ 1.1705
Distributable Cash (Cdn\$) (Note 1)	\$ 10,469	\$ 22,573	\$ 40,187
Per Common and equivalent Common Share (Cdn\$) (Note 2)	\$ 0.28	\$ 0.61	\$ 1.08
Excess (shortfall) distributable cash (Cdn\$)	\$ (89)	\$ 1,763	\$ 4,833
Per Common and equivalent Common Share (Cdn\$) (Note 2)	\$ (0.00)	\$ 0.05	\$ 0.13

Note 1: EBITDA and Distributable Cash are not recognized measures under Canadian GAAP and do not have standardized meanings prescribed by Canadian GAAP. Therefore, EBITDA and Distributable Cash may not be comparable to similar measures presented by other issuers. As the Company intends to distribute substantially all of its cash on an ongoing basis, management believes that EBITDA and Distributable Cash are important measures in evaluating the Company's performance. Distributable Cash is not intended to be representative of cash flow or results of operations determined in accordance with Canadian GAAP.

Note 2: Common and equivalent Common Share computation for Distributable Cash purposes assumes 31,000,000 Common Shares are outstanding for the full period and the conversion of Class B interests into equivalent Common Shares. For the three months, six months and for the period from date of inception through June 30, 2006, the number of Common and equivalent Common Shares outstanding is 37,265,455.

Note 3: Includes distributions declared, but not distributed in reporting period.

Note 4: Hedge rate is based on weighted average of outstanding hedge contracts in place in each respective period.

For the six months ended June 30, 2006, the Company generated Cdn\$22.6 million of Distributable Cash and distributed Cdn\$20.8 million for a payout ratio of 92.2%. The Board of Directors monitors the distribution policy with respect to excess cash, forecasted cash flows, debt levels and spending plans and is prepared to adjust payout levels to balance desired distributions with the need to retain appropriate capital for business operations.

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

Three Months Ended June 30, 2006 Compared to the Pro forma for the Three Months Ended June 30, 2005

The Company's revenue of \$21.9 million in the second quarter of 2006 increased \$2.8 million, or 14.5% compared with revenue of \$19.1 million for the comparable pro forma second quarter of 2005. The improvement in Energy Service revenue for the quarter was primarily the result of increased revenue at the Company's Harbor Coal facility of \$2.4 million due to increased volume.

Operating and maintenance expense for the second quarter of 2006 was \$8.7 million compared to \$6.5 million for the pro forma second quarter of 2005, an increase of \$2.2 million or 33.6%. The increase noted is due to \$2.1 million of additional operating and maintenance expenses at the Company's Harbor Coal facility corresponding to increased revenue and \$0.1 million in other non-specific plant operating expenses. As a percentage of revenue, operating and maintenance expenses increased to 39.8% for the second quarter of 2006 from 34.2% for the second quarter of 2005.

General and administrative expense for the second quarter of 2006 was \$1.1 million compared to \$2.1 million for the pro forma second quarter of 2005, a decrease of \$1.0 million or 48.3%. The decrease is reflective of a \$1.8 million reduction in property tax expense inclusive of property tax refunds and a reduction in accrued property taxes based upon completion of a successful appeal to the state taxing authorities for designation as a non-utility taxpayer. In addition, there was a \$0.7 million reduction in allocated general and administrative expenses. The reductions noted are offset by additional expenses associated with management fees of \$0.8 million, professional fees of \$0.4 million, incentive fees of \$0.1 million, board compensation fees of \$0.1 million and plant and liability insurance of \$0.1 million. As a percentage of revenue, general and administrative expenses decreased to 5.1% for the second quarter of 2006 from 11.2% for the second quarter of 2005.

Depreciation expense for the second quarter of 2006 was \$2.7 million compared to \$2.5 million for the pro forma second quarter of 2005, an increase of \$0.2 million. The increase in depreciation expense was associated with the fair value adjustment to fixed assets resulting from the allocation of purchase price upon the completion of the Offering. As a percentage of revenue, depreciation expense decreased to 12.0% for the second quarter of 2006 from 12.6% for the second quarter of 2005.

Amortization expense for the second quarter of 2006 was \$7.2 million compared to \$0.8 million for the pro forma second quarter of 2005, an increase of \$6.4 million. The increase was due to the additional amortization associated with the allocation of purchase price to Contract Value intangible upon the completion of the Offering. The Contract Value intangible is being amortized over an average term of 8 years. As a percentage of revenue, amortization expense increased to 33.0% for the second quarter of 2006 from 4.3% for the second quarter of 2005.

Income from operations for the second quarter of 2006 was \$2.2 million compared to \$7.2 million pro forma income from operations for the second quarter of 2005, a decrease of \$5.0 million, or 69.3%. The decline was primarily driven from the net effect of items discussed above.

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

Results of Operations

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

	Six Months Ended June 30,	
	Actual 2006	Predecessor Pro forma 2005 (Note 1)
Revenue:		
Capacity	\$ 18,036	\$ 18,036
Energy Service	29,584	21,048
	47,620	39,084
Expenses:		
Operations and maintenance	17,453	12,895
General and administrative	4,818	4,325
Depreciation and amortization	20,002	6,422
	42,273	23,642
Total Operating Expenses	42,273	23,642
Operating income	\$ 5,347	\$ 15,442
Other income (expense):		
Interest income (expense), net	(10,184)	
Unrealized gain on derivative hedge contracts	8,427	
Unrealized loss on Foreign Currency Translation	(3,759)	
	(5,516)	
Income (Loss) before income taxes	(169)	
Income tax expense	(956)	
	(1,125)	
Income (Loss) before non-controlling interest	(1,125)	
Non-controlling interest in class B Preferred	(762)	
Non-controlling interest in class B Common	2,445	
	1,683	
Net Income	\$ 558	
Weighted average number of shares outstanding	31,000,000	
Basic and Diluted net income per share (Note 2)	\$ 0.02	

Note 1: Proforma financial data has been adjusted to reflect investment in PCI Associates on a proportionate consolidation basis for all periods presented and to remove the financial results of Lakeside Energy LLC from historical predecessor financial results.

Note 2: Basic and Diluted net loss per share has been calculated using a weighted average number of Common Shares outstanding during the period of 31,000,000.

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

Six Months Ended June 30, 2006 Compared to the Pro forma for the Six Months Ended June 30, 2005

The Company's revenue of \$47.6 million in the first six months of 2006 increased \$8.5 million, or 21.8% compared with revenue of \$39.1 million for the comparable pro forma 2005 period. The improvement in Energy Service revenue for the six month period was primarily the result of increased revenue at the Company's Harbor Coal facility of \$8.3 million due to increases in volume and in the spread between the cost of coal supplied and the prices of the fuels that coal replaces.

Operating and maintenance expense for the first six months of 2006 was \$17.5 million compared to \$12.9 million for the pro forma first six months of 2005, an increase of \$4.6 million or 35.4%. The increase noted is due to \$4.6 million of plant maintenance expenses comprised of a planned steam turbine overhaul of \$0.8 million and additional processing expenditures at the Company's Harbor Coal facility of \$3.8 million corresponding to increased revenue. As a percentage of revenue, operating and maintenance expenses increased to 36.7% for the first six months of 2006 from 33.0% for the first six months of 2005.

General and administrative expense for the first six months of 2006 was \$4.8 million compared to \$4.3 million for the pro forma first six months of 2005, an increase of \$0.5 million or 11.4%. The increase noted is the result of additional expenses associated with management fees of \$1.6 million, professional fees of \$0.8 million, incentive fees of \$0.8 million, board compensation fees of \$0.2 million and plant and liability insurance of \$0.2 million offset by a \$1.6 million reduction in property tax expense inclusive of property tax refunds and a reduction in accrued property taxes based upon completion of a successful appeal to the state taxing authorities for designation as a non-utility taxpayer. In addition, there was a \$1.5 million reduction in allocated general and administrative expenses. As a percentage of revenue, general and administrative expenses decreased to 10.1% for the first six months of 2006 from 11.1% for the first six months of 2005.

Depreciation expense for the first six months of 2006 was \$5.3 million compared to \$4.8 million for the pro forma first six months of 2005, an increase of \$0.5 million. The increase in depreciation expense was associated with the fair value adjustment to fixed assets resulting from the allocation of purchase price upon the completion of the Offering. As a percentage of revenue, depreciation expense decreased to 11.0% for the first six months of 2006 from 12.2% for the first six months of 2005.

Amortization expense for the first six months of 2006 was \$14.7 million compared to \$1.6 million for the pro forma first six months of 2005, an increase of \$13.1 million. The increase was due to the additional amortization associated with the allocation of purchase price to Contract Value intangible upon the completion of the Offering. The Contract Value intangible is being amortized over an average term of 8 years. As a percentage of revenue, amortization expense increased to 31.0% for the second quarter of 2006 from 4.2% for the second quarter of 2005.

Income from operations for the first six months of 2006 was \$5.3 million compared to \$15.4 million pro forma income from operations for the first six months of 2005, a decrease of \$10.1 million, or 65.4%. The decline was primarily driven from the net effect of items discussed above.

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

Summary of Quarterly Results

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

	Period from 8/24 - 9/30 2005	4th Quarter 2005	1st Quarter 2006	2nd Quarter 2006
Revenues	\$ 9,165	\$ 23,234	\$ 25,718	\$ 21,902
Net income (loss)	\$ 510	\$ (1,474)	\$ (1,316)	\$ 1,874
Net income (loss) per share	\$ 0.02	\$ (0.05)	\$ (0.04)	\$ 0.06

Outstanding Share Data

At July 31, 2006, the Company had 30,843,300 EISs outstanding. Each EIS includes one Common Share. In addition, 156,700 Common Shares not associated with EIS's are outstanding.

Earnings per share

Basic earnings per share are computed based on the weighted average number of Common Shares outstanding. During the period ended June 30, 2006, there were no potentially dilutive securities issued and outstanding. Accordingly, the diluted earnings per share is equivalent to basic earnings per share.

Liquidity and Capital Resources

The Company believes that available cash reserves along with amounts available under the revolving credit facility will be sufficient to meet working capital needs in the near term. For the six months ended June 30, 2006, the Company generated \$22.9 million in cash flow from operations. The Company's financing activities for the first six months of fiscal 2006 resulted in a use of cash of \$13.7 million comprised primarily of planned distributions payments.

At June 30, 2006, the amount of outstanding debt under the Credit Facility was \$135.0 million, with \$15.0 million in additional borrowing capacity available under the revolving credit facility for working capital purposes. Also included in outstanding debt is \$86.1 million in Subordinated Notes and Separate Subordinated Notes. The Credit Facility has a maturity date of August 24, 2009, while the Subordinated Notes and Separate Subordinated Notes have a 12-year term and are due and payable on August 24, 2017. The Credit Facility requires the Company to meet certain financial covenants that among other things, requires the Company to maintain certain defined leverage and coverage ratios. As of June 30, 2006, the Company is in compliance with all debt covenant requirements.

The Company determines distribution declarations, which it intends to pay in equal monthly amounts, based on periodic reviews of its estimated annual earnings and related estimated annual cash flows. The Company expects to follow the distribution policy summarized in its Annual Information Form dated March 30, 2006 available on SEDAR at www.sedar.com, after adjustment to reflect the \$0.05 increase approved in May 2006.

Foreign Currency Exchange Contracts

The Company has entered into forward contracts to purchase Canadian dollars sufficient to make monthly distributions through September 2010 at the current distribution level to all EIS holders, including non-controlling investors, as well as interest payments on the Separate Subordinated Notes. The forward contracts applicable for distributions to EIS holders and the non-controlling interest have an exchange rate of Cdn\$1.1712 to U.S. \$1.00 and a rate of Cdn\$1.0840 to U.S. \$1.00. The forward contracts for the Separate Subordinated Notes have an exchange rate of Cdn\$1.1713 to U.S. \$1.00. For the six month period ended June 30, 2006, the net impact of the change in the foreign exchange

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

rate on the aggregate value of the hedges resulted in an unrealized gain of \$6.7 million. The fair value of these agreements was a net amount of \$10.6 million of which, \$2.0 million is recorded in current assets.

Interest Rate Swap Agreements

The Company entered into interest rate swap agreements on August 31, 2005. The contracts were purchased to mitigate the cash flow risk associated with the impact of changing interest rates on payments due under the New Credit Facility. The agreements do not qualify as a cash flow hedge for accounting purposes and the change in the fair value of the derivative is recorded in income. For the six month period ended June 30, 2006, the net impact of the exchange in the fair value of the agreements resulted in an unrealized gain of \$1.7 million. The fair value of these agreements was a net amount of \$2.4 million as at June 30, 2006, of which \$0.7 million is recorded in current assets.

Commitments and Contractual Obligations

The following table reflects the Company's contractual obligations and commitments related to outstanding indebtedness as of June 30, 2006 and the required payment by period due.

Maturities of long-term debt are as follow (in 000's):

	June 30, 2006 Balance	2006	2007	2008	2009	2010	Thereafter
Notes payable	\$ 135,000	\$ -	\$ -	\$ -	\$ 135,000	\$ -	\$ -
Subordinated debt.....	86,099	-	-	-	-	-	86,099
Total	<u>\$ 221,099</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 135,000</u>	<u>\$ -</u>	<u>\$ 86,099</u>

The Company pays a management fee under the Management Agreement which continues through August 2025. For more detailed discussion, please see "Transactions with Related Parties".

The Company has no off-balance sheet debt or similar obligations.

Transactions with Related Parties

Primary Energy Ventures LLC (the "Manager") is engaged to provide management and administrative services to the Company and its subsidiaries pursuant to the terms of the Management Agreement for which it earns a fixed fee that adjusts annually based on inflation factors. The Manager is also entitled to an incentive fee under the Management Agreement. The incentive fee is designed to align the financial interests of the Manager with those of the Company. The incentive fee for each year will equal 25% of the product of (a) the excess of the Company's distributable cash per Common Share and (b) the weighted average number of EISs, Common Shares not represented by EISs and Class B Common Interests outstanding for such fiscal year. The Management Agreement has an initial 20-year term which commenced August 24, 2005.

During the term of the Management Agreement, if the Manager decides to sell or otherwise alienate any Right of First Offer Project ("ROFO Project") (as defined in the prospectus), it will first provide an offer to the Company in respect thereof (an "Offer"). The Offer will set out a cash price for the ROFO Project and the proposed terms of sale. The Company will have 90 days after receipt of the Offer to accept such Offer or negotiate alternate terms of sale acceptable to the Company. If the Company agrees with the terms of sale for the ROFO Project prior to the end of the 90 day negotiation period, the Manager and the Company shall enter into definitive documentation to effect such transfer, which

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

shall be accepted within 30 days thereafter or such longer period up to a maximum of 90 days as may be necessary to complete a shareholder vote by the Company (if required) or a financing (if required). If within the 90 day negotiation period the Offer is not accepted and the parties cannot agree on other terms then thereafter the Manager may sell the ROFO Project (subject to any changes in form or condition, financial or otherwise, which in the reasonable opinion of the Manager are not material taken as a whole) to a third party dealing at arm's length with the Manager at a price and on terms and conditions that, taken as a whole, in the reasonable opinion of the Manager are not more favorable to the third party than those contained in the Offer. To clarify, the Manager would be permitted to sell to the third party at a lower price than as set out in the Offer if one or more other terms and conditions of the transaction are more attractive than those contained in the Offer.

Critical Accounting Estimates

The preparation of financial statements in conformity with Canadian GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses in the financial statements. Management bases its estimates on historical experience and other assumptions, which it believes are reasonable. If actual amounts are ultimately different from these estimates, the revisions are included in the Company's results of operations for the period in which the actual amounts become known.

Accounting policies are considered critical when they require management to make assumptions about matters that are highly uncertain at the time the estimate is made and when different estimates than those management reasonably could have made have a material impact on the presentation of the Company's financial condition, changes in financial condition or results of operations. The following is a description of the Company's accounting policies that management believes require subjective and complex judgments, and could potentially have a material effect on reported financial condition and results of operations.

Property, Plant and Equipment

Property, plant and equipment have been adjusted, giving effect to the purchase method of accounting. Depreciation for all asset classes is recorded on a straight-line basis over the estimated useful lives of the assets. Generally, the estimated useful lives are 30 years for buildings, plant and equipment. The estimated useful life of office furniture and equipment is 7 years. Leasehold improvements are amortized over the shorter of the lease term or the estimated useful lives of the assets. Expenditures for maintenance and repairs are charged to income as incurred. The carrying amount for long-lived assets is reviewed whenever events or changes in circumstances indicate that impairment may have occurred.

Intangible Assets

Identifiable intangible assets were fair valued based on valuation techniques for the purpose of applying purchase accounting to the acquisition on August 24, 2005 and represent contract rights associated with customer contracts and nitrogen oxide allowances. The respective intangible values are amortized over specified time horizons and evaluated for impairment if events or changes in circumstances indicate that the asset might be impaired. Fair value under Canadian GAAP is defined as "the amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act". Assessing the fair value of intangible assets requires management estimates on future cash flows to be generated by the assets.

Impairment of Long-Lived Assets

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

Management continually evaluates whether events or circumstances have occurred that indicate that the remaining estimated useful lives of property, buildings and equipment may warrant revision or that the remaining balances may not be recoverable. If this review indicates that the assets will not be recoverable, as determined based on the undiscounted future cash flows from the use of the assets, the carrying value of the assets will be reduced to their estimated fair value.

Asset Retirement Obligations

The fair value of estimated asset retirement obligations is recognized in the consolidated balance sheet when identified and a reasonable estimate of fair value can be made. The asset retirement cost, equal to the estimated fair value of the asset retirement obligation, is capitalized as part of the cost of the related long-lived asset. The asset retirement costs are amortized over the asset's estimated useful life and included in depreciation expense on the consolidated statement of operations and members' deficit. Increases in the asset retirement obligation resulting from the passage of time are recorded as accretion of asset retirement obligation, and are included in general and administrative expenses in the consolidated statement of operations and shareholders' deficit. Actual expenditures incurred are charged against the accumulated obligation.

Revenue Recognition

The Company operates its facilities under certain tolling and operation and maintenance agreements with its customers. These agreements with customers qualify as operating lease arrangements for accounting purposes under the principles of the Canadian Institute of Chartered Accountants ("CICA") Handbook Section 3065, "Leases" and (EIC-150), "Determining Whether an Arrangement Contains a Lease." The Company presents the fixed monthly payments from these contracts as Capacity revenue on its consolidated statement of operations. Substantially all of the Company's building and equipment serve as rental property under these operating leases.

Revenue is recorded as services are delivered. Revenue is recorded on the accrual basis and may include estimates for services delivered. Capacity revenue represents the fixed revenue amounts established in the tolling agreements with the Company's customers. Energy Service revenue represents the revenue earned based on measurements of services performed each period.

The Company provides estimates for doubtful accounts it deemed necessary based on the aging category and specific knowledge of the customers ability to pay. No such allowances were recorded at June 30, 2006.

Future Income Taxes

The Company utilizes the liability method of accounting for income taxes under which future income tax assets and liabilities are recognized based upon the differences between the tax basis of an asset or liability and its reported amount in the financial statements. Future tax balances are determined by using tax rates expected to be in effect when the taxes will actually be paid or refunds received.

Accounting for Derivatives

The Company evaluates derivatives in accordance with Accounting Guideline 13 "Hedging Relationships" ("AcG-13"). For those derivatives that do not qualify for hedge accounting under AcG-13 the derivative instrument is recorded on the balance sheet as either an asset or liability measured at its fair value, with changes in fair value recognized currently in earnings.

Risk Factors

The Company's future performance and ability to generate sufficient cash flow to meet its monthly

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

cash distributions to holders of EISs, and the Common Shares and Subordinated Notes represented thereby, involves a number of risks and uncertainties. Any of these risks and uncertainties could have a material adverse effect on results of operations, business prospects, financial condition, the cash available for distribution to holders of EISs, Common Shares, or Subordinated Notes or on the market price or value of EISs, Common Shares or Subordinated Notes. The following is a list of the primary risks facing the Company.

Revenue May be Reduced upon Expiration or Termination of Agreements

Energy generated by the Company's four recycled energy Projects, in most cases, is provided to customers under agreements that expire at various times. In addition, these agreements may be subject to termination in certain circumstances, including, without limitation, default by the Project owner or operator. When such a contract expires or is terminated, there can be no assurance that it will be renewed. Furthermore, even if such agreements are renewed it is possible that the price received by the relevant Project for energy or capacity under subsequent arrangements may be reduced significantly. It is possible that subsequent contracts may not be available at prices or under terms that permit the operation of a Project on a profitable basis. If this occurs, the affected Project may temporarily or permanently cease operations.

The Company has Limited Control Over the Harbor Coal Project

Harbor Coal LLC, an indirect subsidiary of PERH, owns a 50% general partnership interest in PCI Associates which in turn owns the Harbor Coal Project. Harbor Coal LLC has limited control over the operation of the Harbor Coal Project. Ill/PCI, Inc., the other general partner of PCI Associates and an affiliate of Ispat Inland Inc., manages the operations of the Harbor Coal Project. Ispat Inland Inc. is an indirect subsidiary of Mittal Steel, Inc.

Dependence on Key Personnel

PERH's success is largely dependent on the skills, experience and efforts of the senior management team and other key personnel of the Manager. In particular, PERH's success depends on the continued efforts of Tom Casten, William Rockford, V. Michael Alverson, John Prunkl and other key employees of the Manager. The loss of the services of any key employee could materially harm PERH's business, financial condition, future results and cash flow. Although to date PERH has been successful in retaining the services of senior management, such members of senior management may terminate their employment agreements without cause. The Manager may also not be able to locate or employ on acceptable terms qualified replacements for its senior management or key employees if their services were no longer available. PERH has entered into agreements with such members of senior management which prohibit them from competing with or soliciting employees or customers of PERH during and for 12 months following cessation of their employment.

Dependence on the Manager and Potential Conflicts of Interest

PERH and the Company are dependent on the Manager in respect of the administration and management of PERH and the Company and the operations of the Projects. Although the Management Agreement has a 20-year term, the Management Agreement may be terminated earlier in certain circumstances, including by the Manager upon 180 days' prior written notice. Upon termination, PERH and the Company are required to establish replacement arrangements. If PERH and the Company are not able to obtain such arrangements on favorable terms, revenues and profits may decline and Distributable Cash of the Company may be negatively affected.

Certain officers of the Manager are full-time employees of the Manager and will devote their time and efforts exclusively to or for the benefit of the business of PERH and the Company. The Manager and

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

its affiliates and employees or agents may be engaged or invest directly or indirectly in a variety of other companies or other entities involved in owning, managing or advising on or otherwise engaged in the business of the generation, production, transmission, distribution, purchase and sale of electricity, other forms of energy-related projects, infrastructure projects, utility projects or other businesses.

None of the Manager or its affiliates are prohibited by the Management Agreement or any other agreement with PERH or the Company from competing with PERH or the Company, or from acquiring, investing in, or providing administrative or managerial services to, a competitor of PERH or the Company.

The Projects Depend on their Electricity and Thermal Energy Customers

Each Project relies for its revenues on one or more tolling agreement, lease agreement, or other agreement with its host. The amount of cash available for distribution to holders of EISs, Common Shares and Subordinated Notes is highly dependent upon customers under such agreements fulfilling their contractual obligations. There is no assurance that these customers will perform their obligations or make required payments on a timely basis.

Operations are Subject to the Provisions of Various Energy Laws and Regulations

The laws affecting our facilities have undergone major changes recently and, in some cases, remain in a state of flux pending completion of agency and judicial review procedures. The Energy Policy Act of 2005 ("EPAAct 2005"), which was signed into law on August 8, 2005, added new criteria to the definition of a Qualifying Facility that must be satisfied by new Qualifying Facilities. The Company believes that the Projects are not new Qualifying Facilities and that in any event they would satisfy the new criteria, but if this were not the case for any Project, it would lose its Qualifying Facility status. This could subject such a Project to additional regulation as a public utility under the Federal Power Act ("FPA") and/or state law.

EPAAct 2005 also eliminated the requirement that electric utilities must purchase electric energy and capacity from, and sell electric energy and capacity to, Qualifying Facilities, subject to certain conditions and the grandfathering of existing contracts. The Federal Energy Regulatory Commission ("FERC") has issued a proposed -- but not yet a final -- rule to implement this change. This change could affect the ability of a Project to buy electric energy and capacity from, and sell electric energy and capacity to, an electric utility, as well as the price of such energy and capacity.

EPAAct 2005 also created a new FPA section 203(a)(2), which, if applicable to the Company, could require the Company under certain circumstances to obtain FERC approval before acquiring a Qualifying Facility.

EPAAct 2005 also repealed the Public Utility Holding Company Act of 1935 ("PUHCA 1935"), effective February 8, 2006, and abolished the ownership restrictions previously applicable to Qualifying Facilities. Finally, FERC recently revoked the exemptions from FPA sections 205 and 206 previously afforded to Qualifying Facilities, subject to certain exceptions and the grandfathering of existing contracts. To the extent the Projects engage in wholesale power sales, this revocation could subject them to rate regulation by FERC. Additional detail regarding all these changes is contained in the Company's Annual Information Form dated March 30, 2006 and filed on SEDAR.

The Company is Dependent on PERH and the Projects for all Cash Available for Distributions

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

The Company is dependent on the operations and assets of the Projects through its indirect ownership of the Projects. The Company's ability to make payments on the Subordinated Notes and to make cash distributions to holders of EISs and Common Shares is dependent on the ability of PERH to make distributions to the Company, which in turn is dependent on the ability of the Projects to make distributions to PERH. The actual amount of cash available for payments to holders of Subordinated Notes and distributions to holders of EISs and Common Shares will depend upon numerous factors relating to each of the Projects, including profitability, changes in revenues, fluctuations in working capital, capital expenditure levels, applicable laws, compliance with contracts and contractual restrictions contained in the instruments governing any indebtedness. Any reduction in the amount of cash available for distribution, or actually distributed, by the Projects or PERH will reduce the amount of cash available for the Company to make payments to holders of Subordinated Notes and distributions to holders of EISs and Common Shares. While the Company is contractually obligated to make interest payments on the Subordinated Notes, cash distributions by the Company on the Common Shares, including the Common Share component of an EIS, are not guaranteed and will fluctuate with the performance of the Projects.

Distribution of All or a Significant Amount of Available Cash may Restrict Potential Growth of PERH and the Company

The payout by the Company and PERH of substantially all of their operating cash flow will make additional capital and operating expenditures dependent on increased cash flow or additional financing in the future. Lack of these funds could limit the future growth of the Company and PERH and their cash flow. In addition, the Company may be precluded from pursuing otherwise attractive acquisitions or investments because they may not be accretive to the Company on a short-term basis.

Additional Risk Factors are defined in detail in the Company's Annual Information Form dated March 30, 2006 available on SEDAR at www.sedar.com.

Recent Canadian Accounting and Related Pronouncements

The Canadian Accounting Standards Board has recently issued new Handbook sections:

- 1530, Comprehensive Income;
- 3855, Financial Instruments – Recognition and Measurement; and
- 3865, Hedges.

Under these new standards, all financial assets should be measured at fair value with the exception of loans, receivables and investments that are intended to be held to maturity and certain equity investments, which should be measured at cost. Similarly, all financial liabilities should be measured at fair value when they are held for trading or they are derivatives. Gains and losses on financial instruments measured at fair value will be recognized in the income statement in the periods they arise with the exception of gains and losses arising from:

- Financial assets held for sale, for which unrealized gains and losses are deferred in other comprehensive income until sold or impaired; and
- Certain financial instruments that qualify for hedge accounting.

Sections 3855 and 3865 make use of "other comprehensive income". Other comprehensive income comprises revenues, expenses, gains and losses that are excluded from net income. Unrealized

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

gains and losses on qualifying hedging instruments, foreign currency, and unrealized gains or losses on financial instruments held for sale will be included in other comprehensive income and reclassified to net income when realized. Comprehensive income and its components will be a required disclosure under the new standard. These standards are effective for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2006 and are not expected to have a material impact on the consolidated financial statements.

Conditional Asset Retirement Obligations

In December 2005, the CICA Emerging Issues Committee issued Abstract No. 159, "*Conditional Asset Retirement Obligations*" (EIC-159). EIC-159 clarifies that the term conditional asset retirement obligation, as used in CICA Handbook Section 3110, "*Asset Retirement Obligations*" refers to a legal obligation to perform an asset retirement activity where the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. EIC-159 also clarifies when there would be sufficient information to reasonably estimate the fair value of an asset retirement obligation. EIC-159 is effective for interim and annual reporting periods ending after March 31, 2006. The Company does not expect the adoption of EIC-159 to have a material impact on the Company's consolidated financial statements.

Subsequent Event

On August 2, 2006, the Company reached agreement with State of Indiana property tax authorities under which the Company's facilities will be classified as non-utilities for property tax assessment purposes. Prior to the settlement agreement, the Company paid and accrued for property taxes using a utility classification. For the period ended June 30, 2006 the adjustment for the change in status resulted in a benefit of approximately \$1.3 million for previously accrued expenses. The financial statements for the three month and six month period ended June 30, 2006 have been adjusted to reflect the effect of this agreement.

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, 2006 and the Company's Annual Information Form dated March 30, 2006, is available on SEDAR at www.sedar.com.