

**ALGOMA STEEL INC.**  
**2006 SECOND QUARTER REPORT TO SHAREHOLDERS (UNAUDITED)**  
**for the period ended June 30, 2006**

**MANAGEMENT'S DISCUSSION AND ANALYSIS**

The following discussion and analysis should be read in conjunction with the 2005 Management Discussion and Analysis and the unaudited interim consolidated financial statements and notes contained in this report. This discussion of the Company's business may include forward-looking information with respect to the Company, including its business and operations and strategies, as well as financial performance and conditions. The use of forward-looking words, such as "may," "will," "expect" or similar variations, generally identify such statements.

Although management believes that expectations reflected in forward-looking statements are reasonable, such statements involve risks and uncertainties including the factors discussed in the 2005 Management Discussion and Analysis and the Company's 2005 Annual Information Form.

This document has been reviewed by the Audit Committee of Algoma's Board of Directors and contains information that is current as of August 1, 2006. Events occurring after that date could render the information contained herein inaccurate or misleading in a material respect. Additional information about Algoma is available in the Corporation's Annual Information Form which can be accessed from SEDAR at [www.sedar.com](http://www.sedar.com).

**Financial and Operating Results**

*Selected Financial Data for the Eight Quarters Ended June 30, 2006*

<i>(Canadian \$ millions except per share data)</i>	Sales	Income	Basic Income	Diluted Income	Net Income	Basic	Diluted
		From Operations	From Operations Per Share	From Operations Per Share		Net Income Per Share	Net Income Per Share
2006	\$	\$	\$	\$	\$	\$	\$
2nd Quarter	505	111	2.90	2.88	79	2.07	2.06
1st Quarter	500	66	1.71	1.70	33	0.85	0.84
2005							
4th Quarter	478	64	1.61	1.60	55	1.39	1.38
3rd Quarter	446	48	1.20	1.19	31	0.77	0.77
2nd Quarter	495	106	2.65	2.63	65	1.61	1.60
1st Quarter	499	146	3.63	3.61	89	2.22	2.20
2004							
4th Quarter	490	180	4.48	4.46	122	3.05	3.03
3rd Quarter	536	188	4.92	4.65	122	3.17	3.00

The Company's profitability is highly correlated with the level of steel prices which is a major factor causing variation in quarterly operating results. Raw material and energy costs have also emerged as significant factors in recent years. Industry pricing is largely dependent on global supply, the level of steel imports into North America and economic conditions in North America. Since U.S. markets establish pricing levels, the exchange rate of the Canadian dollar to the U.S. dollar significantly impacts pricing realizations for Canadian producers.

Pricing levels increased in 2004 due to stronger global markets, particularly China, and improved steel demand in North America. Pricing in 2005 was influenced by excess steel inventories at the end of 2004 and weaker North American demand from several market sectors, reaching a low in September 2005 as excess inventories were depleted. Selling prices rose in the fourth quarter of 2005 due to a better balance between supply and demand and rose further in the second quarter of 2006.

The cost of raw materials and natural gas escalated in 2004 and 2005 as input prices responded to the stronger demand. Iron ore prices, under a long-term supply agreement denominated in U.S. dollars, increased approximately 85% in 2005 but declined 3.25% in 2006. The impact of an increase or decrease in raw material pricing on earnings is delayed by the consumption of opening inventories acquired at the previous year's price. Coal costs also escalated in 2005 primarily because of spot market purchases due to temporary supply disruptions from the Company's main coal supplier.

### **Net Income**

Net income for the three months ended June 30, 2006 was \$79.2 million compared to \$32.7 million for the first quarter of 2006 and \$64.7 million for the comparable quarter of 2005. The increase in net income from the previous quarter was mainly due to lower costs and a lower effective tax rate. Other contributing factors were higher selling prices, an improved product mix, and the sale of coke. The lower cost of sales was primarily due to lower costs for natural gas, a decline in iron ore prices, and the recognition of a total of \$8.4 million related to the benefit of research and development tax credits and a municipal tax refund. In the first quarter of 2006, higher financial expense was due mainly to the \$7.9 million premium paid to redeem the 11% Notes in January 2006. The increase in earnings versus the second quarter of 2005 was due to lower costs and the effect of higher shipments, offset by lower selling prices and a lower tax rate.

### **Sales**

Revenue for the second quarter of 2006 was \$504.8 million, \$5.2 million higher than the previous quarter and \$10.2 million higher than the comparable period in 2005. The increase from the previous quarter was the result of higher pricing, offset by lower shipments. The increase over the second quarter of 2005 was the result of higher steel shipments, offset by lower steel prices. Steel prices averaged \$753 per ton in the second quarter as compared to \$737 per ton in the previous quarter and \$806 per ton in the second quarter of 2005. Steel shipments totaled 625,000 tons for the three months ended June 30, 2006, 18,000 tons lower than the first quarter of 2006 and 62,000 tons higher than the second quarter of 2005.

### **EBITDA**

EBITDA is not a recognized measure for financial statement presentation under Canadian generally accepted accounting principles. EBITDA is not intended to represent cash flow from operations, as defined by Canadian GAAP, and it should not be considered as an alternative to net earnings, cash flow from operations, or any other measure of performance prescribed by GAAP. The Company's EBITDA may also not be comparable to EBITDA used by other companies which may be calculated differently. The Company considers EBITDA to be a meaningful indicator of operations and uses it as a measure to assess its operating performance. It is included because the Company believes it can be useful in measuring its ability to service debt, fund capital expenditures, and expand its business. EBITDA is also used by investors, analysts, and the Company's lenders as a measure of the Company's financial performance.

The following table shows the reconciliation of EBITDA to net income in accordance with GAAP:

	Three Months Ended <u>June 30, 2006</u>	Six Months Ended <u>June 30, 2006</u>	Three Months Ended <u>June 30, 2005</u>	Six Months Ended <u>June 30, 2005</u>
<u>(\$ Millions)</u>				
Net Income	\$ 79.2	\$111.9	\$ 64.7	\$153.8
Amortization	14.5	28.8	13.0	25.6
Financial Expense	0.3	5.8	1.0	1.7
Other Income	(1.1)	(1.1)	(0.1)	(0.7)
Income Taxes	<u>31.2</u>	<u>59.2</u>	<u>40.5</u>	<u>96.5</u>
EBITDA	<u>\$124.1</u>	<u>\$204.6</u>	<u>\$119.1</u>	<u>\$276.9</u>

EBITDA for the second quarter was \$124.1 million compared to \$80.5 million for the previous quarter and \$119.1 million for the second quarter of 2005. The improvement from the previous quarter was mainly attributable to lower costs, although higher prices, an improved product mix, and coke sales also contributed to better results. The improvement from the comparable quarter in 2005 was mainly due to lower costs and the effect of higher shipments, partially offset by lower selling prices. Coke sales in the second quarter of 2006 amounted to 11,000 tons, contributing \$3.0 million to EBITDA versus nil coke sales in the first quarter. Coke sales in the second quarter of 2005 totaled 27,000 tons and contributed \$8.2 million to EBITDA.

Cost of sales before employees' profit sharing for the three months ended June 30, 2006 was \$351.2 million versus \$397.0 million for the first quarter of 2006 and \$352.0 million for the second quarter of 2005. The decrease over the first quarter of 2006 was mainly attributable to the factors noted above, partially offset by higher shipments in the first quarter. The retroactive settlement of 2006 iron ore pricing resulted in an adjustment to second quarter cost of sales of approximately \$3.0 million that relates to iron ore consumption in the first quarter of 2006. The decrease over the comparable period of 2005 was mainly attributable to lower costs for natural gas, the decline in iron ore prices, the recognition of the benefit of research and development tax credits, and a municipal tax refund, offset by higher shipments.

Excluding employees' profit sharing expense, cost of sales per ton shipped for steel products was \$512 per ton for the three months ended June 30, 2006 versus \$577 for the previous quarter and \$567 per ton for the comparable period in 2005. The decrease from the previous quarter and the comparable period in 2005 was due mainly to the factors noted above.

The Company had inventory of 49,000 tons of purchased slabs at June 30, 2006 compared to 13,000 tons at March 31, 2006. Approximately 40,000 tons of finished goods produced from purchased slabs were sold in the second quarter and these additional sales generated approximately an additional \$3 million of operating income. This compares to approximately 35,000 tons of finished goods produced from purchased slabs in the first quarter generating approximately \$3 million of operating income. There were no purchased slabs in the second quarter of 2005. The Company expects to purchase a minimum of an additional 175,000 tons over the balance of the year, although the quantity purchased will be highly dependent on market conditions in North America and the cost of purchased slabs.

A \$10.7 million (\$17 per ton) expense for employees' profit sharing was recorded in the second quarter versus a \$4.6 million expense (\$7 per ton) for the first quarter and \$8.7 million (\$15 per ton) for the three months ended June 30, 2005.

Raw steel production for the three months ended June 30, 2006 totaled 665,000 tons versus 637,000 tons for the previous quarter and 639,000 tons for the second quarter of 2005.

Administrative and selling expenses totaled \$18.8 million in the second quarter as compared to \$17.5 million for the three months ended March 31, 2006 and \$14.8 million for the comparable period in 2005. The main reasons for the higher level in the second quarter of 2006 were higher expenditures associated with the business systems renewal project and costs related to strategic activities.

### **Amortization**

Amortization was \$14.5 million for the three months ended June 30, 2006 as compared to \$14.3 million for the three months ended March 31, 2006 and \$13.0 million for the comparable period in 2005.

### **Financial Expense (Income)**

A net foreign exchange loss of \$3.2 million was realized in the second quarter of 2006 as compared to a net foreign exchange gain of \$0.3 million in the first quarter of 2006 and a loss of \$0.4 million in the second quarter of 2005. The exchange loss was related to U.S. dollar exposure on receivables and payables.

Interest expense was \$0.5 million for the three months ended June 30, 2006 as compared to \$0.6 million for the three months ended March 31, 2006 and \$4.7 million for the second quarter of 2005. The reduction in interest expense in 2006 is due to the redemption of the 11% Notes on January 3, 2006. Investment income was \$3.4 million for the second quarter of 2006 as compared to \$2.7 million for the first quarter of 2006 and \$4.1 million for the second

quarter of 2005. The differences in investment income are due to fluctuations in interest rates and the balances of cash and cash equivalents and short-term investments. Financial expense in the first quarter of 2006 also included \$7.9 million paid as a premium on the redemption of the 11% Notes.

### **Provision for Income Taxes**

The second quarter provision for income taxes was \$31.2 million (28.3%) compared to \$28.0 million (46.1%) in the first quarter of 2006 and \$40.5 million (38.5%) in the second quarter of 2005. The second quarter provision includes a future tax benefit of \$11.6 million in respect of corporate tax rate reductions included in the 2006 Federal Budget. Without this adjustment, the effective tax rate for the quarter would have been 38.8%. On a year-to-date basis, the provision for income taxes was \$59.2 million or 34.6%. The following table provides a reconciliation of the statutory tax amounts and rate to the actual provision for each quarter:

	<u>Q2 2006</u>		<u>Q1 2006</u>		<u>Q2 2005</u>	
	\$	%	\$	%	\$	%
Tax Provision at the Statutory Manufacturing and Processing Rate	\$ 37.6	34.1%	\$ 20.7	34.1%	\$ 35.9	34.1%
Impact of Future Federal Tax Rate Reductions	(11.6)	(10.5)	-	-	-	-
Change in Future Tax Valuation Allowance:						
Impact of Pension Expense	2.4	2.2	4.1	6.7	4.5	4.3
Impact of Pension Funding	-	-	-	-	(2.3)	(2.2)
Impact of Post-Employment Expenses	<u>1.9</u>	<u>1.7</u>	<u>3.1</u>	<u>5.1</u>	<u>2.3</u>	<u>2.2</u>
	4.3	3.9	7.2	11.8	4.5	4.3
Other	<u>0.9</u>	<u>0.8</u>	<u>0.1</u>	<u>0.2</u>	<u>0.1</u>	<u>0.1</u>
Actual Tax Provision	<u>\$ 31.2</u>	<u>28.3%</u>	<u>\$ 28.0</u>	<u>46.1%</u>	<u>\$ 40.5</u>	<u>38.5%</u>

An additional pension contribution in the fourth quarter of 2005 of \$50.0 million resulted in the reduction of valuation allowances against future income tax assets and a reduction in the tax expense in the fourth quarter of 2005. This prepayment of a portion of the 2006 funding obligation eliminated normal pension funding in the first and second quarters of 2006 and resulted in an increase to the income tax provision. The current portion of the income tax provision in the quarter, which will result in cash taxes payable, was \$40.5 million versus \$28.2 million in the first quarter of 2006 and \$27.5 million for the second quarter of 2005. The effective tax rate for the second quarter of 2006 is lower than the Company's statutory rate of 34% due mainly to the benefit of the future tax rate reduction in the 2006 Federal Budget, offset by the impact of the timing of pension payments on future tax assets and valuation allowances with respect to pension and post-employment expenses.

Included in the current future tax asset at June 30, 2006 is a \$4.1 million tax benefit relating to provincial minimum tax credits that is expected to be realized during the remainder of 2006. The long-term future income tax liability of \$124.0 million at June 30, 2006 primarily reflects cumulative tax depreciation deducted in excess of book amortization. For further information, see note 7 of the Notes to Interim Consolidated Financial Statements.

### **Financial Resources and Liquidity**

Cash provided by operating activities was \$90.1 million for the three months ended June 30, 2006 compared to \$111.0 million for the three months ended June 30, 2005. The decline from the second quarter of 2005 was mainly due to an increase to non-cash operating working capital in the second quarter of 2006. Non-cash operating working capital increased by \$12.4 million in the quarter as compared to a decrease of \$18.9 million for the second quarter of 2005. The increase in the quarter was mainly attributable to increases in accounts receivable and inventories, offset by increases in accounts payable and accrued liabilities and income and other taxes payable.

Accounts receivable increased \$17.8 million in the quarter mainly due to a \$27.0 million receivable from the Company's iron ore supplier, representing the difference between the actual price decrease in 2006 of 3.25% and interim payments in the first half that were based on a 15% increase. This was partially offset by lower trade receivables because of lower sales in June 2006 compared to March 2006 and improved collections. Inventories increased by \$48.8 million in the quarter due to higher quantities of purchased slabs, coal, iron ore and scrap. Inventories increased by \$23.5 million in the second quarter of 2005 mainly due to a seasonal increase in iron ore inventory and higher unit costs for iron ore and steel products.

Accounts payable and accrued liabilities increased \$32.0 million in the quarter primarily due to an increase in payables for purchased slabs and coal and a higher accrual for employee profit sharing. Accounts payable and accrued liabilities increased \$28.6 million in the second quarter of 2005 mainly due to an accrual for higher iron ore costs, representing the difference between the actual price increase in 2005 of 85% and interim payments that were based on a 25% increase. Income and other taxes payable increased by \$13.4 million in the quarter compared to an increase of \$20.6 million in the second quarter of 2005. The increase in the quarter relates primarily to an increased accrual for current income taxes. The increase in the second quarter of 2005 was mainly due to the accrual of current federal taxes after exhausting all non-capital loss carryforwards in the first quarter of 2005.

For the six months ended June 30, 2006, cash provided by operating activities was \$124.9 million compared to \$271.1 million for the six months ended June 30, 2005. Non-cash operating working capital increased by \$50.5 million in the period compared to a decrease of \$23.4 million for the same period in 2005. The increase in 2006 was mainly the result of an increase in accounts receivable of \$31.2 million due mainly to the amounts due from the Company's iron ore supplier noted earlier and an increase in prepaid expenses of \$25.3 million, reflecting a prepayment for purchased slabs and iron ore payments exceeding actual receipts of iron ore. The decrease in 2005 was mainly the result of an increase in accounts payable and accrued liabilities of \$63.2 million and an increase in income and other taxes payable of \$35.4 million, offset by an increase in inventories of \$57.9 million and an increase in prepaid expenses of \$19.3 million.

Investing activities for the three months ended June 30, 2006 included capital expenditures of \$11.3 million, whereas investing activities in the second quarter of 2005 included an increase in short-term investments of \$51.3 million and capital expenditures of \$13.0 million. For the six months ended June 30, 2006, investing activities included a decrease in short-term investments of \$262.2 million and capital expenditures of \$25.6 million. The decrease in short-term investments primarily relates to the use of funds to redeem the 11% Notes and the payment of the outstanding 2005 income tax liability. For the six months ended June 30, 2005, investing activities included an increase in short-term investments of \$165.4 million and capital expenditures of \$24.9 million.

Financing activities for the three-month period ended June 30, 2006 included the purchase of shares pursuant to the normal course issuer bid totaling \$40.1 million. For the six months ended June 30, 2006, financing activities also included the redemption of the 11% Notes for \$153.3 million. There were no significant financing activities in the six months ended June 30, 2005.

Unused availability under the revolving credit facility at June 30, 2006 increased to \$190.9 million compared to \$190.1 million at March 31, 2006 due to a decrease in the outstanding letters of credit.

## **TRADE**

The expiry review of the finding covering hot-rolled carbon and alloy steel sheet and strip is continuing. The finding relates to the dumping in Canada of product originating in or exported from Brazil, Bulgaria, the People's Republic of China, Chinese Taipei, India, the former Yugoslav Republic of Macedonia, South Africa, Ukraine and Serbia and Montenegro (formerly the Federal Republic of Yugoslavia), and the subsidizing of product originating in or exported from India.

On March 30, 2006, the President of the Canada Border Services Agency determined that the expiry of the finding is unlikely to result in the continuation or resumption of dumping of the goods from Bulgaria, the former Yugoslav Republic of Macedonia and Serbia and Montenegro (formerly the Federal Republic of Yugoslavia). A hearing was held the week of June 19 before the Canadian International Trade Tribunal (CITT) to determine whether dumping from the remaining six named countries and subsidizing of product from India will injure the Canadian industry. The decision by the CITT as to whether to continue or rescind the finding is expected by mid-August 2006.

The Company is concerned about the increasing volume of offshore imports. Imports of product marketed by the Company have increased over 38% to July 1, 2006 over the same period in 2005. Prices of some of these offshore imports are significantly below the current market. The Company is reviewing the import offers and will take appropriate action if the imports appear to be unfairly traded.

## **OUTLOOK**

Higher operating income, as compared to income for the second quarter after excluding non-recurring items totaling \$11.4 million, is expected in the third quarter. Higher steel pricing realizations are expected to offset the effect of higher costs. Selling prices and costs are subject to a high degree of variability and certain factors which could cause actual costs to vary from projections are noted in the last paragraph of this outlook section.

Although there have been increased imports into North America and reduced demand from the automotive sector due, in part, to seasonal factors, current market conditions remain favourable. Algoma has implemented price increases for the third quarter consistent with general industry announcements. As a result, higher selling prices are expected in the third quarter and shipments are expected to be similar to the second quarter level of 625,000 tons. Coke shipments for the third quarter are expected to be unchanged at 11,000 tons.

Higher costs are expected in the third quarter due mainly to the absence of certain favourable non-recurring adjustments recorded in the second quarter. Higher coal costs, approximating \$4 million, are expected in the third quarter due to the initial effects of the new coal contract. The full effect of the new coal contract is expected to be incurred in the fourth quarter.

The Company currently projects that it will shut down its blast furnace for approximately 25 days in mid-2007 to perform work related to extending the blast furnace reline to 2010 or later. The Company is continuing to assess the scope and estimated costs related to this outage.

Certain statements made in this news release and report are forward-looking statements that involve risks and uncertainties, including those risks and uncertainties identified in the Company's Management Discussion and Analysis for the year ended December 31, 2005 available on SEDAR at [www.sedar.com](http://www.sedar.com). Some factors, among others, that could affect market conditions, steel prices, costs and shipments include global and North American product demand, product mix, level of contract sales, foreign exchange rates, global steel production levels, plant operating performance, North American production levels and capacity utilization, natural gas prices and usage, raw materials availability and prices, changes in environmental, tax and other laws, and North American and global economic performance and political developments. Steel shipments and prices could be affected by import levels and government actions or lack of actions with regard to imports. These forward-looking statements reflect the Company's best judgment based on current information, and although the Company bases these statements on circumstances that it believed to be reasonable when made, there can be no assurance that future events will not affect the accuracy of such forward-looking information. As such, the forward-looking statements are not guarantees of future performance, and actual results may vary materially from the results and expectations discussed herein. All statements, other than statements of historical facts included in this report, are forward-looking statements. All forward-looking statements speak only as of the date of this report. Algoma does not undertake any obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

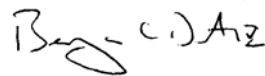
**SECOND QUARTER CONFERENCE CALL/WEBCAST PRESENTATION**

The Company will conduct a conference call/webcast presentation on second quarter earnings on Tuesday, August 1 at 1:30 p.m. ET. The call and presentation can be accessed through Algoma Steel's website at [www.algoma.com](http://www.algoma.com) under Investors, then under Webcasts and Presentations, then under Webcast of Q2-2006 Earnings Results. The conference call can also be accessed by phone at 416-641-6679. For more information on Algoma Steel, visit its website at [www.algoma.com](http://www.algoma.com).



Denis Turcotte  
*President and Chief Executive Officer*

*Sault Ste. Marie, Ontario  
July 31, 2006*



Benjamin Duster  
*Chairman of the Board*

**Algoma Steel Inc.****Consolidated Statements of Income and Retained Earnings (Unaudited)***(millions of Canadian dollars - except per share amounts)*

	Three Months Ended June 30 <u>2006</u>	Six Months Ended June 30 <u>2006</u>	Three Months Ended June 30 <u>2005</u>	Six Months Ended June 30 <u>2005</u>
<b>Sales</b>	<b>\$ 504.8</b>	<b>\$1,004.4</b>	\$ 494.6	\$ 993.6
<b>Operating expenses</b>				
Cost of sales (before the following item)	351.2	748.2	352.0	666.5
Employees' profit sharing	<u>10.7</u>	<u>15.3</u>	<u>8.7</u>	<u>21.2</u>
	361.9	763.5	360.7	687.7
Administrative and selling	18.8	36.3	14.8	29.0
Amortization	<u>14.5</u>	<u>28.8</u>	<u>13.0</u>	<u>25.6</u>
	395.2	828.6	388.5	742.3
Other income	<u>1.1</u>	<u>1.1</u>	<u>0.1</u>	<u>0.7</u>
<b>Income from operations</b>	<b>110.7</b>	<b>176.9</b>	106.2	252.0
<b>Financial expense (income)</b>				
Interest on long-term liabilities	0.1	0.2	4.3	8.5
Foreign exchange loss (gain)	3.2	2.9	0.4	(0.2)
Premium on redemption of 11% Notes (note 3)	-	7.9	-	-
Other interest	0.4	0.9	0.4	0.9
Investment income	<u>(3.4)</u>	<u>(6.1)</u>	<u>(4.1)</u>	<u>(7.5)</u>
	<u>0.3</u>	<u>5.8</u>	<u>1.0</u>	<u>1.7</u>
<b>Income before income taxes</b>	<b>110.4</b>	<b>171.1</b>	105.2	250.3
<b>Income taxes (note 7)</b>				
Current	40.5	68.7	27.5	41.0
Future	<u>(9.3)</u>	<u>(9.5)</u>	<u>13.0</u>	<u>55.5</u>
	<u>31.2</u>	<u>59.2</u>	<u>40.5</u>	<u>96.5</u>
<b>Net income</b>	<b>\$ 79.2</b>	<b>\$ 111.9</b>	\$ 64.7	\$ 153.8
<b>Net income per common share (note 5)</b>				
Basic	<u>\$ 2.07</u>	<u>\$ 2.91</u>	<u>\$ 1.61</u>	<u>\$ 3.83</u>
Diluted	<u>\$ 2.06</u>	<u>\$ 2.89</u>	<u>\$ 1.60</u>	<u>\$ 3.81</u>
<b>Weighted average number of common shares outstanding - millions (note 5)</b>				
Basic	<u>38.23</u>	<u>38.42</u>	<u>40.13</u>	<u>40.12</u>
Diluted	<u>38.48</u>	<u>38.66</u>	<u>40.40</u>	<u>40.41</u>
<b>Retained earnings</b>				
Balance, beginning of period	\$ 378.7	\$ 346.0	\$ 456.2	\$ 367.1
Net income	79.2	111.9	64.7	153.8
Purchase and cancellation of shares (note 4)	<u>(27.9)</u>	<u>(27.9)</u>	<u>-</u>	<u>-</u>
Balance, end of period	<u>\$ 430.0</u>	<u>\$ 430.0</u>	<u>\$ 520.9</u>	<u>\$ 520.9</u>

**SUPPLEMENTAL NON-FINANCIAL INFORMATION****Operations** (thousands of net tons)

Raw steel production	665	1,302	639	1,277
Steel shipments	625	1,268	563	1,112

*See accompanying notes.*

**Algoma Steel Inc.**  
**Consolidated Balance Sheets**  
*(millions of Canadian dollars)*

	<b>June 30</b> <b>2006</b> <small>(Unaudited)</small>	December 31 <u>2005</u> <small>(Audited)</small>
<b>Current assets</b>		
Cash and cash equivalents	\$ 341.4	\$ 172.6
Short-term investments	-	262.2
Accounts receivable	287.4	256.2
Inventories	318.1	321.5
Prepaid expenses	43.3	18.0
Future income taxes (note 7)	<u>5.0</u>	<u>5.3</u>
	<b><u>995.2</u></b>	<b><u>1,035.8</u></b>
Capital assets, net	638.0	641.5
Deferred charges	<u>1.0</u>	<u>1.5</u>
<b>Total assets</b>	<b><u>\$ 1,634.2</u></b>	<b><u>\$ 1,678.8</u></b>
<b>Current liabilities</b>		
Accounts payable and accrued liabilities	\$ 164.5	\$ 153.6
Income and other taxes payable	48.8	57.0
Accrued pension liability and post-employment benefit obligation	45.7	25.9
11% Notes payable (note 3)	<u>-</u>	<u>145.4</u>
	<b><u>259.0</u></b>	<b><u>381.9</u></b>
Accrued pension liability and post-employment benefit obligation	273.0	257.4
Other long-term liabilities	8.4	9.2
Future income tax liability (note 7)	<u>124.0</u>	<u>136.8</u>
	<b><u>405.4</u></b>	<b><u>403.4</u></b>
<b>Shareholders' equity</b>		
Capital stock (notes 4 & 6)	296.9	306.6
Contributed surplus (notes 4 & 7)	242.9	240.9
Retained earnings	<u>430.0</u>	<u>346.0</u>
	<b><u>969.8</u></b>	<b><u>893.5</u></b>
<b>Total liabilities and shareholders' equity</b>	<b><u>\$ 1,634.2</u></b>	<b><u>\$ 1,678.8</u></b>

*See accompanying notes.*

**Algoma Steel Inc.**  
**Consolidated Statements of Cash Flows** (Unaudited)  
(millions of Canadian dollars)

	Three Months Ended June 30 <u>2006</u>	Six Months Ended June 30 <u>2006</u>	Three Months Ended June 30 <u>2005</u>	Six Months Ended June 30 <u>2005</u>
<b>Cash provided by (used in)</b>				
<b>Operating activities</b>				
Net income	\$ 79.2	\$ 111.9	\$ 64.7	\$ 153.8
Adjustments and items not affecting cash:				
Amortization	14.5	28.8	13.0	25.6
Pension expense in excess of payments (note 8)	13.6	27.0	(4.5)	1.1
Post employment benefit expense in excess of payments (note 8)	4.1	8.4	3.3	6.9
Future income tax expense (recovery)	(9.3)	(9.5)	13.0	55.5
Exchange gain on long-term debt and accrued interest	-	-	1.9	2.9
Gain on disposal of capital assets	(0.2)	(0.3)	(0.3)	(0.7)
Premium on redemption of 11% Notes	-	7.9	-	-
Stock-based compensation	1.0	1.4	0.5	1.9
Other	(0.4)	(0.2)	0.5	0.7
	<u>102.5</u>	<u>175.4</u>	<u>92.1</u>	<u>247.7</u>
Changes in non-cash operating working capital	<u>(12.4)</u>	<u>(50.5)</u>	<u>18.9</u>	<u>23.4</u>
	<u>90.1</u>	<u>124.9</u>	<u>111.0</u>	<u>271.1</u>
<b>Investing activities</b>				
Decrease (increase) in short-term investments	-	262.2	(51.3)	(165.4)
Capital asset expenditures	(11.3)	(25.6)	(13.0)	(24.9)
Proceeds on sale of capital assets	0.3	0.5	0.2	1.0
	<u>(11.0)</u>	<u>237.1</u>	<u>(64.1)</u>	<u>(189.3)</u>
<b>Financing activities</b>				
Redemption of 11% Notes	-	(153.3)	-	-
Decrease in other long-term liabilities	-	-	-	(0.2)
Purchase and cancellation of shares (note 4)	(40.1)	(40.1)	-	-
Other	0.3	0.2	-	-
	<u>(39.8)</u>	<u>(193.2)</u>	<u>-</u>	<u>(0.2)</u>
<b>Cash and cash equivalents</b>				
Change during the period	39.3	168.8	46.9	81.6
Balance, beginning of period	302.1	172.6	220.9	186.2
Balance, end of period	<u>\$ 341.4</u>	<u>\$ 341.4</u>	<u>\$ 267.8</u>	<u>\$ 267.8</u>
<b>Changes in non-cash operating working capital</b>				
Accounts receivable	\$ (17.8)	\$ (31.2)	\$ (1.5)	\$ 2.0
Inventories	(48.8)	3.4	(23.5)	(57.9)
Prepaid expenses	8.8	(25.3)	(5.3)	(19.3)
Accounts payable and accrued liabilities	32.0	10.9	28.6	63.2
Income and other taxes payable	13.4	(8.3)	20.6	35.4
	<u>\$ (12.4)</u>	<u>\$ (50.5)</u>	<u>\$ 18.9</u>	<u>\$ 23.4</u>

See accompanying notes.

## Algora Steel Inc.

### Notes to Interim Consolidated Financial Statements (Unaudited)

(millions of Canadian dollars)

#### 1. Basis of presentation and accounting policies

These interim consolidated financial statements have been prepared using the same accounting principles and methods as were used for the consolidated financial statements for the year ended December 31, 2005. Management is required to make estimates and assumptions that affect the amounts reported in the interim financial statements. Management believes that the estimates are reasonable; however, actual results could differ from these estimates. The disclosures in these interim consolidated financial statements do not meet all disclosure requirements of Canadian generally accepted accounting principles ("GAAP") for annual financial statements and they should be read in conjunction with the annual consolidated financial statements of the Corporation for the year ended December 31, 2005 and the notes thereto.

#### 2. Banking facilities

The Corporation's Loan and Security Agreement ("Agreement") with its bank provides the Corporation with a revolving credit facility ("Revolving Facility") with financing equal to the lesser of \$200 million and a borrowing base determined by the levels of the Corporation's accounts receivable and inventories less certain reserves. At June 30, 2006 there was \$190.9 million of unused availability under the Revolving Facility after taking into account \$9.1 million of outstanding letters of credit. The Corporation is required to maintain a minimum availability of \$25 million. The Revolving Facility matures on September 3, 2007 and is collateralized by a first charge on short-term investments, accounts receivable and inventories. Borrowings can be made in either Canadian or United States (U.S.) funds at rates fluctuating between 0.75% and 1.5% above either the Canadian prime bank rate or the U.S. base rate or, at the Corporation's option, at rates fluctuating between 1.75% and 2.5% over bankers' acceptance rate or London interbank offering rate.

#### 3. 11% Notes payable

The 11% Notes were redeemed on January 3, 2006 at a premium of 105.5% of the principal balance. The premium totaled \$7.9 million and was charged to expense in January 2006.

#### 4. Share capital

Authorized - Unlimited common shares

The following table summarizes the share capital transactions since December 31, 2005:

	<u>Common Shares</u>	
	<u>Issued and Outstanding</u>	
	<u># Shares</u>	<u>Stated Capital</u>
Balance at December 31, 2005	38,573,073	\$ 306.6
Shares issued on exercise of restricted share units	35,116	0.2
Shares purchased and cancelled under normal course issuer bid	(1,242,400)	(9.9)
Directors' Share Award Plan (note 6):		
Shares issued	<u>276</u>	<u>-</u>
Balance at June 30, 2006	<u>37,366,065</u>	<u>\$ 296.9</u>

## Algoma Steel Inc.

### Notes to Interim Consolidated Financial Statements (Unaudited)

(millions of Canadian dollars)

#### 4. Share capital (cont'd)

In August 2005, the Corporation filed a normal course issuer bid which entitles the Corporation to acquire up to 3,291,123 of its common shares between August 8, 2005 and August 7, 2006. All purchases are to be made on the open market at the market price at the time of the purchase. All shares acquired pursuant to the bid are cancelled. During the three and six months ended June 30, 2006, 1,242,400 common shares were purchased for \$40.1 million under the program. The excess of the purchase cost of these shares over the average paid-in amount was \$30.2 million, which was charged \$2.3 million to contributed surplus and \$27.9 million to retained earnings.

On June 28, 2006, the Corporation announced its intention to offer to purchase for cancellation up to \$200 million worth of its common shares through a Dutch auction substantial issuer bid. The Corporation expects to complete this substantial issuer bid in September 2006.

#### 5. Earnings per share

Diluted net income per common share assumes the exercising of any share options and restricted share units (note 6).

	<b>Three Months Ended June 30 2006</b>	<b>Six Months Ended June 30 2006</b>	Three Months Ended June 30 2005	Six Months Ended June 30 2005
Basic weighted average number of common shares outstanding	<b>38.23</b>	<b>38.42</b>	40.13	40.12
Common shares issued on the assumed exercising of employee share options and restricted share units	<u><b>0.25</b></u>	<u><b>0.24</b></u>	<u>0.27</u>	<u>0.29</u>
Diluted weighted average number of common shares outstanding	<u><b>38.48</b></u>	<u><b>38.66</b></u>	<u>40.40</u>	<u>40.41</u>

#### 6. Stock-based compensation plans

During the three months ended June 30, 2006, 570 shares were awarded under the share award plan. These consisted of 276 shares issued with an average fair market value of \$33.91 per share and 294 shares with an average fair market value of \$33.98 per share to be issued in the third quarter. No shares were awarded in the first quarter of 2006. During the six months ended June 30, 2005, 11,867 shares were awarded under the share award plan with an average fair market value of \$30.74 per share including 3,398 shares awarded with an average fair market value of \$27.89 per share in the second quarter.

There were 413,360 options granted in the three and six months ended June 30, 2006 with a weighted average exercise price of \$32.67 per share for 373,360 shares and \$32.11 per share for the remaining 40,000 shares. These shares have an estimated weighted average fair value of \$18.01 and \$17.66 respectively per option determined using the Black-Scholes model. There were no options granted in the second quarter of 2005 and 281,480 options were granted in the six months ended June 30, 2005 with a weighted average exercise price of \$28.98 per share, and an estimated weighted average fair value of \$15.69 per option determined using the Black-Scholes model.

There were 2,500 restricted share units granted in the three and six months ended June 30, 2006 with a grant-date fair value of \$32.11. There were no restricted share units granted in the second quarter and 55,940 restricted share units were granted in the six months ended June 30, 2005 with a grant-date fair value of \$28.98 per unit.

The compensation expense recognized for all awards granted under these plans for the three and six month periods ended June 30, 2006 was \$1.0 million and \$1.4 million respectively, and for the three and six month periods ended June 30, 2005 was \$0.5 million and \$1.9 million respectively.

**Algoma Steel Inc.****Notes to Interim Consolidated Financial Statements (Unaudited)**

(millions of Canadian dollars)

**7. Income taxes**

The Corporation's effective income tax rate for the second quarter of 2006 is lower than its statutory manufacturing and processing rate of 34.1% due to an \$11.6 million benefit in respect of future tax rate reductions contained in the 2006 Federal Budget.

Any future tax benefit recognized in respect of unrecorded tax assets that arose prior to fresh start accounting is recorded as an increase to contributed surplus. The increase to contributed surplus for the three and six month periods ended June 30, 2006 was \$1.2 million (2005 – \$5.4 million) and \$3.0 million (2005 - \$8.4 million), respectively.

The Corporation's estimate of non-capital losses available subsequent to the 2002 financial reorganization is currently under review by the Canada Revenue Agency and may be subject to change.

**8. Pension and other post-employment benefits**

Pension expense for the three and six month periods ended June 30, 2006 was \$13.7 million (2005 - \$13.3 million) and \$27.3 million (2005 - \$26.5 million), respectively.

Post-employment benefits expense for the three and six month periods ended June 30, 2006 was \$7.8 million (2005 - \$6.7 million) and \$15.6 million (2005 - \$13.5 million), respectively.

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