
**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**
Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2004

Commission File Number 333-63825

SCOTIA PACIFIC COMPANY LLC

(Exact name of Registrant as Specified in its Charter)

Delaware
(State or other jurisdiction
of incorporation or organization)

P. O. Box 712
125 Main Street, 2nd Floor
Scotia, California
(Address of Principal Executive Offices)

68-0414690
(I.R.S. Employer
Identification Number)

95565
(Zip Code)

Registrant's telephone number, including area code: **(707) 764-2330**

Securities registered pursuant to Section 12(b) of the Act: None.

Securities registered pursuant to Section 12(g) of the Act: None.

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes : No ☒

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Act).

Yes ☒ No :

The aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, as of the last business day of the registrant's most recently completed second fiscal quarter: \$0.00

Registrant meets the conditions set forth in General Instruction (I)(1)(a) and (b) of Form 10-K and is therefore filing this Form with the reduced disclosure format.

DOCUMENTS INCORPORATED BY REFERENCE: Not applicable.

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PART I

ITEM 1. BUSINESS

General

Scotia Pacific Company LLC (the “**Company**”), a special purpose Delaware limited liability company wholly owned by The Pacific Lumber Company (“**Palco**”), was organized by Palco in May 1998 to facilitate the sale of the Company’s 6.55% Series B Class A-1 Timber Collateralized Notes due 2028, (the “**Class A-1 Notes**”), 7.11% Series B Class A-2 Timber Collateralized Notes due 2028 (the “**Class A-2 Notes**”) and 7.71% Series B Class A-3 Timber Collateralized Notes due 2028 (the “**Class A-3 Notes**,” together with the Class A-1 Timber Notes and the Class A-2 Timber Notes, the “**Timber Notes**”). The Indenture governing the Timber Notes is referred to herein as the “**Indenture**.” Palco is a wholly owned subsidiary of MAXXAM Group Inc. (“**MGI**”), and Palco also wholly owns Salmon Creek LLC (“**Salmon Creek**”) and Britt Lumber Co., Inc. (“**Britt**”). MGI is an indirect wholly owned subsidiary of MAXXAM Inc. (“**MAXXAM**”). Any reference to a company includes the subsidiaries of that company unless otherwise noted or the context indicates otherwise.

Except as otherwise indicated, all references herein to “Notes” represent the Notes to the Company’s Financial Statements contained herein.

This Annual Report on Form 10-K contains statements which constitute “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995 (“PSLRA”). These statements appear in a number of places (see Item 1. “Business—Harvesting Practices” and “—Regulatory and Environmental Factors,” Item 3. “Legal Proceedings” and Item 7. “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Background,” “—Results of Operations” and “—Financial Condition and Investing and Financing Activities”). Such statements can be identified by the use of forward-looking terminology such as “believes,” “expects,” “may,” “estimates,” “will,” “should,” “plans” or “anticipates” or the negative thereof or other variations thereon or comparable terminology, or by discussions of strategy. Readers are cautioned that any such forward-looking statements are not guarantees of future performance and involve significant risks and uncertainties, and that actual results may vary materially from the forward-looking statements as a result of various factors. These factors include the effectiveness of management’s strategies and decisions, general economic and business conditions, developments in technology, new or modified statutory or regulatory requirements, litigation developments, and changing prices and market conditions. This Report identifies other factors which could cause differences between such forward-looking statements and actual results. No assurance can be given that these are all of the factors that could cause actual results to vary materially from the forward-looking statements.

The Company’s operations have been adversely affected by the failure of the California North Coast Regional Water Quality Control Board to release for harvest a number of the Company’s timber harvesting plans even though the plans have already been approved by the other government agencies which review its timber harvesting plans and are in compliance with its comprehensive multi-species habitat conservation plan. See “—Regulatory and Environmental Factors—Water Quality” and See Item 7. “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Financial Condition and Investing and Financing Activities.”

Timber and Timberlands

This section contains statements which constitute “forward-looking statements” within the meaning of the PSLRA. See this section and “Business—General” above for cautionary information with respect to such forward-looking statements.

The Company owns, and the obligations of the Company under the Timber Notes are secured by, (i) approximately 204,000 acres of timberlands, (ii) the timber and related harvesting rights (the “**Company Timber Rights**”) with respect to an additional approximately 12,200 acres of timberlands that are owned by Palco and Salmon Creek, (iii) certain computer hardware and software, including a geographic information system (“**GIS**”) containing information on numerous aspects of the Company’s timberlands (subject to certain rights of concurrent use by Palco) and (iv) certain other assets. Substantially all of the Company’s assets serve as security for the Timber Notes. The timberlands owned by the Company and the timberlands subject to the Company Timber Rights are hereinafter collectively referred to as the “**Company Timberlands**.” The timber located on the Company Timberlands is hereinafter referred to as the “**Company Timber**.”

In March 1999, Palco, the Company and Salmon Creek (collectively, the **“Palco Companies”**) consummated the Headwaters Agreement (the **“Headwaters Agreement”**) with the United States and California. Pursuant to the agreement, approximately 5,600 acres of timberlands owned by the Palco Companies (the **“Headwaters Timberlands”**) were transferred to the United States government in exchange for (i) an aggregate of \$300.0 million, (ii) approximately 7,700 acres of timberlands, and (iii) approval by the federal and state governments of habitat conservation and sustained yield plans (the **“Environmental Plans”**) in respect of substantially all of the Company Timberlands. California also agreed to offer to purchase other timberlands owned by the Company and Palco (which purchases were subsequently consummated).

Timber generally is categorized by species and the age of a tree when it is harvested. **“Old growth”** trees are often defined as trees which have been growing for approximately 200 years or longer, and **“young growth”** trees are those which have been growing for less than 200 years. The forest products industry grades lumber into various classifications according to quality. The two broad categories into which all grades fall based on the absence or presence of knots are called **“upper”** and **“common”** grades, respectively. Old growth trees have a higher percentage of upper grade lumber than young growth trees. The overall supply of premium upper grade lumber has diminished greatly due to increasing environmental and regulatory restrictions and other factors.

The Company Timber is comprised of predominantly young growth and old growth redwood, Douglas-fir and other conifer timber. The Company’s conifers consist (by volume) of approximately 66% redwood, 30% Douglas-fir, and 4% other conifer timber. In May 2002, the first timber cruise of the Company Timberlands since 1986 was completed. The results of the timber cruise provided the Company with an estimate of the volume of merchantable Company Timber. The 2002 cruise data reflected a 0.1 million MBF decrease in estimated overall timber volume as compared to the estimated volumes reported as of December 31, 2001 using the 1986 cruise data (adjusted for harvest and estimated growth). The 2002 cruise data indicated that the Company Timber has significantly less old growth timber than estimated as of December 31, 2001, using the 1986 cruise data. There was also an estimated increase in young growth timber volume almost equal to the estimated decrease in old growth timber volume. This shift in timber volume between classifications decreased the overall timber volume reported in Mbfe (see the following paragraph) by 0.2 to 2.9 million. These timber volume numbers do not reflect substantial quantities of sub-merchantable trees which exist but are not yet mature enough to be included within the inventory of Company Timber.

Under the Mbfe concept, one thousand board feet, net Scribner scale, of old growth redwood timber equals one Mbfe. One thousand board feet, net Scribner scale, of each other species and category of timber included in the Company Timber was assigned a value equal to a fraction of an Mbfe (in order to account for their relative values). This fraction was generally determined by dividing the June 1998 SBE Price applicable to such species and category by the June 1998 SBE Price applicable to old growth redwood. **“SBE Price”** is the applicable stumpage price for each species of timber and category thereof pursuant to a schedule published periodically by the California State Board of Equalization. See **“—Operation of Company Timberlands”** and **“—Harvesting Practices”** below.

See **“—Regulatory and Environmental Factors,”** Item 3 **“Legal Proceedings,”** and Item 7. **“Management’s Discussion and Analysis of Financial Condition and Results of Operations”** for various legal, regulatory, environmental and other challenges being faced by the Company in connection with timber harvesting and other operations on the Company Timberlands.

Redwood lumber is a premium, high value-added product which has different supply and demand characteristics from the general lumber market. Redwood is known for its natural beauty, superior ability to retain paints and finishes, dimensional stability and its innate resistance to decay, insects and chemicals. As a result, redwood lumber is generally not used for commodity applications such as structural frames for construction, but is used instead for specialty applications such as exterior siding, trim and fascia for both residential and commercial construction, outdoor furniture, decks, planters and retaining walls. Redwood also has a variety of industrial applications because of its resistance to chemicals and because it does not impart any taste or odor to liquids or solids. Redwood lumber has historically commanded a substantial price premium to other softwood timber types. Redwood is commercially available only in North America in a region that extends for approximately 375 miles along the coast of the Pacific Northwest. The combination of excellent soil conditions and climate makes this region one of the most productive timber regions in North America.

Douglas-fir is used primarily for new construction and some decorative purposes and is widely recognized for its strength, hard surface and attractive appearance. Douglas-fir is grown commercially along the west coast of North America and in Chile and New Zealand.

The Company and Palco engage in extensive efforts to supplement the natural regeneration of the Company Timber and increase the amount of timber on the Company Timberlands. The Company is required to comply with California forestry regulations regarding reforestation, which generally require that an area be reforested to specified standards within an established period of time. Palco's regeneration efforts are required by, and conducted pursuant to, the Services Agreement described below (see "—Operation of Company Timberlands"). Regeneration of redwood timber generally is accomplished through redwood sprouts from harvested trees and the planting of redwood seedlings at levels designed to optimize growth. Douglas-fir timber is regenerated almost entirely by planting seedlings. During 2004, Palco planted an estimated 1,350,000 redwood and Douglas-fir seedlings on the Company Timberlands.

California law requires large timberland owners, including the Company, to demonstrate that their timber operations will not decrease the sustainable productivity of their timberlands. The applicable regulations require timber companies to project timber growth and harvest on their timberlands over a 100-year planning period and to demonstrate sustained yield, i.e. that their projected average annual harvest for any decade within the 100-year planning period will not exceed the average annual growth level at the end of the 100-year planning period. A timber company may comply with this requirement by submitting a sustained yield plan to the California Department of Forestry and Fire Protection ("**CDF**") for review and approval. Timber companies which do not have a sustained yield plan are allowed to follow alternative procedures (see below).

The Company is also subject to federal and state laws providing for the protection and conservation of wildlife species which have been designated as endangered or threatened, certain of which are found on the Company Timberlands. These laws generally prohibit certain adverse impacts on such species (referred to as a "**take**"), except for incidental take which does not jeopardize the continued existence of the affected species and is made in accordance with an approved habitat conservation plan and related incidental take permit. A habitat conservation plan analyzes the impact of the incidental take and specifies measures to monitor, minimize and mitigate such impact. As part of the Headwaters Agreement, the federal and state governments approved the Environmental Plans, which consisted of a sustained yield plan (the "**SYP**") and a multi-species habitat conservation plan (the "**HCP**"), in respect of substantially all of the Company Timberlands. However, in connection with two lawsuits filed against Palco and the Company, a California court invalidated the SYP and the incidental take permits issued by California in connection with the Environmental Plans (the "**California Permits**"), a decision which Palco has appealed. See Item 3, "Legal Proceedings."

As a result of these cases, the Company has since October 2002 been obtaining review and approval of its timber harvesting plans ("**THPs**") under the alternative procedure in the California forest practice rules known as "Option C." Option C is available to landowners who have submitted an "Option A" plan to the CDF for review (as was done by the Palco Companies), and may be used during the review and approval period for the Option A plan. An approved Option A plan is an alternative to obtaining approval of a sustained yield plan. In December 2004, the Palco Companies revised and resubmitted the Option A plan, which document (the "**Option A Plan**") is currently under review by the CDF.

Operation of Company Timberlands

The Company's foresters, wildlife and fisheries biologists, geologists, botanists and other personnel provide a number of forest stewardship techniques, including protecting the Company Timber from forest fires, erosion, insects and other damage, overseeing reforestation activities, and implementing and monitoring environmental and regulatory compliance. The Company's personnel also prepare THPs and maintain and update the GIS that contains information on numerous aspects of the Company Timberlands. See "—Harvesting Practices" below for a description of the Company's GIS updating process and the THP preparation process.

The Company is a party with Palco to a master purchase agreement (the "**Master Purchase Agreement**") which governs the sale to Palco of logs harvested from the Company Timberlands. As Palco purchases logs from the Company pursuant to the Master Purchase Agreement, Palco is responsible, at its own expense, for harvesting and removing the standing Company Timber covered by approved THPs, with the purchase price being based upon "stumpage prices." Title to, and the obligation to pay for, harvested logs passes to Palco once the logs are measured. The Master Purchase Agreement contemplates that all sales of logs by the Company to Palco will be at fair market value (based on stumpage prices) for each species and category of timber. The Master Purchase Agreement provides that if the purchase price equals or exceeds the SBE Price and a structuring price set forth in a schedule to the Indenture, the purchase price is deemed to be at fair market value. If the purchase price equals or exceeds the SBE Price, but is less than the structuring price, then the Company is required to engage an independent forestry consultant to confirm that the purchase price reflects fair market value. SBE Price is the stumpage price for each species and category of timber as set forth in the most recent "**Harvest Value Schedule**" (or any successor publication) published by the California State Board of Equalization (or any successor

agency) applicable to the timber sold during the applicable period. Harvest Value Schedules are published twice a year for purposes of computing a yield tax imposed on timber harvested between January 1 through June 30 and July 1 through December 31. SBE Prices are not necessarily representative of actual prices that would be realized from unrelated parties at subsequent dates. See also Item 7. “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Results of Operations—General—Master Purchase Agreement Provisions” and “—Financial Condition and Investing and Financing Activities.”

After obtaining an approved THP, the Company offers for sale the logs to be harvested pursuant to such THP. While the Company may sell logs to third parties, it derives substantially all of its revenue from the sale of logs to Palco pursuant to the Master Purchase Agreement. Each sale of logs by the Company to Palco is made pursuant to a separate log purchase agreement that relates to the Company Timber covered by an approved THP and incorporates the provisions of the Master Purchase Agreement. Each such log purchase agreement provides for the sale to Palco of the logs harvested from the Company Timber covered by such THP and generally constitutes an exclusive agreement with respect to the timber covered thereby, subject to certain limited exceptions. However, the timing and amount of log purchases by Palco is affected by factors outside the control of the Company, including regulatory and environmental factors, the financial condition of Palco, and the supply and demand for lumber products (which, in turn, will be influenced by demand in the housing, construction and remodeling industries). See “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Financial Condition and Investing and Financing Activities” for recent developments regarding Palco’s financial condition.

The Company relies on Palco to provide a number of operational, management and related services not performed by its own employees with respect to the Company Timberlands pursuant to a services agreement (the “**Services Agreement**”). These services include protecting the Company Timberlands from fire, disease and insects; maintaining and rehabilitating roads on the Company Timberlands; building new roads to permit the harvesting of Company Timber; providing certain timber management services, such as replanting and reforestation, designed to supplement the natural regeneration of, and increase the amount of, Company Timber; assisting the Company to comply with all applicable environmental laws; advising and consulting with the Company regarding legislative matters; preparing and filing on behalf of the Company (at Palco’s cost) all pleadings and motions, and otherwise diligently pursuing, appeals of any denial and defense of any challenge to approval of any THP or the Environmental Plans or similar plan or permit and related matters; and otherwise furnishing all equipment, personnel and expertise not within the Company’s possession and reasonably necessary for the operation and maintenance of the Company Timberlands and the Company Timber.

Palco is required to provide all services under the Services Agreement in a manner consistent in all material respects with prudent business practices which are consistent with then-current applicable industry standards and are in compliance in all material respects with all applicable timber laws. The Company pays Palco a services fee (“**Services Fee**”) which is adjusted annually based on a specified government price index relating to wood products and reimburses Palco for the cost of constructing, rehabilitating and maintaining roads, and performing reforestation services, on the Company Timberlands. Certain of such reimbursable expenses vary in relation to the amount of timber to be harvested in any given period.

The Company provides certain services to Palco pursuant to an additional services agreement (the “**Additional Services Agreement**”). These services include (i) assisting Palco to operate, maintain and harvest its own timber properties, (ii) updating and providing access to the GIS with respect to information concerning Palco’s own timber properties and (iii) assisting Palco with its statutory and regulatory compliance. The Additional Services Agreement provides that Palco shall pay the Company a fee for such services equal to the Company’s actual cost of providing such services, as determined in accordance with generally accepted accounting principles.

The Palco Companies are also parties to a reciprocal rights agreement (the “**Reciprocal Rights Agreement**”) whereby, among other things, the parties have granted to each other certain reciprocal rights of egress and ingress through their respective properties in connection with the operation and maintenance of such properties and their respective businesses. In addition, Palco and the Company are parties to an environmental indemnification agreement (the “**Environmental Indemnification Agreement**”), pursuant to which Palco has agreed to indemnify the Company from and against certain present and future liabilities arising with respect to hazardous materials, hazardous materials contamination or disposal sites, or under environmental laws with respect to the Company Timberlands. In particular, Palco is liable with respect to any contamination which occurred on the Company Timberlands prior to the date of their transfer to the Company.

Harvesting Practices

This section contains statements which constitute “forward-looking statements” within the meaning of the PSLRA. See this section and “Business—General” above for cautionary information with respect to such forward-looking statements.

The ability to harvest Company Timber will depend in large part upon the ability to obtain regulatory approval of THPs prepared by the Company’s foresters. Prior to harvesting timber in California, companies are obligated to obtain the CDF’s approval of a detailed THP for the area to be harvested. A THP must be submitted by a Registered Professional Forester and is required to include information regarding the method of proposed timber operations for a specified area, whether the operations will have any adverse impact on the environment and, if so, the mitigation measures to be used to reduce any such impact. The CDF’s evaluation of THPs incorporates review and analysis of such THPs by several California and federal agencies and public comments received with respect to such THPs. The number of the Company’s approved THPs and the amount of timber covered by such THPs varies significantly from time to time, depending upon the timing of agency review and other factors. Timber covered by an approved THP is typically harvested within a one-year period from the date that harvesting first begins.

The Indenture requires the Company to use its best efforts (consistent with prudent business practices) to maintain a number of pending THPs which, together with THPs previously approved, would cover rights to harvest a quantity of Company Timber adequate to pay interest and principal amortization based on the Minimum Principal Amortization schedule (as set forth in the Indenture) for the Timber Notes for the next succeeding twelve month period. See Item 7. “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Financial Condition and Investing and Financing Activities” regarding delays by the North Coast Water Board in releasing already-approved THPs for harvest. Also see “—Regulatory and Environmental Factors” and Item 3. “Legal Proceedings—Timber Harvesting Litigation” for various legal, regulatory, environmental and other challenges being faced by the Company in connection with timber harvesting and other operations on the Company Timberlands.

The GIS maintained by the Company contains information regarding numerous aspects of the Company Timberlands, including timber type, site productivity class, wildlife and botanical data, geological information, roads, rivers and streams. Pursuant to the Services Agreement, Palco, to the extent necessary, assists the Company in updating, upgrading and improving the GIS and the other computer systems owned by the Company. By carefully monitoring and updating this data base and conducting field studies, the Company’s foresters are better able to develop detailed THPs addressing the various regulatory requirements. The Company also utilizes a Global Positioning System (“GPS”) which can provide precise location of geographic features through satellite positioning. Use of the GPS greatly enhances the quality and efficiency of the GIS data.

The Company employs a variety of well-accepted methods of selecting trees for harvest designed to achieve optimal growth and regeneration. These methods, referred to as “silvicultural systems” in the forestry profession, range from very light thinnings (aimed at enhancing the growth rate of retained trees) to clear cutting which results in the harvest of nearly all trees in an area (with the exception of sub-merchantable trees and trees retained for wildlife protection and future stand enhancement) and replacement with a new forest stand. In between are a number of varying levels of partial harvests which can be employed.

Employees

As of March 1, 2005, the Company employed 125 persons, 118 of whom were Registered Professional Foresters, geologists, wildlife and fisheries biologists, botanists or otherwise involved in the management of the Company Timberlands. None of the Company’s employees are covered by a collective bargaining agreement.

Principal Executive Offices

The principal executive offices of the Company are located at 125 Main Street, 2nd Floor, P.O. Box 712, Scotia, California 95565. The telephone number of the Company is (707) 764-2330.

Regulatory and Environmental Factors

This section contains statements which constitute “forward-looking statements” within the meaning of the PSLRA. See this section and “Business—General” above for cautionary information with respect to such forward-looking statements.

General

The Company’s business is subject to a variety of California and federal laws and regulations, as well as the HCP, dealing with timber harvesting practices, threatened and endangered species and habitat for such species, and air and water quality. Compliance with such laws and regulations also plays a significant role in the Company’s business. The California Forest Practice Act (the “**Forest Practice Act**”) and related regulations adopted by the California Board of Forestry and Fire Protection (the “**BOF**”) set forth detailed requirements for the conduct of timber harvesting operations in California. These requirements include the obligation of timber companies to obtain regulatory approval of detailed THPs containing information with respect to areas proposed to be harvested. See “—Harvesting Practices” above. California law also requires large timberland owners, including the Company, to demonstrate that their proposed timber operations constitute the maximum sustainable production of their timberlands over time. See “—Timber and Timberlands” above.

The federal Endangered Species Act (the “**ESA**”) and California Endangered Species Act (the “**CESA**”) provide in general for the protection and conservation of specifically listed wildlife and plants. These laws generally prohibit the take of certain species, except for specifically authorized incidental take pursuant to otherwise lawful activities which do not jeopardize the continued existence of the affected species and which are made in accordance with an approved habitat conservation plan and related incidental take permits. A habitat conservation plan, among other things, specifies measures to minimize and mitigate the potential impact of the incidental take of species and to monitor the effects of the activities covered by the plan. The Company is also subject to the California Environmental Quality Act (the “**CEQA**”), which provides for protection of the state’s air and water quality and wildlife, and the California Porter-Cologne Water Quality Control Act and federal Clean Water Act (the “**CWA**”), which require that the Company conduct its operations so as to reasonably protect the water quality of nearby rivers and streams. Compliance with such laws, regulations and judicial and administrative interpretations, together with other regulatory and environmental matters, have resulted in substantial restrictions on the scope and timing of timber operations on the Company Timberlands, increased operational costs significantly, and engendered continual litigation and other challenges to its operations. Moreover, the cash flows of the Company have recently been adversely affected by the failure of the North Coast Water Board to release for harvest THPs which have already been approved by the other government agencies that approve the Company’s THPs. See “—Water Quality” below.

Environmental Plans

The Environmental Plans, consisting of the HCP and the SYP, which cover the substantial portion of the timberlands of the Palco Companies, were approved by the federal and state governments upon the consummation of the Headwaters Agreement. In connection with approval of the Environmental Plans, incidental take permits (the “**Permits**”) were issued with respect to certain threatened, endangered and other species found on the timberlands covered by the Environmental Plans. The Permits were to cover the 50-year term of the HCP and allow incidental take of 17 different species covered by the HCP, including nine species which are found on the Company Timberlands that have been listed under the ESA and/or the CESA. On October 31, 2003, the Court hearing the *EPIC-SYP/Permits lawsuit* (as defined below), entered a judgment invalidating the SYP and the California Permits, and that decision is now on appeal. See Item 3. “Legal Proceedings—Timber Harvesting Litigation” for further information regarding this matter. The agreements which implement the Environmental Plans also provide for various remedies (including the issuance of written stop orders and liquidated damages) in the event of a breach by the Palco Companies of these agreements or the Environmental Plans.

Under the HCP, harvesting activities are prohibited or restricted on certain areas of the Company Timberlands. Some of these restrictions continue for the entire 50-year term of the HCP. For example, several areas (consisting of substantial quantities of timber, including old growth redwood and Douglas-fir timber) are designated as habitat conservation areas for the marbled murrelet, a coastal seabird, and certain other species. Harvesting in certain other areas of the Company Timberlands is currently prohibited while these areas are evaluated for the potential risk of landslide. Further, additional areas alongside streams have been designated as buffers, in which harvesting is prohibited or restricted, to protect aquatic and riparian habitat. Restrictions on harvest in streamside buffers and potential landslide prone acres may be adjusted up or down, subject to certain minimum and maximum buffers, based upon the ongoing watershed analysis process described below. The adaptive management process described below may also be used to modify most of these restrictions.

The first analysis of a watershed, Freshwater, was released in June 2001. This analysis was used by the Palco Companies and the government agencies to develop proposed harvesting prescriptions. Prescriptions for the Van Duzen watershed were approved in January 2004. Prescriptions for a third watershed (Lower Eel - Eel Delta) were approved in March 2004. The Freshwater, Van Duzen and Lower Eel prescriptions each resulted in a reduction in the size of the streamside buffers set forth in the Environmental Plans and also provide for geologic reviews in order to conduct any harvesting activities on potential landslide-prone areas. This effectively reduced both the size and operational restrictions in respect of landslide-prone areas. The analysis for a fourth watershed, Elk River, was submitted in mid-2004 for agency and public review, and prescriptions for Elk River have been developed and are undergoing review by the relevant agencies.

The HCP required the Palco Companies, together with the government agencies, to establish a schedule resulting in completion of the initial watershed analysis process for all covered lands within five years. However, due largely to the number of agencies involved and the depth and complexity of the analyses, the process has proven to require more time than originally anticipated. Accordingly, the Palco Companies have been working with the government agencies to establish an appropriate timeline and to streamline the process for implementation of watershed analysis on the remaining portions of Company Timberlands to ensure that such studies are time and cost efficient, and that such studies continue to provide scientific results necessary to evaluate potential changes to the harvesting restrictions on those lands. The Palco Companies have received an extension to March 2007 of the time in which the watershed analysis process must be completed. A proposed streamlined process is undergoing review by the relevant agencies.

The HCP imposes certain restrictions on the use of roads on the timberlands covered by the HCP during several months of the year and during periods of wet weather. However, some harvesting has been conducted during these periods, and the Company expects that in the future some harvesting will still be able to be conducted during these periods. An adaptive management change approved in 2003 for the road restrictions has improved the ability to construct and use roads on the Company Timberlands in ways that are consistent with the operational needs of the Palco Companies. The HCP also requires that 75 miles of roads be stormproofed (i.e., reconstructed to reduce sediment generation) on an annual basis and that certain other roads must be improved or repaired. The nature of this work requires that it be performed in the dry periods of the year. To date, over 450 miles of roads have been stormproofed.

The HCP contains an adaptive management provision, which both the state and federal governments have clarified will be implemented on a timely and efficient basis, and in a manner which will be both biologically and economically sound. This provision allows the Palco Companies to propose changes to many of the HCP prescriptions based on, among other things, economic considerations. The regulatory agencies have also clarified that in applying this adaptive management provision, to the extent the changes proposed do not result in the jeopardy of a particular species, the regulatory agencies will consider the practicality of the suggested changes, including the cost and economic feasibility and viability. The Palco Companies and the agencies have implemented various adaptive management changes related to wildlife and rare plants, and other changes relating to roads and streamside buffers. These adaptive management changes have increased the ability to conduct harvesting operations on the Company Timberlands and/or reduce operating costs while still meeting the obligations of the Environmental Plans.

Water Quality

Laws and regulations dealing with water quality are impacting the Palco Companies primarily in four areas: efforts by the federal Environmental Protection Agency (the “EPA”) and the North Coast Water Board to establish total maximum daily load limits (“TMDLs”) in watercourses that have been declared to be water quality impaired; actions by the North Coast Water Board to impose waste discharge reporting requirements in respect of watersheds on the Company Timberlands and in some cases, clean-up or prevention measures; actions by the North Coast Water Board during the THP approval process which impose certain operational requirements on individual THPs; and a directive of the North Coast Water Board to its staff to develop watershed-wide waste discharge requirements (“WWDRs”) for the Freshwater and Elk River watersheds.

Under the CWA, the EPA is required to establish TMDLs for relevant contaminants in watercourses that have been declared to be “water quality impaired.” The EPA and the North Coast Water Board are in the process of establishing TMDLs for many northern California rivers and certain of their tributaries, including nine watercourses that flow within the Company Timberlands. On the Company Timberlands, the relevant contaminant is simple sediment – dust, dirt and gravel – that is abundant in watercourses largely as a function of the area’s normally heavy rainfall and soil that erodes easily. The Company expects this process to continue into 2010. In December 1999, the EPA issued a report dealing with TMDLs on two of the nine watercourses. The agency indicated that the requirements under the HCP would significantly address the sediment issues that resulted in TMDL requirements for these watercourses. The North Coast Water Board has begun the process of establishing the TMDL requirements applicable to two other watercourses on the Company

Timberlands, with a targeted completion of 2006 for these two watercourses. The Company's scientists are actively working with North Coast Water Board staff to ensure these TMDLs recognize and incorporate the environmental protection measures of the HCP. The final TMDL requirements applicable to the Company Timberlands may require aquatic protection measures that are different from or in addition to those in the HCP or that result from the prescriptions to be developed pursuant to the watershed analysis process provided for in the HCP.

For each of the three winter periods since 2002, the North Coast Water Board has required the Palco Companies to submit "Reports of Waste Discharge" in order to conduct winter harvesting operations in the Freshwater and Elk River watersheds. After consideration of these reports, the North Coast Water Board imposed requirements on the Palco Companies to implement additional mitigation and erosion control practices in these watersheds for each of the three winter operating periods. The North Coast Water Board has also extended the requirements for certain mitigation and erosion control practices in three additional watersheds (Bear, Jordan and Stitz Creek). The Palco Companies and the North Coast Water Board are currently in discussions to determine what these measures will be. The requirements imposed to date by the North Coast Water Board have significantly increased operating costs; additional requirements imposed in the future could further increase costs and cause delays in THP approvals.

The North Coast Water Board has also issued a clean up and abatement order (the "**Elk River Order**") for the Elk River watershed, which is aimed at addressing existing sediment production sites through clean up actions. The North Coast Water Board has also initiated the process which could result in similar orders for the Freshwater and Bear Creek watersheds, and is contemplating similar actions for the Jordan and Stitz Creek watersheds. The Elk River Order has resulted in increased costs to the Palco Companies that could extend over a number of years. Additional orders in other watersheds (should they be issued), may also result in further cost increases. Palco's appeal of the Elk River Order to the State Water Resources Control Board (the "**State Water Board**") was denied. Palco has appealed the decision of the State Water Board in state court, but is holding such appeal in abeyance until resolution of the *THP No. 520 lawsuit* discussed below. See Item 3. "Legal Proceedings—Timber Harvesting Litigation."

In addition to the foregoing actions, the North Coast Water Board in December 2003 directed its staff to create WWDRs for the Freshwater and Elk River watersheds. As harvesting activities on the Company Timberlands cannot readily be moved between watersheds due to, among other things, historic harvest patterns, adjacency restrictions, and the age classes of trees, that action and the other matters described above could, in addition to the potential effects noted above, individually or collectively result in reduced harvest. In that regard, the staff of the North Coast Water Board has not yet formulated the required WWDRs for the Freshwater and Elk River watersheds, and has on several occasions postponed its projected date for their completion. As a result, the North Coast Water Board has failed to release for harvest a number of the Company's THPs that are located in the Freshwater and Elk River watersheds, even though these THPs have already been approved by the other government agencies which review its THPs and are in compliance with the HCP. The delay in receiving the release of these THPs has adversely impacted the cash flows of both the Company and Palco. Furthermore, it is likely that additional delays in the development of the Freshwater and Elk River WWDRs will occur, and such delays could have adverse impacts beyond those currently being experienced.

On February 25, 2005, the Executive Officer of the staff of the North Coast Water Board publicly announced approval of the release of additional THPs that would allow the harvest of up to 50% of the harvest limit established by the CDF for the Freshwater and Elk River watersheds. Since this announcement, the Company and Palco have continued their efforts with the North Coast Water Board staff to obtain the release of additional THPs and will make a presentation to the North Coast Water Board itself on March 16, 2005, in furtherance of these efforts. No assurance can be given that the efforts of the Company and Palco will be successful. See "Management's Discussion and Analysis of Financial Condition and Results of Operations—Financial Condition and Investing and Financing Activities" for further information regarding this matter, including extraordinary actions which Palco and the Company could be forced to take if their efforts are not successful.

California Senate Bill 810, which became effective January 1, 2004, provides regional water quality control boards with additional authority related to the approval of THPs on land within impaired watersheds. Under this law, a THP "may not be approved if the appropriate regional water quality control board finds, based on substantial evidence, that the timber operations proposed in the plan will result in a discharge into a watercourse that has been classified as impaired due to sediment...that causes or contributes, to a violation of the regional water quality control plan." The Company is uncertain of the operational and financial effects which will ultimately result from Senate Bill 810. While this provision has not yet been invoked in respect of the Company Timberlands, because substantially all rivers and waterbodies on the Company Timberlands are classified as sediment-impaired, implementation of this law could result in delays in obtaining approval of THPs, lower harvest levels and increased costs and additional protection measures beyond those contained in the HCP. Also see the description of the *THP No. 520 lawsuit* under Item 3. "Legal Proceedings—Timber Harvesting Litigation."

Impact of Future Legislation

Laws, regulations and related judicial decisions and administrative interpretations dealing with the Company's business are subject to change and new laws and regulations are frequently introduced concerning the California timber industry. From time to time, bills are introduced in the California legislature and the U.S. Congress which relate to the business of the Company, including the protection and acquisition of old growth and other timberlands, threatened and endangered species, environmental protection, air and water quality and the restriction, regulation and administration of timber harvesting practices. In addition to existing and possible new or modified statutory enactments, regulatory requirements and administrative and legal actions, the California timber industry remains subject to potential California or local ballot initiatives, and federal and California judicial decisions which could affect timber harvesting practices. It is not possible to assess the effect of such future legislative, judicial and administrative developments on the Company or its business.

Timber Operators License

In order to conduct logging operations, road building, stormproofing and certain other activities, a company must obtain a Timber Operator's License from the CDF. In December 2003, Palco was granted a Timber Operator's License for 2004-2005.

ITEM 2. PROPERTIES

A description of the Company's properties is included under Item 1. above.

ITEM 3. LEGAL PROCEEDINGS

This section contains statements which constitute "forward-looking statements" within the meaning of the PSLRA. See this section and "Business—General" above for cautionary information with respect to such forward-looking statements.

Timber Harvesting Litigation

A California state court has invalidated the SYP in connection with two lawsuits filed against the Palco Companies, as described below, which decision has been appealed. Other pending judicial and administrative proceedings could affect the Company's ability to implement the HCP, implement certain approved THPs, or carry out other operations, as discussed below. One such lawsuit was resolved during 2004 (see below). Certain of the remaining pending cases are described below. The Services Agreement requires Palco to prepare and file on behalf of the Company (at Palco's cost) all pleadings and motions, and otherwise diligently pursue, appeals of any denial, and defense of any challenge to approval, of any THP or the Environmental Plans or similar plan or permit and related matters.

In March 1999, an action entitled *Environmental Protection Information Association, Sierra Club v. California Department of Forestry and Fire Protection, California Department of Fish and Game, The Pacific Lumber Company, Scotia Pacific Company LLC, Salmon Creek Corporation, et al.* (the "**EPIC-SYP/Permits lawsuit**") was filed in Superior Court in Humboldt County, California (No. CV-990445). This action alleged, among other things, various violations of the CESA and the CEQA, and challenged, among other things, the validity and legality of the SYP and the California Permits. The plaintiffs sought, among other things, to set aside California's approval of the SYP and the California Permits and injunctive relief to prevent implementation of THPs approved in reliance upon these documents. In March 1999, a similar action, entitled *United Steelworkers of America, AFL-CIO, CLC, and Donald Kegley v. California Department of Forestry and Fire Protection, The Pacific Lumber Company, Scotia Pacific Company LLC and Salmon Creek Corporation* (the "**USWA lawsuit**"), was filed in Humboldt County Superior Court (No. CV-990452) challenging the validity and legality of the SYP. The *EPIC-SYP/Permits* and *USWA lawsuits* were consolidated for trial.

Following trial, the Court on October 31, 2003, entered a judgment invalidating the SYP and the California Permits due to several deficiencies in agency procedures and the failure of the Company and Palco to submit a complete and comprehensible SYP. The Court's decision, however, allowed for harvesting on THPs which rely on the SYP and were approved prior to July 23, 2003. The short-term effect of the ruling was to preclude approval, under the SYP, of a small number of THPs which were under review but had not been approved, and a minor reduction in 2003 harvesting that had been expected from these specific THPs. As a result of this case, the Company has since October 2002, when the Court issued a stay order preventing future reliance upon the SYP, been obtaining review and approval of new THPs under a procedure provided for in the forest practice rules that does not depend upon the SYP and the California Permits. The Company expects to follow this procedure until the Option A Plan is approved. See Item 1. "Business—Timber and Timberlands." Palco and the State of California have appealed the October 31, 2003, decision. In September 2004, the

Court granted the plaintiffs' request for reimbursement of an aggregate of \$5.8 million in attorneys fees and other expenses incurred in connection with these matters. Palco and the State of California have also appealed this decision.

In July 2001, an action entitled *Environmental Protection Information Center v. The Pacific Lumber Company, Scotia Pacific Company LLC* (the "**Bear Creek lawsuit**") was filed in the U.S. District Court for the Northern District of California (No. C01-2821), and later amended to add the EPA as a defendant. The lawsuit alleges that harvesting and other forestry activities under certain of the Company's approved THPs will result in discharges of pollutants in violation of the CWA. The plaintiff asserts that the CWA requires the defendants to obtain a permit from the North Coast Water Board before beginning timber harvesting and road construction activities and is seeking to enjoin these activities until such permit has been obtained. The plaintiff also seeks civil penalties of up to \$27,500 per day for the defendant's alleged continued violation of the CWA. On October 14, 2003, in connection with certain motions that had been filed, the Court upheld the validity of an EPA regulation which exempts harvesting and other forestry activities from certain discharge requirements.

Both state and federal agencies, along with the Company and other timber companies, have relied upon this regulation for more than 25 years. However, the Court interpreted the regulation in such a way as to narrow the forestry operations which are exempted, thereby limiting the regulation's applicability and subjecting culverts and ditches to permit requirements. This ruling has widespread implications for the timber industry in the United States. The case is not yet final as the trial has not yet been held, and there are many unresolved issues involving interpretation of the Court's decision and its application to actual operations. Should the decision ultimately become final and held to apply to all operations on the Company Timberlands, it may have some or all of the following effects: imposing additional permitting requirements, delaying approvals of THPs, increasing harvesting costs, and adding water protection measures beyond those contained in the HCP. Nonetheless, it is not likely that civil penalties will be awarded for operations that occurred prior to the Court's decision due to the historical reliance by timber companies on the regulation and the Company's belief that the requirements under the HCP are adequate to ensure that sediment and pollutants from harvesting activities on the Company Timberlands will not reach levels harmful to the environment. While the impact of a conclusion to this case that upholds the October 14, 2003, ruling may be adverse, the Company does not believe that such an outcome would have a material adverse impact on the Company's financial condition, results of operations or liquidity. Nevertheless, due to the numerous ways in which the Court's interpretation of the regulation could be applied to actual operations, there can be no assurance that this will be the case.

On November 20, 2002, two similar actions entitled *Alan Cook, et al. v. Gary Clark, et al.* (the "**Cook action**") and *Steve Cave, et al. v. Gary Clark, et al.* (the "**Cave action**") were filed in Humboldt County Superior Court (No.'s DR020718 and DR020719, respectively), which also name the Company and certain affiliates as defendants. On April 4, 2003, the plaintiffs in these actions filed amended complaints and served the defendants with notice of the actions. The *Cook action* alleges, among other things, that defendants' logging practices have contributed to an increase in flooding along Freshwater Creek (which runs through the Company Timberlands), resulting in personal injury and damage to the plaintiffs' properties. Plaintiffs further allege that in order to have THPs approved in the affected areas, the defendants engaged in certain unfair business practices. The plaintiffs seek, among other things, compensatory and exemplary damages, injunctive relief, and appointment of a receiver to ensure that the watershed is restored. The *Cave action* contains similar allegations and requests similar relief with respect to the Elk River watershed (a portion of which is contained on the Company Timberlands). The Company does not believe the resolution of these actions should result in a material adverse effect on its financial condition, results of operations or liquidity.

On February 25, 2003, the District Attorney of Humboldt County filed a civil suit entitled *The People of the State of California v. The Pacific Lumber Company, Scotia Pacific Holding Company and Salmon Creek Corporation* in the Humboldt County Superior Court (No. DR030070) (the "**Humboldt DA action**"). The suit was filed under California's unfair competition law and alleges that the Palco Companies used certain unfair business practices in connection with completion of the Headwaters Agreement, and that this resulted in the Palco Companies being able to harvest significantly more trees under the Environmental Plans than would have otherwise been the case. The suit sought a variety of remedies including a civil penalty of \$2,500 for each additional tree that has been or will be harvested due to this alleged increase in harvest, as well as restitution and an injunction in respect of the additional timber harvesting allegedly being conducted. In response to motions filed by the Company and Palco for sanctions and dismissal of this suit, on April 30, 2004, the Court issued a ruling requiring the District Attorney to amend his suit to prove that "extrinsic" fraud occurred. In addition, the Court eliminated the remedies being sought, other than for civil penalties, and suggested that it would be inappropriate to base civil penalties on the additional trees harvested. The Court also ruled that it declined "at this juncture" to impose sanctions on the District Attorney. The District Attorney subsequently amended his suit, and the Palco Companies later filed new motions to dismiss and for sanctions. After delays resulting from the District Attorney's efforts to disqualify the trial judge, and that judge's later self-disqualification, a hearing on these motions was held on February 18, 2005. The

Court rejected the sanctions motion, but has not yet ruled on the motion for dismissal. The Company believes that this suit is without merit and that the April 30, 2004, ruling diminished significantly its exposure with respect to this matter; however, there can be no assurance that the Palco Companies will ultimately prevail or that an adverse outcome would not be material to the Company's consolidated financial condition, results of operations or liquidity.

On December 17, 2003, an action entitled *Humboldt Watershed Council, et al. v. North Coast Regional Water Quality Board, et al.* (the "**HWC 2003 lawsuit**"), naming the Company and Palco as real parties in interest, was filed in the Humboldt County Superior Court (No. CV030961). The plaintiffs allege that the North Coast Water Board should have required waste discharge reports in respect of all timber harvesting activities in the Freshwater and Elk River watersheds, including those on the Company Timberlands. This action has been dismissed by the plaintiffs.

On November 4, 2004, an action entitled *Environmental Protection Information Center, et al. v. California Department of Forestry and Fire Protection, et al.* was filed in Humboldt County Superior Court (No. CV04-0809). This action sought an order staying or setting aside CDF's approval of six of the Company's THPs along the Van Duzen river, and an order requiring CDF to conduct further review and analysis of the six THPs and to refrain from reliance on information not made available for public review and comment. Following denial by the trial judge of the plaintiffs' request for injunctive relief and various appellate proceedings which resulted in harvesting operations being allowed to continue, the case was dismissed by the plaintiffs.

On November 2, 2004, an action entitled *Environmental Protection Information Center v. U.S. Fish & Wildlife Service, NOAA Fisheries, et al.* was filed in the U.S. District Court for the Northern District of California (No. C04-4647). This lawsuit alleges that two federal agencies have violated certain federal laws and related regulations in connection with their oversight of the HCP and the related incidental take permits issued by the federal government (the "**Federal Permits**"). The plaintiff also alleges that the Federal Permit for the northern spotted owl was unlawfully issued and that the Company and Palco violated California's unfair competition law by using false advertising and making misleading environmental claims. The plaintiff seeks a variety of remedies, including requiring additional actions by the federal agencies and precluding them from authorizing take of the northern spotted owl, an injunction requiring the Company and Palco to cease certain alleged unlawful activities, as well as restitution and remediation by the Company and Palco. Motions have been filed by the federal government and Palco seeking dismissal of substantial portions of this case, but a hearing date on this motion has not yet been set. The Company does not believe the resolution of this action should result in a material adverse effect on its financial condition, results of operations or liquidity.

On November 16, 2001, Palco filed a case entitled *The Pacific Lumber Company, et al. v. California State Water Resources Control Board* (No. DR010860) in Humboldt County Superior Court (the "**THP No. 520 lawsuit**") alleging that the State Water Board had no legal authority to impose mitigation measures that were requested by the staff of the North Coast Water Board during the THP review process and rejected by the CDF prior to approving the THP. When the staff of the North Coast Water Board attempted to impose these mitigation measures in spite of the CDF's decision, Palco appealed to the State Water Board, which imposed certain of the requested mitigation measures and rejected others. Palco filed the *THP No. 520 lawsuit* challenging the State Water Board's decision, and in January 2003, the Superior Court granted Palco's request for an order invalidating the imposition of these additional measures. The State Water Board appealed this decision, and on March 18, 2004 the appellate court reversed the decision of the Superior Court. The appellate court's decision could result in increased demands by the regional and state water boards and their staffs to impose controls and limitations upon timber harvesting on the Company Timberlands beyond those provided for by the Environmental Plans or could provide additional regulatory powers to the regional and state water boards and their staffs beyond those provided in Senate Bill 810. Palco filed a petition for review of the appellate court's decision by the California Supreme Court, which in June 2004 agreed to review the decision.

Other Litigation

The Company is involved in other claims, lawsuits and proceedings. While uncertainties are inherent in the final outcome of such matters and it is presently impossible to determine the actual costs that ultimately may be incurred or their effect on the Company, management believes that the resolution of such uncertainties and the incurrence of such costs should not result in material adverse effect on the Company's financial position, results of operations or liquidity.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Not applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Palco holds a 100% member interest in the Company. Accordingly, there is no established public trading market for the Company's equity securities. The Company did not make any cash distributions in respect of such interest during 2004.

ITEM 6. SELECTED FINANCIAL DATA

Not applicable.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following should be read in conjunction with the Company's Financial Statements and the Notes thereto appearing in Item 8.

Background

This section contains statements which constitute "forward-looking statements" within the meaning of the PSLRA. See Item 1. "Business—General" and below for cautionary information with respect to such forward-looking statements.

Regulatory and environmental matters as well as certain pending legal matters play a significant role in the Company's operations. See Item 1. "Business – Regulatory and Environmental Matters" and Note 7 for further discussion of these matters. Regulatory compliance and related litigation have caused and may continue to cause delays in approval of THPs and delays in harvesting on THPs once they are approved. This has resulted and may continue to result in a decline in harvest.

The Company expects that without the release of additional THPs, its cash flows from operations, together with funds available under its line of credit, will be inadequate to pay the entire amount of interest due on the July 20, 2005, payment date for its Timber Notes. Delays by the staff of the North Coast Water Board in formally releasing the THPs could further exacerbate matters. For further information, see "—Financial Condition and Investing and Financing Activities."

Results of Operations

This section contains statements which constitute "forward-looking statements" within the meaning of the PSLRA. See this section and Item 1. "Business—General" and below for cautionary information with respect to such forward-looking statements.

General

Mbfe Concept. The Mbfe concept was used in structuring the Timber Notes in order to take account of the relative values of the species and categories of timber included in the Company Timber. Under the Mbfe concept, one thousand board feet, net Scribner scale, of old growth redwood timber equates to one Mbfe. One thousand board feet, net Scribner scale, of each other species and category of timber included in the Company Timber was assigned a value in Mbfe equal to a fraction of an Mbfe. This fraction was generally determined by dividing the SBE Price applicable to such species and category for the first half of 1998 by the SBE Price applicable to old growth redwood for the first half of 1998.

Master Purchase Agreement Provisions. The Master Purchase Agreement contemplates that all sales of logs by the Company to Palco will be at fair market value (based on stumpage prices) for each species and category of timber. The Master Purchase Agreement provides that if the purchase price equals or exceeds the SBE Price and a structuring price set forth in a schedule to the Indenture, the purchase price is deemed to be at fair market value. If the purchase price equals or exceeds the SBE Price, but is less than the structuring price, then the Company is required to engage an independent forestry consultant to confirm that the purchase price reflects fair market value. Harvest Value Schedules setting forth the SBE Prices are published by the California State Board of Equalization twice a year for the purpose of computing a yield tax imposed on timber harvested between January 1 and June 30 and July 1 and December 31. Harvest Value Schedules are based on twenty-four months of actual log and timber sales that occur within nine specified timber value areas. These

sales are arms length transactions adjusted for time by indexing the prices (using log and lumber price trends) to a specific date, which is approximately sixty days prior to the effective date of the Harvest Value Schedules. SBE Prices may not necessarily be representative of actual prices that would be realized from unrelated parties at subsequent dates.

In January 2004, the State Board of Equalization adopted the new Harvest Value Schedule for the first half of 2004. The prices published in that schedule reflected a 12.7% increase in the SBE Price for small redwood logs and a 3.4% decrease for small Douglas-fir logs from the prices published for the second half of 2003.

In June 2004, the State Board of Equalization adopted the new Harvest Value Schedule for the second half of 2004. The prices published in that schedule reflected a 1.6% increase in the SBE Price for small redwood logs and a 14.3% increase for small Douglas-fir logs from the prices published for the first half of 2004.

In December 2004, the State Board of Equalization adopted the new Harvest Value Schedule for the first half of 2005. The prices published in that schedule reflected a 14.3% increase in the SBE Price for small redwood logs and a 12.5% increase for small Douglas-fir logs from the prices published for the second half of 2004.

Seasonality. Logging operations on the Company Timberlands are highly seasonal and have historically been significantly higher in the months of April through November than in the months of December through March. Management expects that the Company's revenues and cash flows will continue to be markedly seasonal because of the harvesting, road use, wet weather and other restrictions imposed by the HCP and regulation. As a result, a substantial majority of the future harvesting on the Company's timberlands can be expected to be concentrated during the period from June through October of each year.

Log Sales to Pacific Lumber

The following table presents price, volume and revenue amounts for the Company for the periods indicated (revenues in millions).

	Years Ended December 31,								
	2004			2003			2002		
	MBFEs	Average Price \$/MBFE	Revenues	MBFEs	Average Price \$/MBFE	Revenues	MBFEs	Average Price \$/MBFE	Revenues
Redwood	73,000	\$ 757	\$ 55.3	96,900	\$ 667	\$ 64.7	98,700	\$ 555	\$ 54.8
Douglas-fir . . .	21,200	505	10.7	18,100	446	8.1	23,300	394	9.2
Other	1,900	233	0.4	2,200	227	0.5	2,800	206	0.6
	<u>96,100</u>	<u>691</u>	<u>\$ 66.4</u>	<u>117,200</u>	<u>625</u>	<u>\$ 73.3</u>	<u>124,800</u>	<u>518</u>	<u>\$ 64.6</u>

The decrease in log sales for 2004 versus 2003 was due to an decrease in harvest volumes, offset somewhat by an increase in SBE prices. The decrease in harvest volumes was due largely to a decrease in the Company's available-to-log THPs during 2004 as a result of an increase in THPs subject to seasonal harvesting restrictions and increased THP approval time due to regulatory constraints. The Company's average realized price in 2004 increased by 11% over 2003.

The increase in log sales for 2003 versus 2002 was due to an increase in SBE Prices, offset somewhat by a decrease in harvest volumes. Overall, the Company's average realized price in 2003 increased by 21% over 2002. The decrease in harvest volumes was due largely to a decrease in the Company's available-to-log THPs during 2003 as a result of an increase in THPs subject to seasonal harvesting restrictions.

Operating Income and Net Loss

Operating income was \$34.4 million and \$47.0 million for the years ended December 31, 2004 and 2003, respectively. This decrease in operating income was principally due to the decrease in log sales revenue discussed above, and because 2003 included a gain on sale of timberlands of \$8.3 million. The decrease in log sales revenue was partially offset by lower expenses relating to THP preparation, winter road maintenance, insurance, employee benefits, and security costs, and a decrease in depletion, depreciation and amortization expense.

Net losses were \$19.8 million in 2004 compared to \$5.3 million in 2003, due to the lower operating income discussed above, and lower returns on investments (see also Note 3).

Operating income was \$47.0 million and \$30.2 million for the years ended December 31, 2003 and 2002, respectively. The increase in operating income was principally due to the increase in log sales discussed above, in addition to gains resulting from the sale of timberlands. The increases were partially offset by higher expenses relating to winter road maintenance, insurance, employee benefits, and security costs.

Net losses were \$5.3 million in 2003 compared to \$23.1 million in 2002, again principally due to the increase in log sales discussed above, gains resulting from the sale of timberlands and repurchases of debt, and to a lesser extent a decrease in interest expense. The favorable impact of these items was offset somewhat by a decrease in interest income realized from investments.

Financial Condition and Investing and Financing Activities

This section contains statements which constitute “forward-looking statements” within the meaning of the PSLRA. See this section and Item 1. “Business—General” for cautionary information with respect to such forward-looking statements.

Due to its highly leveraged condition, the Company is more sensitive than less leveraged companies to factors affecting its operations, including low log prices, governmental regulation and litigation affecting timber harvesting practices on the Company Timberlands (see Item 1. “Business—Regulatory and Environmental Factors,” Item 3. “Legal Proceedings—Timber Harvesting Litigation,” and Note 7), and general economic conditions. The Company’s cash flows from operations are significantly impacted by harvest volumes and log prices. The Master Purchase Agreement between the Company and Palco contemplates that all sales of logs by the Company to Palco will be at fair market value (based on stumpage prices) for each species and category of timber. See “—Results of Operations—Master Purchase Agreement” above for further information concerning this agreement.

Regulatory and environmental matters as well as certain pending legal matters play a significant role in the Company’s operations. See Item 1. “Business—Regulatory and Environmental Matters” and Note 7 for further discussion of these matters. Regulatory compliance and related litigation have caused and may continue to cause delays in approval of the Company’s THPs and delays in harvesting on its THPs once they are approved. This has resulted and may continue to result in a decline in harvest, an increase in the cost of logging operations, and increased costs related to timber harvest litigation.

As discussed in Item 1. “Business—Regulatory and Environmental Factors—Water Quality,” the North Coast Water Board is requiring the Company and Palco to apply various waste discharge reporting, mitigation and erosion control requirements in respect of timber harvesting activities in several watersheds, and may impose additional measures in the future. The North Coast Water Board in December 2003 directed its staff to formulate WWDRs for the Freshwater and Elk River watersheds. These requirements have not yet been formulated, and the North Coast Water Board has failed to release for harvest a number of THPs already approved by the other government agencies which review the Company’s THPs.

The failure of the North Coast Water Board to release these THPs for harvest has adversely impacted the cash flows of both the Company and Palco. The Company estimates that, without the prompt release of a substantial portion of these THPs, its cash flows from operations, together with funds available under the Line of Credit described below, will be inadequate to pay the entire amount of interest due on the July 20, 2005, Timber Notes payment date, which would constitute an event of default under the Indenture. Palco is in default under a \$30.0 million asset-based credit agreement with a bank (the **“Palco Credit Agreement”**) and estimates that, without the prompt release of a substantial portion of these THPs and necessary amendments to the Palco Credit Agreement, its cash flow from operations, together with funds available under the Palco Credit Agreement, will not provide sufficient liquidity to fund its current level of operations. The Company and Palco are continuing efforts to obtain the clearance of the North Coast Water Board of sufficient THPs. Palco has received a limited waiver of the default through March 18, 2005, from the lender under the Palco Credit Agreement and is seeking a more permanent solution to the default. There can be no assurance that these efforts with the North Coast Water Board and the lender under the Palco Credit Agreement will be successful.

In the event of a failure to pay interest on the Timber Notes in full when due, the trustee under the Indenture (the **“Trustee”**) or the holders of at least 25% of the aggregate outstanding principal amount of the Timber Notes may cause all principal, interest and other amounts related to the Timber Notes to become immediately due and payable. Also, in the event of a failure by the Company or Palco to perform its respective covenants or agreements under the Master Purchase Agreement or by Palco to perform its covenants or agreements under the Services Agreement that continues for 30 days after notice from the Trustee or the holders of 25% or more of the outstanding principal amount of the Timber Notes, the

holders of a majority of the aggregate outstanding principal amount of the Timber Notes may cause all principal, interest and other amounts related to the Timber Notes to become immediately due and payable. In the event of any such acceleration, the Agent under the Line of Credit may also accelerate the advances then outstanding thereunder. If such accelerations of Timber Notes and/or advances under the Line of Credit occur, the Trustee may exercise all rights under the Indenture and related security documents, including applying funds to pay accelerated amounts, and selling the Company Timberlands and other assets and using the proceeds thereof to pay accelerated amounts. In the event that the Company were to seek protection by filing under the U. S. Bankruptcy Code (the “**Bankruptcy Code**”), all amounts related to the Timber Notes would become immediately due and payable under the Indenture and all advances under the Line of Credit agreement could be accelerated. The foregoing rights of the Trustee and holders of Timber Notes are subject to the rights of the Company under the Bankruptcy Code.

Palco will require funds available under the Palco Credit Agreement in order to meet its working capital and capital expenditure requirements for the next year. Palco’s ability to meet such requirements could be adversely affected should Palco be unsuccessful in its efforts to obtain a more permanent solution to the default discussed above. Furthermore, Palco’s cash flows from operations may be adversely affected by diminished availability of logs from the Company, lower lumber prices, adverse weather conditions, pending legal, regulatory and environmental matters or increased funding requirements for its pension plan. See “—Background” above, as well as Note 7 for further discussion of the regulatory, environmental and legal matters affecting harvest levels and operating costs. Without an extension of the limited waiver of Palco’s default under the Palco Credit Agreement and a restructuring or replacement of that facility, Palco’s lender may take any of the following actions: reduce the amount of funds available to Palco for borrowing; refuse to make new loans to or issue new letters of credit for the benefit of Palco; declare any or all loans and other amounts owed under the agreement to be immediately due and payable; require Palco to cash collateralize all outstanding letters of credit; or pursue its other rights and remedies under the Palco Credit Agreement and related security agreements. The existence of the default also requires Palco to pay interest on amounts borrowed under the Palco Credit Agreement at a per annum rate 2% higher than the rate at which interest would be owed if no default existed. If any acceleration under the Palco Credit Agreement occurs, then the agent for the lender may exercise all rights under that agreement and related security documents, including selling Palco’s assets and using the proceeds thereof to pay the accelerated amounts. In the event that Palco were to seek protection by filing under the Bankruptcy Code, all loans and other amounts owed under the Palco Credit Agreement would become immediately due and payable. The foregoing rights of the lender under the Palco Credit Agreement are subject to the rights of Palco under the Bankruptcy Code.

In the event of a Company default or a Palco liquidity shortfall, whether resulting from a failure to extend the limited waiver past March 18, 2005, any action described above taken by Palco’s lender, or otherwise, the Company and Palco could be forced to take extraordinary actions, which may include: reducing expenditures by laying off employees and shutting down various operations; seeking other sources of liquidity, such as from asset sales; and seeking protection by filing under the Bankruptcy Code.

As discussed further below, on December 8, 2004, Standard & Poor’s Ratings Services (“**S&P**”) lowered Palco’s credit rating from B- to CCC+. As a result, Palco may be required to post a security deposit for workers compensation liabilities in July 2005, in an amount that has not been determined but that could be material to Palco’s liquidity, capital resources, and results of operations. If improvements in Palco’s liquidity, capital resources, and results of operations produce an upward revision in Palco’s credit rating, or if a waiver of this requirement is allowed under applicable law, then posting of such a security deposit may not be necessary. Palco management is in the process of evaluating the potential amount of such a security deposit, if required. There can be no assurance that such a security deposit will not be required or that, if required, the amount will not be material. Palco management is also evaluating whether other potential obligations or unanticipated adverse financial reports may result from the S&P credit action described above.

In addition, there can be no assurance that certain other pending legal, regulatory and environmental matters or future governmental regulations, legislation or judicial or administrative decisions, adverse weather conditions, or low log prices, will not have a material adverse effect on the Company’s financial condition, results of operations or liquidity. See Item 1. “Business—Regulatory and Environmental Factors,” Item 3. “Legal Proceedings” and Note 7 for further information regarding regulatory and legislative matters and legal proceedings.

The Company has an agreement with a group of banks which allows it to borrow up to one year’s interest on the Timber Notes (the “**Line of Credit**”). On June 20, 2003, the Line of Credit was extended to July 7, 2006. At or near the completion of such extension, the Company intends to request that the Line of Credit be extended for an additional period of not less than 364 days. If not extended, the Company may draw upon the full amount available. The amount drawn would be repayable in 12 semiannual installments on each note payment date (after the payment of certain other items, including the Aggregate Minimum Principal Amortization Amount, as defined, then due), commencing approximately two

and one-half years following the date of the draw. At December 31, 2004, the Company could have borrowed a maximum of \$57.1 million under the Line of Credit, and there was \$18.2 million outstanding under the facility. At January 31, 2005, the maximum availability under the Line of Credit was \$55.9 million, and there were \$45.9 million in borrowings outstanding under this facility.

On the note payment date in January 2004, the Company had \$4.1 million set aside in the note payment account to pay the \$27.2 million of interest due (net of \$2.0 million of additional interest due in respect of Timber Notes held by the Company). The funds available under the Line of Credit were used to pay the remaining amount of interest due. The Company repaid \$12.7 million of principal on the Timber Notes (an amount equal to Scheduled Amortization, as set forth in the Indenture (**“Scheduled Amortization;”** see Note 5)) using funds held in the Scheduled Amortization Reserve Account, a reserve account used to support principal payments on the Timber Notes (the **“SAR Account”**).

On the note payment date in July 2004, the Company used \$26.6 million (net of \$2.1 million of additional interest due in respect of Timber Notes held by the Company) of the funds available under the Line of Credit to pay the entire amount of interest due. The Company repaid \$4.5 million of principal on the Timber Notes (an amount equal to Scheduled Amortization) using funds held in the SAR Account.

On the note payment date in January 2005, the Company used \$26.3 million (net of \$2.2 million of additional interest due in respect of Timber Notes held by the Company) of the funds available under the Line of Credit to pay the entire \$26.3 million of interest due. The Company repaid \$10.6 million of principal on the Timber Notes (an amount equal to Scheduled Amortization) using funds held in the SAR Account.

With respect to the note payment date in July 2005, as a result of the matters discussed above, the Company may not have adequate funds available under the Line of Credit to pay the entire \$25.9 million of interest which will be due (net of \$2.0 million of additional interest which would be due in respect of Timber Notes held by the Company). Should this occur, the Company would be in default under the Indenture. Should a default not occur, the Company anticipates paying the \$5.0 million of principal on the Timber Notes (an amount equal to Scheduled Amortization) by using funds held in the SAR Account.

During 2004, \$10.9 million of funds from the SAR Account were used to repurchase \$11.0 million principal amount of Timber Notes, as permitted under the Indenture, resulting in a loss of \$0.3 million (net of unamortized deferred financing costs) on the repurchase of debt.

On January 27, 2005, S&P announced that it was placing its ratings on all classes of Timber Notes on CreditWatch with negative implications. S&P indicated that the CreditWatch placements reflected the Company's difficulties in obtaining approval from the North Coast Water Board to move forward with harvesting related to certain THPs. S&P also indicated that any additional delays in the ability to harvest on the Company Timberlands (and the inability to generate adequate revenue) could put into question whether the Company will have sufficient funds to make payment of full and timely interest on the July 2005 Timber Notes note payment date. In addition, on February 7, 2005, Moody's Investors Services lowered the ratings on all classes of the Timber Notes, reflecting concerns over continued weak cash flow from timber operations due to difficulties in obtaining approval of THPs. The rating on the Class A-1 Timber Notes was lowered from A1 to Baa2; the rating on the Class A-2 Timber Notes was lowered from A3 to Baa3; and the rating on the Class A-3 Timber Notes was lowered from Baa2 to Ba1. All three ratings will remain on review for possible downgrade, as Moody's noted that there is some risk that there will be insufficient cash to make full payment of interest on the July 2005 note payment date.

Off-Balance Sheet Arrangements

The Company does not have any off-balance sheet financing or unconsolidated special purpose entities. The Company does not utilize interest rate swaps, hedging arrangements or any other type of derivative instruments.

Contractual Obligations

The following table presents information with respect to the Company's contractual obligations as of December 31, 2004 (in millions).

Contractual Obligations	Payments Due by Period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Long-term debt obligations ⁽¹⁾	\$ 721.5	\$ 33.7	\$ 44.7	\$ 44.7	\$ 598.4
Interest due on long-term debt obligations ⁽²⁾	431.7	51.9	100.3	93.7	185.8
Total	<u>\$ 1,153.2</u>	<u>\$ 85.6</u>	<u>\$ 145.0</u>	<u>\$ 138.4</u>	<u>\$ 784.2</u>

⁽¹⁾ The table above reflects principal payments on the Timber Notes in accordance with Scheduled Amortization. If all payments of principal and interest are made in accordance with Scheduled Amortization, the scheduled maturity dates for the Class A-1, Class A-2, and Class A-3 Timber Notes are January 20, 2007, January 20, 2014, and January 20, 2014, respectively. If the Timber Notes were amortized in accordance with the minimum principal which the Company must pay on any note payment date, subject to available cash (as set forth in the Indenture ("Minimum Principal Amortization")), the final installments of principal would be paid on January 20, 2010, July 20, 2017, and July 20, 2028 for the Class A-1, Class A-2 and Class A-3 Timber Notes, respectively. See Note 5 for further discussion of the Timber Notes.

⁽²⁾ Interest due on long-term debt obligations is net of additional interest due in respect of Timber Notes held by the Company.

Critical Accounting Policies and Estimates

The discussion and analysis of the Company's financial condition and results of operations is based upon the Company's financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities. Estimates are based on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. The result of this process forms the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. The Company re-evaluates its estimates and judgments on a regular, ongoing basis. Actual results may differ from these estimates due to changed circumstances and conditions.

The following accounting policies and estimates are considered critical in light of the potentially material impact that the estimates, judgments and uncertainties affecting the application of these policies might have on the Company's reported financial information.

Loss Contingencies

The Company is involved in various claims, lawsuits and other proceedings discussed in Note 7. Such litigation involves uncertainty as to possible losses the Company may ultimately realize when one or more future events occur or fail to occur. The Company accrues and charges to income estimated losses from contingencies when it is probable (at the balance sheet date) that an asset has been impaired or liability incurred and the amount of loss can be reasonably estimated. Differences between estimates recorded and actual amounts determined in subsequent periods are treated as changes in accounting estimates (i.e., they are reflected in the financial statements in the period in which they are determined to be losses, with no retroactive restatement).

The Company estimates the probability of losses on legal contingencies based on the advice of internal and external counsel, the outcomes from similar litigation, the status of the lawsuits (including settlement initiatives), legislative and regulatory developments, and other factors. Risks and uncertainties are inherent with respect to the ultimate outcome of litigation. Palco provides services to the Company with respect to the defense of certain legal actions. The Services Agreement requires Palco to (at its cost) prepare and file on behalf of the Company all pleadings and motions, and otherwise diligently pursue, appeals of any denial, and defense of any challenge to approval, of any THP or the Environmental Plans or similar plan or permit and related matters. See Note 7 for further discussion of the Company's material legal contingencies.

Depletion

Depletion of the Company Timber and Company Timberlands is computed utilizing the units-of-production method based upon estimates of timber quantities. The depletion base is the total historical cost attributable to the Company

Timberlands. Depletion for the period is determined by multiplying the depletion base by the ratio of harvested units for the period over the total expected recoverable units. The Company's total for expected recoverable units is reviewed on a periodic basis and revised, if necessary. Any adjustments are made prospectively (i.e., the remaining undepleted cost is expensed over the remaining recoverable units).

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company is exposed to changes in interest rates under the Line of Credit, which was established in conjunction with the offering of the Timber Notes. This facility bears interest at either the prime interest rate or LIBOR plus a specified percentage point spread. As of December 31, 2004, there was \$18.2 million of borrowings outstanding under the Line of Credit. Based on the amount of borrowings outstanding under the Line of Credit during 2004, the impact of a 1% change in interest rates effective from the beginning of the year would not have been material to the Company's interest expense for 2004.

All of the Company's other debt is fixed-rate, and therefore, does not expose the Company to the risk of higher interest payments due to changes in market interest rates. The Company does not utilize interest rate swaps or similar hedging arrangements.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Managers and Member of
Scotia Pacific Company LLC:

We have audited the accompanying balance sheet of Scotia Pacific Company LLC (a Delaware limited liability company and a wholly owned subsidiary of The Pacific Lumber Company (“Palco”)) (the “Company”) as of December 31, 2004 and 2003, and the related statements of loss and of cash flows for each of the three years in the period ended December 31, 2004. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such financial statements referred to above present fairly, in all material respects, the financial position of Scotia Pacific Company LLC as of December 31, 2004 and 2003, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2004, in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1 to the financial statements, at December 31, 2004, the cash flows of the Company and Palco, have been adversely affected by delays in obtaining regulatory approvals to harvest timber. Palco was in default under an asset-based credit agreement with a bank. The Company has estimated that without additional timber harvest plan approvals, the Company will be unable to pay the entire amount of interest due in July, 2005, on its timber notes. Such failure to pay interest would constitute an event of default under the indenture governing the timber notes. The difficulties of the Company and Palco in meeting their loan agreement covenants and paying the interest on the timber notes raise substantial doubts about the Company’s ability to continue as a going concern. Further, the difficulties of the Company raises substantial doubt about the Company’s ability to realize its timber related assets and discharge its timber related liabilities in the normal course of business and to continue as a going concern. The financial statements do not include any adjustments that might result from the outcome of these uncertainties.

DELOITTE & TOUCHE LLP

Portland, Oregon
March 14, 2005

SCOTIA PACIFIC COMPANY LLC

BALANCE SHEET
(In millions of dollars)

	<u>December 31,</u>	
	<u>2004</u>	<u>2003</u>
Assets		
Current assets:		
Cash, cash equivalents, and restricted cash	\$ 0.5	\$ 0.9
Marketable securities, including restricted amounts of \$25.1 and \$24.6, respectively . . .	28.2	26.5
Receivables from Palco	3.3	4.9
Prepaid timber harvesting costs	6.2	5.6
Other current assets	1.1	1.2
Total current assets	<u>39.3</u>	<u>39.1</u>
Timber and timberlands, net of accumulated depletion of \$290.1 and \$282.2, respectively	225.1	230.0
Property and equipment, net of accumulated depreciation of \$19.6 and \$17.1, respectively	28.1	25.7
Deferred financing costs, net	11.8	13.5
Restricted cash, marketable securities and other investments	9.2	35.4
Intangible assets	3.8	4.7
	<u>\$ 317.3</u>	<u>\$ 348.4</u>
Liabilities and Member Deficit		
Current liabilities:		
Payables to Palco	\$ 1.5	\$ 0.9
Accrued interest	23.8	24.5
Other accrued liabilities	1.9	2.4
Short-term borrowings and current maturities of long-term debt, excluding \$9.5 and \$4.6, respectively, of repurchased Timber Notes held in the SAR Account	33.8	17.6
Total current liabilities	<u>61.0</u>	<u>45.4</u>
Long-term debt, less current maturities and excluding \$55.4 and \$54.3, respectively, of repurchased Timber Notes held in the SAR Account	687.7	713.9
Other noncurrent liabilities	0.2	0.3
Total liabilities	<u>748.9</u>	<u>759.6</u>
Contingencies (See Note 7)		
Member deficit	(431.6)	(411.2)
	<u>\$ 317.3</u>	<u>\$ 348.4</u>

The accompanying notes are an integral part of these financial statements.

SCOTIA PACIFIC COMPANY LLC

STATEMENT OF LOSS
(In millions of dollars)

	Years Ended December 31,		
	2004	2003	2002
Log sales to Palco	\$ 66.4	\$ 73.3	\$ 64.6
Operating expenses:			
General and administrative	20.6	21.5	20.6
Depletion, depreciation and amortization	11.4	13.1	13.8
Gain on sales of timberlands and other assets	—	(8.3)	—
	<u>32.0</u>	<u>26.3</u>	<u>34.4</u>
Operating income	<u>34.4</u>	<u>47.0</u>	<u>30.2</u>
Other income (expense):			
Gain (loss) on repurchases of debt	(0.3)	0.7	—
Interest and other income	1.3	3.9	4.6
Interest expense	<u>(55.2)</u>	<u>(56.9)</u>	<u>(57.9)</u>
	<u>(54.2)</u>	<u>(52.3)</u>	<u>(53.3)</u>
Net loss	<u>\$ (19.8)</u>	<u>\$ (5.3)</u>	<u>\$ (23.1)</u>

The accompanying notes are an integral part of these financial statements.

SCOTIA PACIFIC COMPANY LLC

STATEMENT OF CASH FLOWS
(In millions of dollars)

	<u>Years Ended December 31,</u>		
	<u>2004</u>	<u>2003</u>	<u>2002</u>
Cash flows from operating activities:			
Net loss	\$ (19.8)	\$ (5.3)	\$ (23.1)
Adjustments to reconcile net loss to net cash used for operating activities:			
Gain on sales of timberlands and other assets	—	(8.3)	—
Loss (gain) on repurchases of debt	0.3	(0.7)	—
Depletion, depreciation and amortization	11.4	13.1	13.8
Amortization of deferred financing costs	1.3	1.4	1.4
Increase (decrease) in cash resulting from changes in:			
Receivables from Palco	1.6	(2.3)	1.2
Prepaid timber harvesting costs	(0.6)	1.7	0.6
Payables to Palco	0.6	0.1	(0.2)
Accrued interest	(0.7)	(0.4)	(0.4)
Other accrued liabilities	(0.5)	0.3	(0.8)
Other	(0.2)	(0.4)	(0.3)
Net cash used for operating activities	<u>(6.6)</u>	<u>(0.8)</u>	<u>(7.8)</u>
Cash flows from investing activities:			
Proceeds from sales of assets	—	11.4	—
Capital expenditures	<u>(7.8)</u>	<u>(7.7)</u>	<u>(7.2)</u>
Net cash provided by (used for) investing activities	<u>(7.8)</u>	<u>3.7</u>	<u>(7.2)</u>
Cash flows from financing activities:			
Principal payments on Timber Notes and other timber related debt	(17.2)	(16.6)	(15.0)
Net changes in restricted cash and marketable securities	13.0	13.8	59.2
Borrowings under line of credit agreement, net	18.2	—	—
Member distributions	<u>—</u>	<u>—</u>	<u>(29.4)</u>
Net cash provided by (used for) financing activities	<u>14.0</u>	<u>(2.8)</u>	<u>14.8</u>
Net decrease in cash, cash equivalents, and restricted cash	(0.4)	0.1	(0.2)
Cash, cash equivalents and restricted cash at beginning of period	0.9	0.8	1.0
Cash, cash equivalents and restricted cash at end of period	<u>\$ 0.5</u>	<u>\$ 0.9</u>	<u>\$ 0.8</u>
Supplemental disclosure of non-cash investing and financing activities:			
Transfer of marketable debt securities from held-to-maturity to available-for-sale	\$ —	\$ 11.9	\$ —
Repurchases of debt using restricted cash	10.9	5.4	—
Supplemental disclosure of cash flow information:			
Interest paid	\$ 54.6	\$ 56.0	\$ 57.0

The accompanying notes are an integral part of these financial statements.

SCOTIA PACIFIC COMPANY LLC
NOTES TO FINANCIAL STATEMENTS

1. Basis of Presentation and Summary of Significant Accounting Policies

Basis of Presentation

Scotia Pacific Company LLC (the “**Company**”) is a Delaware limited liability company wholly owned by The Pacific Lumber Company (“**Palco**”), which is a wholly owned subsidiary of MAXXAM Group Inc. (“**MGI**”). MGI is an indirect wholly owned subsidiary of MAXXAM Inc. (“**MAXXAM**”). The Company is a special purpose limited liability company organized in May 1998 to facilitate the offering of the 6.55% Class A-1, 7.11% Class A-2 and 7.71% Class A-3 Timber Collateralized Notes due 2028 of the Company (the “**Timber Notes**”). Concurrent with the closing in July 1998 (the “**Closing**”) of the Timber Notes offering, Scotia Pacific Holding Company (“**Scotia Pacific**”) was merged into the Company and Palco and Salmon Creek LLC, a wholly owned subsidiary of Palco (“**Salmon Creek**,” and together with the Company and Palco; the “**Palco Companies**”), transferred to the Company approximately 13,500 acres of timberlands and the timber and related timber harvesting rights (but not the underlying land) with respect to an additional approximately 19,700 acres of timberlands. The Company in turn transferred to Palco the timber and related timber harvesting rights (but not the underlying land) with respect to approximately 1,400 acres of timberlands. The merger and the transfers have been accounted for as a reorganization of entities under common control which requires the Company to record the assets, liabilities and results of operations of Scotia Pacific after giving effect to the transfers as well as the assets, liabilities and results of operations acquired from Palco and Salmon Creek at their respective historical cost. Accordingly, the Company is the successor entity to all of Scotia Pacific’s historical operations (exclusive of the assets transferred to Palco) and to the historical operations attributable to the timberlands and timber and related timber harvesting rights acquired from Palco and Salmon Creek.

Consistent with the Company’s purpose and pursuant to the terms of the indenture governing the Timber Notes (the “**Indenture**”), the Company is obligated to set aside each month a portion of the funds it receives from the sale of logs to Palco sufficient to make the specified payments of principal and interest on the Timber Notes computed in accordance with the Indenture and to retain a sufficient amount to pay operating expenses and capital improvements.

Use of Estimates and Assumptions

The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires the use of estimates and assumptions that affect (i) the reported amounts of assets and liabilities, (ii) the disclosure of contingent assets and liabilities known to exist as of the date the financial statements are published and (iii) the reported amount of revenues and expenses recognized during each period presented. The Company reviews all significant estimates affecting its financial statements on a recurring basis and records the effect of any necessary adjustments prior to filing the financial statements with the Securities and Exchange Commission. Adjustments made to estimates often relate to improved information not previously available. Uncertainties regarding such estimates and related assumptions are inherent in the preparation of the Company’s financial statements; accordingly, actual results could differ from these estimates. Risks and uncertainties are inherent with respect to the ultimate outcome of the litigation discussed in Note 7. The results of a resolution of such uncertainties could have a material effect on the Company’s financial position, results of operations and liquidity.

Liquidity and Cash Resources

Regulatory and environmental matters as well as certain pending legal matters play a significant role in the Company’s operations. See Note 7 for discussion of these matters. Regulatory compliance and related litigation have caused and may continue to cause delays in approval of the Company’s timber harvesting plans (“**THPs**”) and delays in harvesting on its THPs once they are approved. This has resulted and may continue to result in a decline in harvest, an increase in the cost of logging operations, and increased costs related to timber harvest litigation.

As discussed in Note 7, the California North Coast Regional Water Quality Control Board (the “**North Coast Water Board**”) is requiring the Company and Palco to apply various waste discharge reporting, mitigation and erosion control requirements in respect of timber harvesting activities in several watersheds, and may impose additional measures in the future. The North Coast Water Board in December 2003 directed its staff to formulate watershed-wide waste discharge

requirements (“**WWDRs**”) for the Freshwater and Elk River watersheds. These requirements have not yet been formulated, and the North Coast Water Board has failed to release for harvest a number of THPs already approved by the other government agencies which review the Company’s THPs.

The failure of the North Coast Water Board to release these THPs for harvest has adversely impacted the cash flows of both the Company and Palco. The Company estimates that, without the prompt release of a substantial portion of these THPs, its cash flows from operations, together with funds available under an agreement (the “**Line of Credit**”) with a group of banks pursuant to which the Company may borrow to pay interest on the Timber Notes will be inadequate to pay the entire amount of interest due on the July 20, 2005, Timber Note payment date, which would constitute an event of default under the Indenture. Palco is in default under a \$30.0 million asset-based credit agreement with a bank (the “**Palco Credit Agreement**”) and estimates that, without the prompt release of a substantial portion of these THPs and necessary amendments to the Palco Credit Agreement, its cash flow from operations, together with funds available under the Palco Credit Agreement, will not provide sufficient liquidity to fund its current level of operations. The Company and Palco are continuing efforts to obtain the clearance of the North Coast Water Board of sufficient THPs. Palco has received a limited waiver of the default through March 18, 2005, from the lender under the Palco Credit Agreement and is seeking a more permanent solution to the default. There can be no assurance that these efforts with the North Coast Water Board and the lender under the Palco Credit Agreement will be successful.

In the event of a failure to pay interest on the Timber Notes in full when due, the trustee under the Indenture (the “**Trustee**”) or the holders of at least 25% of the aggregate outstanding principal amount of the Timber Notes may cause all principal, interest and other amounts related to the Timber Notes to become immediately due and payable. Also, in the event of a failure by the Company or Palco to perform its respective covenants or agreements under the master purchase agreement (the “**Master Purchase Agreement**”) which governs the sale to Palco of logs harvested from the timberlands owned by the Company (the “**Company Timberlands**”) or by Palco to perform its covenants or agreements under a services agreement between the Company and Palco (the “**Services Agreement**”) relating to the provision of operational, management and related services not performed by the Company’s own employees with respect to the Company Timberlands, which failure continues for 30 days after notice from the Trustee or the holders of 25% or more of the outstanding principal amount of the Timber Notes, the holders of a majority of the aggregate outstanding principal amount of the Timber Notes may cause all principal, interest and other amounts related to the Timber Notes to become immediately due and payable. In the event of any such acceleration, the Agent under the Line of Credit may also accelerate the advances then outstanding thereunder. If such accelerations of Timber Notes and/or advances under the Line of Credit occur, the Trustee may exercise all rights under the Indenture and related security documents, including applying funds to pay accelerated amounts, and selling the Company Timberlands and other assets and using the proceeds thereof to pay accelerated amounts. In the event that the Company were to seek protection by filing under the U. S. Bankruptcy Code (the “**Bankruptcy Code**”), all amounts related to the Timber Notes would become immediately due and payable under the Indenture and all advances under the Line of Credit agreement could be accelerated. The foregoing rights of the Trustee and holders of Timber Notes are subject to the rights of the Company under the Bankruptcy Code.

Palco will require funds available under the Palco Credit Agreement in order to meet its working capital and capital expenditure requirements for the next year. Palco’s ability to meet such requirements could be adversely affected should Palco be unsuccessful in its efforts to obtain a more permanent solution to the default discussed above. Furthermore, Palco’s cash flows from operations may be adversely affected by diminished availability of logs from the Company, lower lumber prices, adverse weather conditions, pending legal, regulatory and environmental matters or increased funding requirements for its pension plan. See Note 7 for further discussion of the regulatory, environmental and legal matters affecting harvest levels and operating costs. Without an extension of the limited waiver of Palco’s default under the Palco Credit Agreement and a restructuring or replacement of that facility, Palco’s lender may take any of the following actions: reduce the amount of funds available to Palco for borrowing; refuse to make new loans to or issue new letters of credit for the benefit of Palco; declare any or all loans and other amounts owed under the agreement to be immediately due and payable; require Palco to cash collateralize all outstanding letters of credit; or pursue its other rights and remedies under the Palco Credit Agreement and related security agreements. The existence of the default also requires Palco to pay interest on amounts borrowed under the Palco Credit Agreement at a per annum rate 2% higher than the rate at which interest would be owed if no default existed. If any acceleration under the Palco Credit Agreement occurs, then the agent for the lender may exercise all rights under that agreement and related security documents, including selling Palco’s assets and using the proceeds thereof to pay the accelerated amounts. In the event that Palco were to seek protection by filing under the Bankruptcy Code, all loans and other amounts owed under the Palco Credit Agreement would become immediately due and payable. The foregoing rights of the lender under the Palco Credit Agreement are subject to the rights of Palco under the Bankruptcy Code.

In the event of a Company default or a Palco liquidity shortfall, whether resulting from a failure to extend the limited waiver past March 18, 2005, any action described above taken by Palco's lender, or otherwise, the Company and Palco could be forced to take extraordinary actions, which may include: reducing expenditures by laying off employees and shutting down various operations; seeking other sources of liquidity, such as from asset sales; and seeking protection by filing under the Bankruptcy Code.

As discussed further below, on December 8, 2004, Standard & Poor's Ratings Services ("S&P") lowered Palco's credit rating from B- to CCC+. As a result, Palco may be required to post a security deposit for workers compensation liabilities in July 2005, in an amount that has not been determined but that could be material to Palco's liquidity, capital resources, and results of operations. If improvements in Palco's liquidity, capital resources, and results of operations produce an upward revision in Palco's credit rating, or if a waiver of this requirement is allowed under applicable law, then posting of such a security deposit may not be necessary. Palco management is in the process of evaluating the potential amount of such a security deposit, if required. There can be no assurance that such a security deposit will not be required or that, if required, the amount will not be material. Palco management is also evaluating whether other potential obligations or unanticipated adverse financial reports may result from the S&P credit action described above.

In addition, there can be no assurance that certain other pending legal, regulatory and environmental matters or future governmental regulations, legislation or judicial or administrative decisions, adverse weather conditions, or low lumber or log prices, will not have a material adverse effect on the Company's financial condition, results of operations or liquidity. See Note 7 for further information regarding regulatory and legislative matters and legal proceedings relating to the Company's operations.

Summary of Significant Accounting Policies

Concentrations of Credit Risk

Cash equivalents and marketable securities are invested primarily in short to medium-term investment grade debt instruments as well as other types of corporate and government debt obligations. The Company mitigates its concentration of credit risk with respect to these investments by generally purchasing investment grade products (ratings of A1/P1 short-term or at least BBB/Baa3 long-term). No more than 5% is invested in the same issue.

Securities Available-for-Sale

Management determines the appropriate classification of investment securities at the time of purchase and re-evaluates such designation as of each balance sheet date. Available-for-sale securities are stated at fair market value, with the unrealized gains and losses reported in other comprehensive loss, a separate component of member deficit. Realized gains and losses and declines in value judged to be other-than-temporary on available-for-sale securities are included in interest and other income. Interest and dividends on securities classified as available-for-sale are also included in interest and other income. The cost of securities sold is determined using the first-in, first-out method. The fair value of substantially all securities is determined by quoted market prices. The fair value of marketable debt securities includes accrued interest.

Prepaid Timber Harvesting Costs and Other Assets

Direct costs associated with the preparation of THPs are capitalized and reflected in prepaid timber harvesting costs on the balance sheet. These costs are expensed as the timber covered by the related THP is harvested. Costs associated with the preparation of the Company's sustained yield plan ("SYP") and the Company's multi-species habitat conservation plan ("HCP") were capitalized and are reflected in other assets. These costs are being amortized on a straight-line basis over 10 years.

The carrying amounts of the Company's SYP and HCP intangible assets are as follows (in millions):

	December 31,		
	2004	2003	2002
SYP/HCP	\$ 8.3	\$ 8.3	\$ 8.3
Less: Accumulated amortization	(4.5)	(3.6)	(2.7)
	<u>\$ 3.8</u>	<u>\$ 4.7</u>	<u>\$ 5.6</u>

The Company evaluates its intangible assets with finite lives for impairment whenever events or changes in circumstances indicate that such assets might be impaired. The remaining useful life of intangible assets with finite lives are evaluated annually to determine whether events or circumstances warrant changes in the estimated useful lives of such assets.

Amortization of intangible assets for the years ended December 31, 2004, 2003 and 2002, was \$0.9 million per year. The estimated amortization expense for 2005 through 2008 is \$0.9 million per year, and \$0.2 million for 2009. Estimated amortization will change if events or circumstances warrant the revision of estimated useful lives.

Property and Equipment

Property and equipment is stated at cost, net of accumulated depreciation. Depreciation is computed principally utilizing the straight-line method at rates based upon the estimated useful lives of the various classes of assets. The carrying value of property and equipment is assessed when events and circumstances indicate that an impairment might exist. The existence of an impairment is determined by comparing the net carrying value of the asset to its estimated undiscounted future cash flows. A probability-weighted approach is used for situations in which alternative courses of action to recover the carrying amount of long-lived assets are under consideration or a range is estimated for the amount of possible future cash flows. If an impairment is present, assets are written down to fair value and a loss is recognized.

Timber and Timberlands

Timber and timberlands were recorded at the historical cost of Scotia Pacific, Palco and Salmon Creek. Depletion is computed utilizing the units-of-production method based upon estimates of timber quantities. Periodically, the Company will review its depletion rates considering currently estimated merchantable timber and will adjust the depletion rates prospectively.

Revenue Recognition

Revenues from the sale of logs are recorded when the legal ownership and the risk of loss passes to the buyer, which is at the time each log is measured.

Deferred Financing Costs

Costs incurred to obtain debt financing are deferred and amortized, generally on a straight-line basis, over the estimated term of the related borrowing. The amortization of deferred financing costs is included in interest expense on the Statement of Loss.

Legal Contingencies

The Company is currently involved in various claims and proceedings which are reviewed for potential financial exposure on a regular basis. If the potential loss from any claim or legal proceeding is considered probable and is reasonably estimable as of the balance sheet date, a liability is accrued. The Company estimates the probability of losses on legal contingencies based on the advice of internal and external counsel, the outcomes from similar litigation, the status of the lawsuits (including settlement initiatives), legislative developments, and other factors. See Note 7 for a description of the Company's material legal proceedings.

Income Taxes

The Company, a single member limited liability company, has not made an election to be treated as an association and, therefore, is disregarded as a separate taxable entity solely for income tax purposes. The Company is treated as a division of Palco for tax purposes. All income taxes with respect to the Company are shown on Palco's financial statements, and all deferred income tax assets and deferred income tax liabilities with respect to the Company at December 31, 2004 and 2003, are reflected in Palco's financial statements.

Reclassifications

Certain reclassifications have been made to the prior years' financial statements to be consistent with the current year's presentation. The reclassification of prior year balances includes \$4.3 million of auction rate securities which were reclassified from cash and cash equivalents to marketable securities in the Balance Sheet.

2. Significant Acquisitions and Dispositions

In November 2003, Palco and the Company sold approximately 681 acres of timberlands within an area known as the Grizzly Creek grove. The Company received \$8.2 million in cash, resulting in a gain of \$7.5 million.

3. Cash, Cash Equivalents, Marketable Securities and Other Investments

Cash equivalents consist of highly liquid money market instruments with original maturities of three months or less. As of December 31, 2004 and 2003, carrying amounts of the Company's cash equivalents approximated fair value.

The following is a summary of available-for-sale securities (in millions):

	December 31,	
	2004	2003
Cost	\$ 15.9	\$ 38.8
Estimated fair value	15.8	39.6

During 2003, marketable debt securities classified as held-to-maturity were sold to generate funds for principal payments on long-term debt and for the repurchase of Timber Notes. The amortized cost of the securities sold was \$11.7 million, and the realized gain on the sale of such securities was \$0.1 million. There were no such sales during 2004.

At December 31, 2003, management re-evaluated the classification of its investment securities in accordance with Statement of Financial Accounting Standard No. 115, "Accounting for Certain Investments in Debt and Equity Securities" ("SFAS No. 115"). As a result, marketable debt securities previously classified as held-to-maturity were transferred to the available-for-sale category. The amortized cost and fair value of the transferred securities was \$11.8 million and \$11.9 million, respectively, at December 31, 2003. There were no investments classified as held-to-maturity at December 31, 2004 and 2003.

Interest and other income includes gross realized gains and losses on sales of available-for-sale securities for each of the three years in the period ended December 31, 2004, as follows (in millions):

	Years Ended December 31,		
	2004	2003	2002
Gross realized gains	\$ 0.4	\$ 0.3	\$ 2.4
Gross realized losses	(0.2)	—	(0.1)

The net adjustment to unrealized holding gains (losses) on available-for-sale securities included as a separate component of member deficit totaled \$(0.6) million, \$(0.4) million, and \$(0.7) million in 2004, 2003, and 2002, respectively. Gross unrealized losses on investment securities at December 31, 2004, were not material, and investment securities in an unrealized loss position for twelve months or more totaled \$3.6 million.

Available-for-sale securities generally consist of U.S. corporate debt securities, U.S. treasury obligations, and other debt securities with contractual maturities ranging from one year to five years. Held-to-maturity securities during 2003 consisted of U.S. government agency obligations with contractual maturities ranging from one year to five years. Amounts invested in auction rate securities are classified as marketable securities.

Restricted Cash, Cash Equivalents, Marketable Securities and Other Investments

Cash, marketable securities and other investments include the following amounts which are restricted under the terms of the Company's debt agreements (in millions):

	December 31,	
	2004	2003
Current assets:		
Restricted cash and cash equivalents	\$ —	\$ 0.2
Marketable securities, restricted:		
Amounts held in SAR Account	25.1	22.2
Other amounts restricted under the Indenture	—	1.2
	<u>25.1</u>	<u>23.6</u>
Long-term restricted cash, cash equivalents, marketable securities and other investments:		
Amounts held in SAR Account	68.5	87.7
Other amounts restricted under the Indenture	2.5	2.5
Less: Amounts attributable to Timber Notes held in		
SAR Account	(61.8)	(54.8)
	<u>9.2</u>	<u>35.4</u>
Total restricted cash, cash equivalents, marketable securities and other investments	<u>\$ 34.3</u>	<u>\$ 59.0</u>

Amounts in the Scheduled Amortization Reserve Account, which is a reserve account used to support principal payments on the Timber Notes (the “**SAR Account**”) are being held by the trustee under the Indenture to support principal payments on the Timber Notes. See Note 5 for further discussion on the SAR Account.

Other Investments

Funds held in the SAR Account include interests in several limited partnerships which invest in diversified portfolios of common stocks and equity securities, in addition to exchange traded options, futures, forward foreign currency contracts, and other arbitrage opportunities. The Company’s ownership percentages in these partnerships are not significant. As of December 31, 2004 and 2003, these investments amounted to \$16.0 million and \$15.5 million, respectively.

Interest and other income includes income from the Company’s investment in these partnerships for each of the three years in the period ended December 31, 2004, as follows (in millions):

	Years Ended December 31,		
	2004	2003	2002
Earnings from investments in partnerships	\$ 0.5	\$ 2.2	\$ 0.6

4. Property and Equipment

The major classes of property and equipment are as follows (dollar amounts in millions):

	Estimated Useful Lives	December 31,	
		2004	2003
Logging roads	15 years	\$ 45.4	\$ 40.8
Other	5 – 15 years	2.3	2.0
		47.7	42.8
Less: accumulated depreciation		(19.6)	(17.1)
		\$ 28.1	\$ 25.7

Depreciation expense for the years ended December 31, 2004, 2003 and 2002 was \$2.6 million, \$2.2 million and \$2.0 million, respectively.

5. Debt

In July 1998, the Company issued \$867.2 million aggregate principal amount of Timber Notes, which are due at various times through July 20, 2028. The Timber Notes are senior secured obligations of the Company and do not constitute obligations of, and are not guaranteed by, Palco or any other person. The Timber Notes were issued in three classes: Class A-1 Timber Notes aggregating \$160.7 million, Class A-2 Timber Notes aggregating \$243.2 million and Class A-3 Timber Notes aggregating \$463.3 million. Pursuant to the terms of the Indenture, the Company is permitted to incur up to \$75.0 million at any one time of non-recourse indebtedness secured by purchase money mortgages to acquire additional timberlands, an unspecified amount of Additional Timber Notes (as defined in the Indenture) provided certain conditions are met, and certain other debt on a limited basis. The Company is not permitted to incur any other indebtedness for borrowed money. The Timber Notes and the Line of Credit are secured by a lien on (i) the Company’s timber, timberlands and timber rights, (ii) certain contract rights and other assets, (iii) the proceeds of the foregoing and (iv) funds held by the Trustee in various accounts relating to the Timber Notes. Amounts payable on the Timber Notes are paid semi-annually, generally on January 20 and July 20 of each year (each, a “**Note Payment Date**”).

In the event of a failure to pay interest in full, the Trustee and/or the holders of at least 25% of the Timber Notes may declare all amounts related to the Timber Notes immediately due and payable. If, upon demand, the Company fails to pay such amounts, then the Trustee may exercise all rights under the Indenture and the Deed of Trust, including instituting a court proceeding and / or exercising the note holders’ rights to sell the Company’s timberlands and use the proceeds from such a sale to pay all amounts due under the Indenture. In the event that the Company seeks protection by filing under the United States Bankruptcy Code, then all amounts related to the Timber Notes would become immediately due and payable.

The Timber Notes were structured to link, to the extent of cash available, the deemed depletion of the Company’s timber (through the harvest and sale of logs) to the required amortization of the Timber Notes. The required amount of amortization on any Note Payment Date is determined by various mathematical formulas set forth in the Indenture. “**Scheduled Amortization**” of the Timber Notes represents the amount of principal which the Company must pay through

each Note Payment Date in order to avoid payment of prepayment or deficiency premiums, as described below. The Scheduled Maturity Dates for the Class A-1 and Class A-2 Timber Notes, which are January 20, 2007 and January 20, 2014, respectively, represent the Note Payment Dates on which the Company will pay the final installment of principal if all payments of principal are made in accordance with Scheduled Amortization. The Scheduled Maturity Date for the Class A-3 Timber Notes is also January 20, 2014. The Scheduled Amortization for the Class A-3 Timber Notes does not include any principal amortization prior to their Scheduled Maturity Date. If the Class A-3 Timber Notes are not paid in full on or before their Scheduled Maturity Date, a Cash Retention Event (as defined in the Indenture) will occur as a result of which 75% of all Excess Funds (as defined in the Indenture) will be deposited in the note payment account (“**Payment Account**”) until all classes of Timber Notes are paid in full, generally in sequential order.

“**Minimum Principal Amortization**” of the Timber Notes represents the minimum amount of principal which the Company must pay (on a cumulative basis and subject to available cash) on such Class, to the extent of available funds on deposit in the Payment Account, through any Note Payment Date. If the Timber Notes were amortized in accordance with Minimum Principal Amortization, the final installments of principal would be paid on January 20, 2010, July 20, 2017 and July 20, 2028 for the Class A-1, Class A-2 and Class A-3 Timber Notes, respectively.

In November 1999, \$169.0 million of funds from the sale of 5,600 acres of timberlands (the “**Headwaters Timberlands**”) were contributed to the Company and set aside in the SAR Account. Amounts in the SAR Account are part of the collateral securing the Timber Notes and are used to make principal payments to the extent that cash flows from operations are insufficient to pay Scheduled Amortization on the Class A-1 and Class A-2 Timber Notes. In addition, during the six years beginning January 20, 2014, any amounts then remaining in the SAR Account would be used to amortize the Class A-3 Timber Notes. Funds may from time to time be released to the Company from the SAR Account if the amount in the account at that time exceeds the Required Scheduled Amortization Reserve Balance (as defined and set forth in the Indenture). If the balance in the SAR Account falls below the Required Scheduled Amortization Reserve Balance, up to 50% of any Remaining Funds (funds that could otherwise be released to the Company free of the lien securing the Timber Notes) are required to be used on each monthly deposit date to replenish the SAR Account. As of December 31, 2004, the amount held in the SAR Account was \$27.6 million below the Required Scheduled Amortization Reserve Balance.

If the principal of the Timber Notes is paid in advance of Scheduled Amortization, the Company must pay a prepayment premium on such accelerated payment. The prepayment premium on any Note Payment Date is equal to the excess, if any, of (a) the sum of (i) the present value of the prepayment amount (discounted from the date(s) that the prepayment amount would otherwise have been paid under the Scheduled Amortization to the Note Payment Date) plus (ii) the sum of the present values of the amounts of interest that would have accrued thereafter with respect to the prepayment amount over (b) the amount of the prepayment. The present value is computed using a “Reinvestment Yield” (as defined in the Indenture) which is comparable to the yield of like term U.S. Treasury securities plus 0.50% per annum. In addition to possible prepayments under the mathematical formulas set forth in the Indenture, the Company has the right to cause additional prepayments of principal to be made on any Note Payment Date.

If the principal of the Timber Notes is paid later than as provided for under Scheduled Amortization, the Company will pay a deficiency premium on such deficient amount. The deficiency premium payable on any Note Payment Date equals an amount of interest on the amount of the deficient principal amount from the previous Note Payment Date to the current Note Payment Date at 1.50% per annum.

The amount attributable to Timber Notes held in the SAR Account of \$61.8 million at December 31, 2004, reflected in Note 3 represents the amount paid to acquire \$64.9 million principal amount of Timber Notes. The following table presents (in millions) the amortization of the Timber Notes outstanding (excluding \$61.8 million face value of repurchased Timber Notes held in the SAR Account) based on Minimum Principal Amortization and Scheduled Amortization (subject to available cash):

	Minimum Principal Amortization⁽¹⁾	Scheduled Amortization⁽²⁾
Years Ending December 31:		
2005	\$ —	\$ 15.6
2006	—	18.2
2007	14.3	26.5
2008	12.9	25.1
2009	8.7	19.6
Thereafter	667.4	598.3
	<u>\$ 703.3</u>	<u>\$ 703.3</u>

⁽¹⁾ Minimum Principal Amortization amounts are net of additional amounts due in respect of Timber Notes held by the Company and also reflect payments made in accordance with Scheduled Amortization in excess of Minimum Principal Amortization amounts.

⁽²⁾ Scheduled Amortization amounts are net of additional amounts due in respect of Timber Notes held by the Company.

As of December 31, 2004 and 2003, the estimated fair value of debt, including current maturities, was \$591.2 million and \$562.5 million, respectively. The estimated fair value of debt is determined based on the quoted market price for the Timber Notes. The Timber Notes are thinly traded financial instruments; accordingly, their market price at any balance sheet date may not be representative of the price which would be derived from a more active market.

The Company has entered into a line of credit (the **“Line of Credit”**) with a group of banks pursuant to which the Company may borrow to pay interest on the Timber Notes. The maximum amount the Company may borrow is equal to one year’s interest on the aggregate outstanding principal balance of the Timber Notes (the **“Required Liquidity Amount”**). On June 20, 2003, the Line of Credit was extended to July 7, 2006. At or near the completion of such extension, the Company intends to request that the Line of Credit be extended for an additional period of not less than 364 days. If not extended, the Company may draw upon the full amount available. The amount drawn would be repayable in 12 semiannual installments on each note payment date (after the payment of certain other items, including the Aggregate Minimum Principal Amortization Amount, as defined, then due), commencing approximately two and one-half years following the date of the draw. At December 31, 2004, the Company could have borrowed a maximum of \$57.1 million under the Line of Credit, and there was \$18.2 million outstanding under this facility. At January 31, 2005, the maximum availability under the Line of Credit was \$55.9 million, and there were \$45.9 million in borrowings outstanding under this facility. As discussed further in Note 1, the Company is experiencing financial difficulties due to the failure of the North Coast Water Board to release for harvest already-approved THPs. As a result, the Company may not have adequate availability under the Line of Credit to pay the entire amount of interest due on the Timber Notes in July 2005. Such a failure to pay interest would constitute an event of default under the Indenture.

On the note payment date in January 2004, the Company had \$4.1 million set aside in the note payment account to pay the \$27.2 million of interest due (net of \$2.0 million of additional interest due in respect of Timber Notes held by the Company). The funds available under the Line of Credit were used to pay the remaining \$26.6 million of interest due. The Company repaid \$12.7 million of principal on the Timber Notes (an amount equal to Scheduled Amortization) using funds held in the SAR Account).

On the note payment date in July 2004, the Company used \$26.6 million (net of \$2.1 million of additional interest due in respect of Timber Notes held by the Company) of the funds available under the Line of Credit to pay the entire \$26.6 million of interest due. The Company repaid \$4.5 million of principal on the Timber Notes (an amount equal to Scheduled Amortization) using funds held in the SAR Account.

On the note payment date in January 2005, the Company used \$26.3 million (net of \$2.2 million of additional interest due in respect of Timber Notes held by the Company) of the funds available under the Line of Credit to pay the entire \$26.3 million of interest due. The Company repaid \$10.6 million of principal on the Timber Notes (an amount equal to Scheduled Amortization) using funds held in the SAR Account.

During 2004, \$10.9 million of funds from the SAR Account were used to repurchase \$11.0 million principal amount of Timber Notes, as permitted under the Indenture, resulting in a loss of \$0.3 million (net of unamortized deferred financing costs) on the repurchase of debt.

6. Related Party Transactions

At the time of the Closing, the Company and Palco entered into the “**Master Purchase Agreement**” which governs all log sales by the Company to Palco. Substantially all of the Company’s revenues have been and are expected to continue to be derived from the sale of logs to Palco. The harvested logs are purchased by Palco (i.e., title passes and the obligation to make payment therefor is incurred) at the time each log is measured. The Master Purchase Agreement contemplates that all sales of logs by the Company to Palco will be at fair market value (based on stumpage prices) for each species and category of timber. The Master Purchase Agreement provides that if the purchase price equals or exceeds the applicable stumpage price for each species of timber and category thereof (the “**SBE Price**”) as set forth in the most recent schedule published periodically by the California State Board of Equalization (the “**Harvest Value Schedule**”) and a structuring price set forth in a schedule to the Indenture, the purchase price is deemed to be at fair market value. If the purchase price equals or exceeds the SBE Price, but is less than the structuring price, then the Company is required to engage an independent forestry consultant to confirm that the purchase price reflects fair market value.

SBE Prices improved in 2004 versus 2003. In December 2004, the State Board of Equalization adopted the new Harvest Value Schedule for the first half of 2005. The prices published in that schedule reflected a 14.3% increase in the SBE Price for small redwood logs and a 12.5% increase for small Douglas-fir logs from the prices published for the second half of 2004.

The Company and Palco also entered into a services agreement at the time of Closing (the “**Services Agreement**”), pursuant to which Palco provides a variety of operational, management and related services in respect of the Company’s timber properties not provided by the Company employees, including reforestation, fire protection and road maintenance, rehabilitation and construction. In addition, Palco provides services to the Company with respect to the defense of any legal challenges. The Company pays a Services Fee (as defined in the Services Agreement) in an initial amount of \$107,000 per month adjusted annually based on a designated producer price index and reimburses Palco for the cost of constructing, rehabilitating and maintaining roads and performing reforestation services. For the years ended December 31, 2004, 2003, and 2002, \$10.9 million, \$10.6 million, and \$10.4 million, respectively, was recorded under the Services Agreement.

7. Contingencies

Regulatory and environmental matters play a significant role in the Company’s business, which is subject to a variety of California and federal laws and regulations, as well as the HCP, dealing with timber harvesting practices, threatened and endangered species and habitat for such species, and air and water quality.

Environmental Plans

From March 1999 until October 2002, the Company prepared THPs in accordance with the SYP. The SYP was intended to comply with regulations of the California Department of Forestry and Fire Protection (“**CDF**”) requiring timber companies to project timber growth and harvest on their timberlands over a 100-year planning period and to demonstrate sustained yield, i.e. that their projected average annual harvest for any decade within a 100-year planning period would not exceed the average annual growth level during the last decade of the 100-year planning period. The forest practice rules allow companies which do not have a sustained yield plan to follow an alternative procedure to document compliance with the sustained yield requirements. As discussed below, on October 31, 2003, the Court hearing the *EPIC-SYP/Permits lawsuit* (as defined below) entered a judgment invalidating the SYP and the incidental take permits issued by California pursuant to the HCP (“**California Permits**”), and that decision is now on appeal. As a result of an earlier stay order issued in this case, the Company has since October 2002 been obtaining review and approval of THPs under this alternative procedure and expects to follow this procedure until approval of its pending Option A Plan (“**Option A Plan**”), which is an alternative to a sustained yield plan.

The HCP and related incidental take permits issued by the federal government pursuant to the HCP (“**Federal Permits**”) allow incidental “take” of certain federally listed species located on the Company’s timberlands so long as there is no “jeopardy” to the continued existence of such species. The HCP identifies the measures to be instituted in order to minimize and mitigate the anticipated level of take to the greatest extent practicable. The HCP and Federal Permits have terms of 50 years. Since the consummation of the Headwaters Agreement in March 1999, there has been a significant amount of work required in connection with the implementation of the HCP and SYP (together, the “**Environmental Plans**”), and this work is expected to continue for several more years.

Water Quality

Laws and regulations dealing with water quality are impacting the Company primarily in four areas: efforts by the federal Environmental Protection Agency (“**EPA**”) and the North Coast Water Board to establish total maximum daily load limits (“**TMDLs**”) in watercourses that have been declared to be water quality impaired; actions by the North Coast Water Board to impose waste discharge reporting requirements in respect of watersheds on the Company’s timberlands and in some cases, clean-up or prevention measures; actions by the North Coast Water Board during the THP approval process which impose certain operational requirements on individual THPs; and a directive of the North Coast Water Board to its staff to develop WWDRs for the Freshwater and Elk River watersheds.

Under the federal Clean Water Act (“**CWA**”), the EPA is required to establish TMDLs in watercourses that have been declared to be “water quality impaired.” The EPA and the North Coast Water Board are in the process of establishing TMDLs for many northern California rivers and certain of their tributaries, including nine watercourses that flow within the Company’s timberlands. The Company expects this process to continue into 2010. The final TMDL requirements applicable to the Company’s timberlands may require aquatic protection measures that are different from or in addition to those in the HCP or that result from the prescriptions to be developed pursuant to the watershed analysis process provided for in the HCP.

Beginning with the 2002-2003 winter operating period, the Company and Palco has been required to submit “Reports of Waste Discharge” to the North Coast Water Board each year in order to conduct winter harvesting activities in the Elk River and Freshwater watersheds. After consideration of these reports, the North Coast Water Board imposed requirements on the Company and Palco to implement additional mitigation and erosion control practices in these watersheds for these winter operating periods. In addition, the North Coast Water Board has extended the requirements for certain mitigation and erosion control practices to the Bear, Jordan and Stitz watersheds. Reporting and mitigation requirements imposed by the North Coast Water Board have significantly increased operating costs and may in the future further increase costs or cause delays in THP approvals.

The North Coast Water Board has also issued a clean up and abatement order (the “**Elk River Order**”) which is aimed at addressing existing sediment production sites in the Elk River watershed through clean up actions. The North Coast Water Board has also initiated the process which could result in similar orders for the Freshwater and Bear Creek watersheds, and is contemplating similar actions for the Jordan and Stitz Creek watersheds. The Elk River Order has resulted in increased costs to the Palco Companies that could extend over a number of years. Additional orders in other watersheds (should they be issued) may also result in further cost increases. Palco’s appeal of the Elk River Order to the State Water Resources Control Board (the “**State Water Board**”) was denied. Palco has appealed the decision of the State Water Board, but is holding such appeal in abeyance until resolution of the *THP No. 520 lawsuit* discussed below.

In addition to the foregoing actions, the North Coast Water Board in December 2003 directed its staff to create WWDRs for the Freshwater and Elk River watersheds. As harvesting activities on the Company’s timberlands cannot readily be moved between watersheds due to, among other things, historic harvest patterns, adjacency restrictions, and the age classes of trees, that action and the other matters described above could, in addition to the potential effects noted above, individually or collectively result in reduced harvest. In that regard, the staff of the North Coast Water Board has not yet formulated the required WWDRs for the Freshwater and Elk River watersheds. As a result, the North Coast Water Board has failed to release for harvest a number of the Company’s THPs which have already been approved by the other government agencies which review the Company’s THPs. The unreleased THPs represent a significant portion of the Company’s planned harvest for the first half of 2005. The ongoing delay in receiving the approval of the North Coast Water Board has adversely impacted the cash flows of both the Company and Palco. See Note 1 for further discussion.

Effective January 1, 2004, California Senate Bill 810 provides regional water quality control boards with additional authority related to the approval of THPs on land within impaired watersheds. The Company is uncertain of the operational and financial effects which will ultimately result from Senate Bill 810; however, because substantially all rivers and waterbodies on the Company’s timberlands are classified as sediment-impaired, implementation of this law could result in delays in obtaining approvals of THPs, lower harvest levels and increased costs and additional protection measures beyond those contained in the HCP. Also see the description of the *THP No. 520 lawsuit* below.

Timber Harvest Litigation

A California state court has invalidated the SYP in connection with two lawsuits filed against the Palco Companies, as described below, which decision has been appealed. Other judicial and administrative proceedings, as discussed below, could affect the Company's ability to implement the HCP, implement certain approved THPs, or carry out other operations, as discussed below. The Services Agreement requires Palco to prepare and file on behalf of the Company (at Palco's cost) all pleadings and motions, and otherwise diligently pursue, appeals of any denial, and defense of any challenge to approval, of any THP or the Environmental Plans or similar plan or permit and related matters.

In March 1999, an action entitled *Environmental Protection Information Association, Sierra Club v. California Department of Forestry and Fire Protection, California Department of Fish and Game, The Pacific Lumber Company, Scotia Pacific Company LLC, Salmon Creek Corporation, et al.* (the "**EPIC-SYP/Permits lawsuit**") was filed. This action alleged, among other things, various violations of the CESA and the California Environmental Quality Act, and challenged, among other things, the validity and legality of the SYP and the California Permits. The plaintiffs sought, among other things, to set aside California's approval of the SYP and the California Permits and injunctive relief to prevent implementation of THPs approved in reliance upon these documents. In March 1999, a similar action, entitled *United Steelworkers of America, AFL-CIO, CLC, and Donald Kegley v. California Department of Forestry and Fire Protection, The Pacific Lumber Company, Scotia Pacific Company LLC and Salmon Creek Corporation* (the "**USWA lawsuit**"), was filed challenging the validity and legality of the SYP. The *EPIC-SYP/Permits* and *USWA lawsuits* were consolidated for trial.

Following trial, the Court on October 31, 2003, entered a judgment invalidating the SYP and the California Permits due to several deficiencies in agency procedures and the failure of the Company and Palco to submit a complete and comprehensible SYP. The Court's decision, however, allowed for harvesting on THPs which rely on the SYP and were approved prior to July 23, 2003. The short-term effect of the ruling was to preclude approval, under the SYP, of a small number of THPs which were under review but had not been approved, and a minor reduction in 2003 harvesting that had been expected from these specific THPs. As a result of this case, the Company has since October 2002, when the Court issued a stay order preventing future reliance upon the SYP, been obtaining review and approval of new THPs under a procedure provided for in the forest practice rules that does not depend upon the SYP and the California Permits. The Company expects to follow this procedure until the Option A Plan is approved. Palco and the State of California have appealed the October 31, 2003, decision. In September 2004, the Court granted the plaintiffs' request for reimbursement of an aggregate of \$5.8 million in attorneys fees and other expenses incurred in connection with these matters. Palco and the State of California have also appealed this decision.

In July 2001, an action entitled *Environmental Protection Information Center v. The Pacific Lumber Company, Scotia Pacific Company LLC* (the "**Bear Creek lawsuit**") was filed and later amended to add the EPA as a defendant. The lawsuit alleges that harvesting and other forestry activities under certain of the Company's approved THPs will result in discharges of pollutants in violation of the CWA. The plaintiff asserts that the CWA requires the defendants to obtain a permit from the North Coast Water Board before beginning timber harvesting and road construction activities and is seeking to enjoin these activities until such permit has been obtained. The plaintiff also seeks civil penalties of up to \$27,500 per day for the defendant's alleged continued violation of the CWA. On October 14, 2003, in connection with certain motions that had been filed, the Court upheld the validity of an EPA regulation which exempts harvesting and other forestry activities from certain discharge requirements.

Both state and federal agencies, along with the Company and other timber companies, have relied upon this regulation for more than 25 years. However, the Court interpreted the regulation in such a way as to narrow the forestry operations which are exempted, thereby limiting the regulation's applicability and subjecting culverts and ditches to permit requirements. This ruling has widespread implications for the timber industry in the United States. The case is not yet final as the trial has not yet been held, and there are many unresolved issues involving interpretation of the Court's decision and its application to actual operations. Should the decision ultimately become final and held to apply to all operations on the Company's timberlands, it may have some or all of the following effects: imposing additional permitting requirements, delaying approvals of THPs, increasing harvesting costs, and adding water protection measures beyond those contained in the HCP. Nonetheless, it is not likely that civil penalties will be awarded for operations that occurred prior to the Court's decision due to the historical reliance by timber companies on the regulation and the Company's belief that the requirements under the HCP are adequate to ensure that sediment and pollutants from harvesting activities on the Company's timberlands will not reach levels harmful to the environment. While the impact of a conclusion to this case that upholds the October 14, 2003, ruling may be adverse, the Company does not believe that such an outcome would have a material adverse impact on the Company's financial condition, results of operations or liquidity. Nevertheless, due to the numerous ways in which the Court's interpretation of the regulation could be applied to actual operations, there can be no assurance that this will be the case.

On November 20, 2002, two similar actions entitled *Alan Cook, et al. v. Gary Clark, et al.* (the “**Cook action**”) and *Steve Cave, et al. v. Gary Clark, et al.* (the “**Cave action**”) were filed, which also name the Company and certain affiliates as defendants. On April 4, 2003, the plaintiffs in these actions filed amended complaints and served the defendants with notice of the actions. The *Cook action* alleges, among other things, that defendants’ logging practices have contributed to an increase in flooding along Freshwater Creek (which runs through the Company’s timberlands), resulting in personal injury and damage to the plaintiffs’ properties. Plaintiffs further allege that in order to have THPs approved in the affected areas, the defendants engaged in certain unfair business practices. The plaintiffs seek, among other things, compensatory and exemplary damages, injunctive relief, and appointment of a receiver to ensure that the watershed is restored. The *Cave action* contains similar allegations and requests similar relief with respect to the Elk River watershed (a portion of which is contained on the Company’s timberlands). The Company does not believe the resolution of these actions should result in a material adverse effect on its financial condition, results of operations or liquidity.

On February 25, 2003, the District Attorney of Humboldt County filed a civil suit entitled *The People of the State of California v. The Pacific Lumber Company, Scotia Pacific Holding Company and Salmon Creek Corporation* (the “**Humboldt DA action**”). The suit was filed under California’s unfair competition law and alleges that the Palco Companies used certain unfair business practices in connection with completion of the Headwaters Agreement, and that this resulted in these companies being able to harvest significantly more trees under the Environmental Plans than would have otherwise been the case. The suit sought a variety of remedies including a civil penalty of \$2,500 for each additional tree that has been or will be harvested due to this alleged increase in harvest, as well as restitution and an injunction in respect of the additional timber harvesting allegedly being conducted. In response to motions filed by the Company and Palco for sanctions and dismissal of this suit, on April 30, 2004, the Court issued a ruling requiring the District Attorney to amend his suit to prove that “extrinsic” fraud occurred. In addition, the Court eliminated the remedies being sought, other than for civil penalties, and suggested that it would be inappropriate to base civil penalties on the additional trees harvested. The Court also ruled that it declined “at this juncture” to impose sanctions on the District Attorney. The District Attorney subsequently amended his suit, and the Palco Companies later filed new motions to dismiss and for sanctions. After delays resulting from the District Attorney’s efforts to disqualify the trial judge, and that judge’s later self-disqualification, a hearing on these motions was held on February 18, 2005. The Court rejected the sanctions motion, but has not yet ruled on the motion for dismissal. The Company believes that this suit is without merit and that the April 30, 2004, ruling diminished significantly its exposure with respect to this matter; however, there can be no assurance that the Palco Companies will ultimately prevail or that an adverse outcome would not be material to the Company’s financial condition, results of operations or liquidity.

On December 17, 2003, an action entitled *Humboldt Watershed Council, et al. v. North Coast Regional Water Quality Board, et al.* (the “**HWC 2003 lawsuit**”), naming the Company and Palco as real parties in interest, was filed. The plaintiffs allege that the North Coast Water Board should have required waste discharge reports in respect of all timber harvesting activities in the Freshwater and Elk River watersheds, including those on the Company Timberlands. This action has been dismissed by the plaintiffs.

On November 2, 2004, an action entitled *Environmental Protection Information Center v. U.S. Fish & Wildlife Service, NOAA Fisheries, et al.* (the “**EPIC-USFWS/NOAA lawsuit**”) was filed. This lawsuit alleges that two federal agencies have violated certain federal laws and related regulations in connection with their oversight of the HCP and Federal Permits. The plaintiff also alleges that the Federal Permit for the northern spotted owl was unlawfully issued and that the Company and Palco violated California’s unfair competition law by using false advertising and making misleading environmental claims. The plaintiff seeks a variety of remedies including requiring additional actions by the federal agencies and precluding them from authorizing take of the northern spotted owl, an injunction requiring the Company and Palco to cease certain alleged unlawful activities, as well as restitution and remediation by the Company and Palco. The Company does not believe the resolution of this action should result in a material adverse effect on its financial condition, results of operations or liquidity.

On November 16, 2001, Palco filed a case entitled *The Pacific Lumber Company, et al. v. California State Water Resources Control Board* (the “**THP No. 520 lawsuit**”) alleging that the State Water Board had no legal authority to impose mitigation measures that were requested by the staff of the North Coast Water Board during the THP review process and rejected by the CDF prior to approving the THP. When the staff of the North Coast Water Board attempted to impose these mitigation measures in spite of the CDF’s decision, Palco appealed to the State Water Board, which imposed certain of the requested mitigation measures and rejected others. Palco filed the *THP No. 520 lawsuit* challenging the State Water Board’s decision, and in January 2003, the Superior Court granted Palco’s request for an order invalidating the imposition of these additional measures. The State Water Board appealed this decision, and on March 18, 2004, the appellate court reversed the decision of the Superior Court. The appellate court’s decision could result in increased demands by the regional and state water boards and their staffs to impose controls and limitations on harvesting on the

Company's timberlands beyond those provided for by the Environmental Plans or could provide additional regulatory powers to the regional and state water boards and their staffs beyond those provided in Senate Bill 810. Palco filed a petition for review of the appellate court's decision by the California Supreme Court, which in June 2004 agreed to review the decision.

8. Comprehensive Loss and Member Deficit

Comprehensive loss includes the following (in millions):

	Years Ended December 31,		
	2004	2003	2002
Net loss	\$ (19.8)	\$ (5.3)	\$ (23.1)
Other comprehensive loss:			
Change in value of available-for-sale investments	(0.6)	(0.4)	(0.7)
Total comprehensive loss	<u>\$ (20.4)</u>	<u>\$ (5.7)</u>	<u>\$ (23.8)</u>

A reconciliation of the activity in member deficit is as follows (in millions):

	Years Ended December 31,		
	2004	2003	2002
Balance at beginning of period	\$ (411.2)	\$ (405.5)	\$ (352.3)
Comprehensive loss	(20.4)	(5.7)	(23.8)
Distributions	—	—	(29.4)
Balance at end of period	<u>\$ (431.6)</u>	<u>\$ (411.2)</u>	<u>\$ (405.5)</u>

9. Quarterly Financial Information (Unaudited)

Summary quarterly financial information for the years ended December 31, 2004 and 2003 is as follows (in millions):

	Three Months Ended			
	March 31	June 30	September 30	December 31
2004:				
Log sales to Palco	\$ 15.9	\$ 13.3	\$ 21.7	\$ 15.5
Operating income	7.9	6.1	12.0	8.4
Net loss	(4.7)	(7.6)	(2.0)	(5.5)
2003:				
Log sales to Palco	\$ 18.4	\$ 15.1	\$ 22.4	\$ 17.4
Operating income	9.2	8.7	12.6	16.5
Net income (loss)	(4.8)	(3.7)	(0.5)	3.7

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

Our management is responsible for establishing and maintaining disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company's reports under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As of the end of the period covered by this report, our management carried out an evaluation, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on the evaluation, our management, including our Chief Executive Officer and Chief Financial Officer, concluded that the Company's disclosure controls and procedures were effective as of December 31, 2004.

Changes in Internal Control over Financial Reporting

Since September 30, 2004, there have been no changes in the Company's internal controls over financial reporting that materially affected or are reasonably likely to materially affect the internal controls over financial reporting.

ITEM 9B. OTHER INFORMATION

Not applicable.

PART III

ITEMS 10-13.

Not applicable.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The following table sets forth the aggregate fees billed to the Company for professional services provided in 2004 and 2003 by Deloitte & Touche LLP ("**Deloitte**"), the Company's independent auditor and principal accounting firm:

	Years Ended December 31,	
	2004	2003
Audit Fees ⁽¹⁾	\$ 110,670	\$ 100,000
Audit-Related Fees	—	—
Tax Fees	—	—
All Other Fees	—	—
Total	<u>\$ 110,670</u>	<u>\$ 100,000</u>

⁽¹⁾ Consists of professional services rendered for the audit of the annual financial statements of the Company and for the review of the quarterly financial statements of the Company.

The Company is an indirect wholly owned subsidiary of MAXXAM. As such, the Audit Committee of MAXXAM's Board of Directors (the **"Audit Committee"**) is charged with the oversight responsibility as to the audit process of the Company. The Audit Committee has responsibility for appointing, setting compensation and overseeing the work of the independent auditor. In recognition of this responsibility, the Audit Committee's Charter requires pre-approval by the Audit Committee of all audit and non-audit services to be furnished by the independent auditor to the Company. Pre-approval is waived in those instances permitted by applicable SEC regulation so long as the Audit Committee subsequently approves such services within any applicable deadline. None of the foregoing services were approved by the Audit Committee pursuant to the provisions of Section 2-01(c)(7)(i)(C) of SEC Regulation S-X.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) Index to Financial Statements Page

1. Financial Statements (included under Item 8):

Report of Independent Registered Public Accounting Firm	21
Balance Sheet at December 31, 2004 and 2003	22
Statement of Loss for the Years Ended December 31, 2004, 2003 and 2002	23
Statement of Cash Flows for the Years Ended December 31, 2004, 2003 and 2002	24
Notes to Financial Statements	25

2. Financial Statement Schedules:

Schedules are inapplicable or the required information is included in the financial statements or the notes thereto.

(b) Exhibits

Reference is made to the Index of Exhibits immediately preceding the exhibits hereto (beginning on page 40), which index is incorporated herein by reference.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

SCOTIA PACIFIC COMPANY LLC

Date: March 16, 2005

By: ROBERT E. MANNE
Robert E. Manne
President and Chief Executive Officer
(Principal Executive Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Date: March 16, 2005

By: J. KENT FRIEDMAN
J. Kent Friedman
Manager

Date: March 16, 2005

By: EZRA G. LEVIN
Ezra G. Levin
Manager

Date: March 16, 2005

By: ROBERT E. MANNE
Robert E. Manne
Manager

Date: March 16, 2005

By: PAUL N. SCHWARTZ
Paul N. Schwartz
Manager

Date: March 16, 2005

By: JACK M. WEBB
Jack M. Webb
Independent Manager

Date: March 16, 2005

By: SID C. WEISS
Sid C. Weiss
Independent Manager

Date: March 16, 2005

By: GARY L. CLARK
Gary L. Clark
Vice President – Finance and Administration
(Principal Financial and Accounting Officer)

INDEX OF EXHIBITS

Exhibit Number	Description
3.1	Certificate of Formation of the Company (incorporated herein by reference to Exhibit 3.1 to the Company's Registration Statement on Form S-4 dated September 21, 1998; Registration No. 333-63825; the "Company's Form S-4")
3.2	Agreement of Limited Liability Company of the Company (incorporated herein by reference to Exhibit 3.2 to the Company's Form S-4)
4.1	Indenture, dated July 20, 1998, between the Company and State Street Bank and Trust Company ("State Street") regarding the Timber Notes (incorporated herein by reference to Exhibit 4.1 to the Quarterly Report on Form 10-Q of MAXXAM Inc. for the quarter ended June 30, 1998; File No. 1-3924; the "MAXXAM June 1998 Form 10-Q")
4.2	First Supplemental Indenture, dated July 16, 1999, to the Indenture (incorporated herein by reference to Exhibit 4.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 1999; the "Company June 1999 Form 10-Q")
4.3	Second Supplemental Indenture, dated November 18, 1999, to the Indenture (incorporated herein by reference to Exhibit 99.3 to the Company's Report on Form 8-K dated November 19, 1999)
4.4	Credit Agreement, dated July 20, 1998, among the Company, the financial institutions party thereto and Bank of America National Trust and Savings Association, as agent (incorporated herein by reference to Exhibit 4.3 to the MAXXAM June 1998 Form 10-Q)
4.5	First Amendment, dated July 16, 1999, to the Credit Agreement (incorporated herein by reference to the Company June 1999 Form 10-Q)
4.6	Second Amendment, dated June 15, 2001, to the Credit Agreement (incorporated herein by reference to Exhibit 4.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2001)
4.7	Third Amendment, dated June 30, 2003, to the Credit Agreement (incorporated herein by reference to Exhibit 4.1 to the Company's Form 10-Q for the quarter ended June 30, 2003)
4.8	Deed of Trust, Security Agreement, Financing Statement, Fixture Filing and Assignment of Proceeds, dated July 20, 1998, among the Company, Fidelity National Title Insurance Company, as trustee, and State Street, as collateral agent (incorporated herein by reference to Exhibit 4.2 to the MAXXAM June 1998 Form 10-Q)
10.1	New Master Purchase Agreement, dated July 20, 1998, between the Company and Palco (incorporated herein by reference to Exhibit 10.1 to the Quarterly Report on Form 10-Q of MAXXAM Group Holdings Inc. for the quarter ended June 30, 1998; File No. 333-18723; the "MGHI June 1998 Form 10-Q")
10.2	New Services Agreement, dated July 20, 1998, between Palco and the Company (incorporated herein by reference to Exhibit 10.2 to the MGHI June 1998 Form 10-Q)
10.3	New Additional Services Agreement, dated July 20, 1998, between the Company and Palco (incorporated herein by reference to Exhibit 10.3 to the MGHI June 1998 Form 10-Q)
10.4	New Reciprocal Rights Agreement, dated July 20, 1998, among Palco, the Company and Salmon Creek Corporation ("Salmon Creek") (incorporated herein by reference to Exhibit 10.4 to the MGHI June 1998 Form 10-Q)
10.5	New Environmental Indemnification Agreement, dated July 20, 1998, between Palco and the Company (incorporated herein by reference to Exhibit 10.5 to the MGHI June 1998 Form 10-Q)

Exhibit Number	Description
10.6	Implementation Agreement with Regard to Habitat Conservation Plan for the properties of Palco, the Company and Salmon Creek, dated March 1, 1999, by and among the United States Department of the Interior Fish and Wildlife Service (“ USFWS ”), the National Marine Fisheries Service, the California Department of Fish and Game (“ CDF&G ”), the CDF and Pacific Lumber, Salmon Creek and the Company (incorporated herein by reference to Exhibit 99.3 to the Company’s Form 8-K dated March 19, 1999; the “ Company March 19, 1999 Form 8-K ”)
10.7	Agreement Relating to Enforcement of AB 1986, dated February 25, 1999, by and among The California Resources Agency, CDF&G, the CDF, The California Wildlife Conservation Board, Palco, Salmon Creek and the Company (incorporated herein by reference to Exhibit 99.4 to the Company March 19, 1999 Form 8-K)
10.8	Habitat Conservation Plan, dated March 1, 1999 (incorporated herein by reference to Exhibit 99.5 to the Company March 19, 1999 Form 8-K)
10.9	Letter, dated February 25, 1999, from the CDF to Palco (incorporated herein by reference to Exhibit 99.8 to the Company March 19, 1999 Form 8-K)
10.10	Letter, dated March 1, 1999, from the CDF to Palco (incorporated herein by reference to Exhibit 99.9 to the Company March 19, 1999 Form 8-K)
10.11	Letter, dated March 1, 1999, from the USFWS and the U.S. Department of Commerce National Oceanic and Atmospheric Administration to Palco, Salmon Creek and the Company (incorporated herein by reference to Exhibit 99.10 to the Company March 19, 1999 Form 8-K)
*31.1	Section 302 Certification of Chief Executive Officer
*31.2	Section 302 Certification of Chief Financial Officer
*32.1	Section 906 Certification of Chief Executive Officer
*32.2	Section 906 Certification of Chief Financial Officer