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

FORM 10-Q

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

For the quarterly period ended September 30, 2005

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)

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

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

95565
(Zip Code)

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

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 :

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ☒ No :

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

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SCOTIA PACIFIC COMPANY LLC

BALANCE SHEET
(In millions of dollars)

	September 30, 2005	December 31, 2004
	(Unaudited)	
Assets		
Current assets:		
Cash and cash equivalents	\$ 0.4	\$ 0.5
Marketable securities, including restricted amounts of \$24.8 and \$25.1, respectively	26.8	28.2
Receivables from Palco	10.5	3.3
Prepaid timber harvesting costs	6.4	6.2
Other current assets	1.8	1.1
Total current assets	45.9	39.3
Timber and timberlands, net of accumulated depletion of \$296.0 and \$290.1, respectively	220.9	225.1
Property and equipment, net of accumulated depreciation of \$21.7 and \$19.6, respectively	29.0	28.1
Deferred financing costs, net	10.8	11.8
Restricted cash, marketable securities and other investments	0.5	9.2
Intangible assets	3.1	3.8
	<u>\$ 310.2</u>	<u>\$ 317.3</u>
Liabilities and Member Deficit		
Current liabilities:		
Payable to Palco	\$ 1.1	\$ 1.5
Accrued interest	11.0	23.8
Other accrued liabilities	2.8	1.9
Short-term borrowings and current maturities of long-term debt, excluding \$11.1 and \$9.5, respectively, of repurchased Timber Notes held in the SAR Account	67.7	33.8
Total current liabilities	82.6	61.0
Long-term debt, less current maturities and excluding \$44.3 and \$55.4, respectively, of repurchased Timber Notes held in the SAR Account	669.6	687.7
Other noncurrent liabilities	0.6	0.2
Total liabilities	752.8	748.9
Contingencies (See Note 3)		
Member deficit	(442.6)	(431.6)
	<u>\$ 310.2</u>	<u>\$ 317.3</u>

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

SCOTIA PACIFIC COMPANY LLC

STATEMENT OF OPERATIONS
(In millions of dollars)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
	(Unaudited)			
Log sales to Palco	\$ 25.7	\$ 21.7	\$ 59.2	\$ 50.9
Operating expenses:				
General and administrative	8.2	6.4	22.3	16.3
Depletion, depreciation and amortization	<u>3.3</u>	<u>3.3</u>	<u>8.8</u>	<u>8.6</u>
	<u>11.5</u>	<u>9.7</u>	<u>31.1</u>	<u>24.9</u>
Operating income	<u>14.2</u>	<u>12.0</u>	<u>28.1</u>	<u>26.0</u>
Other income (expense):				
Interest and other income	1.1	(0.2)	2.3	1.1
Interest expense	<u>(14.1)</u>	<u>(13.8)</u>	<u>(41.6)</u>	<u>(41.4)</u>
	<u>(13.0)</u>	<u>(14.0)</u>	<u>(39.3)</u>	<u>(40.3)</u>
Net income (loss)	<u>\$ 1.2</u>	<u>\$ (2.0)</u>	<u>\$ (11.2)</u>	<u>\$ (14.3)</u>

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

SCOTIA PACIFIC COMPANY LLC

STATEMENT OF CASH FLOWS
(In millions of dollars)

	Nine Months Ended September 30,	
	2005	2004
	(Unaudited)	
Cash flows from operating activities:		
Net loss	\$ (11.2)	\$ (14.3)
Adjustments to reconcile net loss to net cash used for operating activities:		
Depletion, depreciation and amortization	8.8	8.6
Amortization of deferred financing costs	1.0	1.0
Increase (decrease) in cash resulting from changes in:		
Receivables from Palco	(7.3)	(2.9)
Prepaid timber harvesting costs	(0.2)	(0.4)
Payable to Palco	0.4	0.1
Accrued interest	(12.8)	(14.0)
Other accrued liabilities	0.6	0.4
Other	(0.6)	(0.3)
Net cash used for operating activities	<u>(21.3)</u>	<u>(21.8)</u>
Cash flows from investing activities:		
Proceeds from sales of marketable securities and other investments	1.1	1.2
Net proceeds from restricted cash	9.1	12.0
Capital expenditures	<u>(4.8)</u>	<u>(6.1)</u>
Net cash provided by investing activities	<u>5.4</u>	<u>7.1</u>
Cash flows from financing activities:		
Principal payments on Timber Notes and other timber related debt	(15.6)	(17.2)
Borrowings under line of credit agreement, net	<u>31.4</u>	<u>31.4</u>
Net cash provided by financing activities	<u>15.8</u>	<u>14.2</u>
Net decrease in cash and cash equivalents	<u>(0.1)</u>	<u>(0.5)</u>
Cash and cash equivalents at beginning of period	<u>0.5</u>	<u>0.9</u>
Cash and cash equivalents at end of period	<u><u>\$ 0.4</u></u>	<u><u>\$ 0.4</u></u>
Supplemental disclosure of non-cash financing activities:		
Repurchases of debt using restricted cash	\$ —	\$ 4.8
Supplemental disclosure of cash flow information:		
Interest paid	\$ 53.4	\$ 54.3

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

SCOTIA PACIFIC COMPANY LLC

CONDENSED NOTES TO FINANCIAL STATEMENTS

1. Basis of Presentation

The information contained in the following condensed notes to the financial statements is condensed from that which would appear in the annual financial statements; accordingly, the financial statements included herein should be read in conjunction with the financial statements and related notes thereto contained in the Form 10-K. Any capitalized terms used but not defined in these Condensed Notes to Financial Statements are defined in the "Glossary of Defined Terms" contained in Appendix A. Accounting measurements at interim dates inherently involve greater reliance on estimates than at year end. The results of operations for the interim periods presented are not necessarily indicative of the results to be expected for the entire year.

The financial statements included herein are unaudited; however, they include all adjustments of a normal recurring nature which, in the opinion of management, are necessary for a fair presentation of the financial position of the Company at September 30, 2005, the results of operations for the three and nine months ended September 30, 2005 and 2004, and the cash flows for the nine months ended September 30, 2005 and 2004. The Company is a wholly owned subsidiary of Palco, which is a wholly-owned subsidiary of MGI. MGI is an indirect wholly owned subsidiary of MAXXAM.

Liquidity and Cash Resources

Regulatory and environmental matters as well as legal actions have played and are expected to continue to play a significant role in the Company's operations. The Company has previously experienced delays in the approval of its THPs as the result of regulatory compliance and litigation challenges, and expects these difficulties to persist. Moreover, the Company expects a recurrence of the additional delays that have recently been experienced in harvesting on previously-approved THPs due to regulatory oversight by the North Coast Water Board (see below). The foregoing matters have in the past adversely affected timber harvest levels and timber harvesting and other costs; these effects are expected to continue.

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 is likely to 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 on the Company Timberlands. 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, development of WWDRs and the other matters described in the "Water Quality" section of Note 3 are expected to result in reduced harvest in the future. The staff of the North Coast Water Board has circulated for public review and comment draft WWDRs for the Freshwater and Elk River watersheds. If these draft WWDRs are approved in their current form, there would likely be a significant adverse impact on current and future harvest levels.

As WWDRs had not been formulated, the North Coast Water Board for some time failed to release for harvest a number of THPs that had already been approved by the other governmental agencies which approve the Company's THPs. In February 2005, the Executive Officer of the staff of the North Coast Water Board released sufficient THPs to allow the harvest of up to 50% of the CDF Harvest Limit for these two watersheds. On March 16, 2005, the North Coast Water Board ordered the enrollment of additional THPs that would allow the harvest of up to 75% of the CDF Harvest Limit for these two watersheds. Third parties subsequently appealed this decision to the State Water Board. On June 16, 2005, the State Water Board heard this appeal and rendered a decision, which had the effect of disallowing further harvesting on the additional 25% of the CDF Harvest Limit approved by the North Coast Water Board on March 16, 2005. The State Water Board's decision also has the effect of disallowing further harvesting in the Freshwater and Elk River watersheds until WWDRs for these watersheds are adopted by the North Coast Water Board. The Company and Palco have appealed the State Water Board's June 16, 2005, decision in a California state court. A hearing on the appeal has not yet been scheduled.

On September 2, 2005, the North Coast Water Board set hearings on the draft WWDRs for September 14 and 15, 2005. On September 9, 2005, the Company and Palco filed a petition in California state court seeking an order mandating that the North Coast Water Board not take any further action on the proposed WWDRs. The petition alleges defects in the proposed WWDRs and the North Coast Water Board's hearing procedures. The Company and Palco also requested a temporary restraining order and preliminary injunction to prevent the North Coast Water Board from taking

any further action until their petition is heard. The temporary restraining order was granted and the preliminary injunction hearing is scheduled for November 9, 2005.

The unreleased and disallowed THPs in the Freshwater and Elk River watersheds represented a significant portion of the harvest that had been planned for the first nine months of 2005. The ongoing regulatory, environmental and litigation matters faced by the Company and Palco, exacerbated by the developments described in the previous paragraph, have materially 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. Should the Freshwater-Elk River WWDRs not be approved during 2005 or in the first few months of 2006, or be approved with additional restrictions on harvest, there could be a material adverse impact on the Company's and Palco's future cash flows from operations.

As previously announced, the Company's estimates indicated that its cash flows from operations, together with its Line of Credit and other available funds, would likely be inadequate to pay all of the interest due on the July 20, 2005, payment date for the Timber Notes. As the July 20, 2005, payment date approached, it became apparent that the Company's estimates would prove correct and that the cash shortfall as of the payment date would be approximately \$2.2 million. Based upon a review of its alternatives under the circumstances, consultation with its own legal and financial advisors, and consideration of discussions with the advisors of the Noteholders Committee, the Company requested that Palco make an early payment, equal to the shortfall, in respect of certain logs that had already been delivered to and purchased by Palco from the Company. Palco approved and delivered the early log payment, which allowed the Company to fund the July 20, 2005, cash shortfall and pay all of the \$27.9 million of interest due (\$25.9 million net of interest due in respect of Timber Notes held by the Company).

The Company's ability to pay all of the \$27.7 million of interest due (\$25.8 million net of interest due in respect of Timber Notes held by the Company) on the January 20, 2006, payment date will depend upon many factors, including the Company's harvest levels for the remainder of 2005, cash flows from operations through the January 20, 2006, payment date, together with access to its Line of Credit. At September 30, 2005, the maximum availability under the Line of Credit was \$55.4 million, and borrowings outstanding were \$49.5 million. There can be no assurance that the Company will have sufficient liquidity to make this interest payment.

In March 2005, UBS agreed to assist the Company in seeking to restructure its obligations with respect to the Company's outstanding Timber Notes. In June 2005, the Company agreed to be responsible for certain payments and other obligations of the Noteholder Committee relating to their legal counsel and financial advisors. On September 23, 2005, the Company terminated its agreement to be responsible for further payments, effective immediately in the case of legal counsel and effective October 23, 2005 in the case of the financial advisor. The Company terminated its agreement upon the recommendation of a special committee of independent managers since it concluded that insufficient progress had been made in negotiations with the Noteholder Committee and was advised that holders of less than 15% of Timber Notes (measured by principal amount) had agreed to confidentiality provisions necessary in order to participate in a process intended to lead to a restructuring agreement. The Company continues to evaluate its liquidity alternatives in respect of the January 20, 2006, payment date and beyond.

The Company and UBS have conducted extensive reviews and analyses of the Company's assets, operations and prospects. As a result of these extensive reviews and analyses, management has concluded that, in the absence of significant regulatory relief and accommodations, annual timber harvest levels and cash flows from operations will in future years be substantially below both historical levels and the minimum levels necessary in order to allow the Company to satisfy its debt service obligations in respect of the Timber Notes. The Company has announced that its projected average annual harvest level over the ten-year period beginning 2006 is estimated at approximately 100 million board feet per year. This harvest level reflects management's most recent estimate of the cumulative impact of ongoing regulatory limitations, prescriptions, and other actions and is based upon a number of assumptions which may or may not prove to be accurate. Management also determined that reductions must be made to its cost structure in line with these anticipated reductions in harvest levels and cash flows. Accordingly, on August 30, 2005, the Company implemented a restructuring plan reducing its workforce by approximately one third. To the extent that the Company is unable to restructure its Timber Notes consistent with management's expectations as to future harvest levels and cash flows, or secure additional liquidity from external sources, the Company expects that it, and as may be required, Palco, will be forced to take extraordinary actions, which may include: further 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 of December 31, 2004 and March 31, 2005, Palco was in default under the Palco Credit Agreement and obtained

limited waivers of the default through April 22, 2005. On April 19, 2005, Palco and Britt, as Borrowers, closed the Revolving Credit Facility and the Term Loan. The Term Loan was fully funded at closing and the Borrowers used approximately \$10.8 million of the funds from the Term Loan to pay off amounts previously borrowed under the Palco Credit Agreement and terminated that facility. As of September 30, 2005, \$34.8 million was outstanding under the Term Loan and \$12.1 million was outstanding under the Revolving Credit Facility. Palco estimates that its cash flow from operations will not provide sufficient liquidity to fund its operations until the fourth quarter of 2006. Accordingly, Palco expects to be dependent on the funds available under the Revolving Credit Facility, and expects additional liquidity will be needed, to fund its working capital and other cash requirements in 2005 and 2006. The Revolving Credit Facility and Term Loan are each secured by a security interest in the stock of Palco and substantially all of the assets of the Borrowers (other than Palco's equity interest in the Company).

As of September 30, 2005, borrowings under the Revolving Credit Facility were limited to the sum of 85% of Palco and Britt's eligible accounts receivable plus 75% of their eligible inventories (up to a maximum of \$30.0 million, subject to limitations such as the ability of the lender to establish reasonable reserves). Both the Term Loan and the Revolving Credit Facility contain EBITDA maintenance covenants that, if not met, could trigger a mandatory prepayment of outstanding borrowings. The operating cash flow estimates used to establish the EBITDA maintenance covenants are subject to a number of assumptions about future operating cash flow and actual results could differ from these estimates. Accordingly, the availability of these funds is largely dependent on Palco's ability to harvest adequate timber from the Company Timberlands and reduce operating costs. Available resources to fund Palco's and Britt's operating needs at September 30, 2005 were \$8.0 million, comprised of the maximum availability under the Revolving Credit Facility of \$7.7 million and unrestricted cash and marketable securities of \$0.3 million.

Subsequent to September 30, 2005, Palco borrowed the maximum available under the Revolving Credit Facility and on October 26, 2005, Palco, Britt and certain of their affiliates entered into the Omnibus Amendment which amended the Term Loan and the Revolving Credit Facility to, among other things, temporarily increase the amount of the Revolving Credit Facility from \$30.0 million to \$35.0 million and temporarily increase the advance rate applicable to the Borrowers' inventory from 75% to 80%. The increase in the inventory advance rate is subject to satisfactory inventory appraisals, and the amount of the increase in such advances is capped at \$1.5 million. The increase in the amount of the Revolving Credit Facility and the increase in the inventory advance rate will be gradually phased out in January through March 2006. The Omnibus Amendment also revises financial covenants applicable to the Revolving Credit Facility and the Term Loan. MGI furnished cash collateral of \$2.0 million as additional security for the Borrowers' obligations under the Revolving Credit Facility and the Term Loan Facility. This cash collateral will be released on April 1, 2006, so long as the Borrowers have achieved earnings and borrowing availability targets to be determined by the Lenders.

Palco's available cash resources, including proceeds from and availability under the Term Loan and Revolving Credit Facility have been primarily utilized during the first nine months of 2005 in the following areas: (i) \$10.8 million was used to pay off amounts previously borrowed under the Palco Credit Agreement; (ii) approximately \$ 6.2 million was used to fund capital expenditures related to Palco's new state-of-the-art sawmill in Scotia, California; (iii) \$9.9 million was used as collateral to secure Palco's workers compensation liabilities; (iv) \$13.5 million was used to build log inventory levels; and (v) the remainder was used to pay advisor fees and to fund working capital shortfalls. Palco's ability to generate sufficient liquidity to fund its short term liquidity needs will depend upon many factors, including Palco's ability to achieve planned production rates its new sawmill. While production levels at the new sawmill continue to improve, the new sawmill is not yet operating at planned capacity and is not expected to achieve planned production rates for the remainder of 2005. Accordingly, additional liquidity will be needed at Palco to fund working capital requirements in 2005 and 2006, but there can be no assurance that Palco will be able to secure additional liquidity. In the event that Palco were unable to secure the necessary liquidity, it would be forced to take extraordinary actions, which may include: further reducing expenditures by laying off employees and shutting down various operations and seeking protection by filing under the Bankruptcy Code.

On April 21, 2005, Moody's lowered its ratings on the Class A-1 Timber Notes from Baa2 to Ba3; the Class A-2 Timber Notes from Baa3 to B1; and the Class A-3 Timber Notes from Ba1 to B1. On June 20, 2005, Moody's further lowered its ratings on all classes of the Timber Notes to Caal. S&P announced on April 7, 2005, that it had lowered Palco's credit rating to CCC- (which rating it affirmed on April 28, 2005). As a result of the S&P credit rating actions related to Palco, Palco was required to post a \$9.9 million letter of credit with the State of California to secure its workers compensation liabilities, which reduced Palco's availability under the Revolving Credit Facility by a corresponding amount.

The Company's Line of Credit allows it to borrow up to one year's interest due on the Timber Notes. On June 20, 2003, the Line of Credit was extended to July 7, 2006. At or near the completion of such extension, the Company would 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 were \$18.2 million in borrowings outstanding under the facility. At September 30, 2005, the maximum availability under the Line of Credit was \$55.4 million, and borrowings outstanding were \$49.5 million.

On the note payment date in January 2005, the Company used the funds available under the Line of Credit to pay all of the \$28.5 million of interest due (\$26.3 million net of interest due in respect of Timber Notes held by the Company). The Company also repaid \$17.1 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 2005, the Company used its existing cash resources, all of the remaining funds available under the Line of Credit, and the additional funds made available from the \$2.2 million early log payment by Palco, to pay all of the \$27.9 million of interest due (\$25.9 million net of interest due in respect of Timber Notes held by the Company). The Company also repaid \$8.0 million of principal on the Timber Notes (an amount equal to Scheduled Amortization) using funds held in the SAR Account.

In the event of a failure to pay interest on the Timber Notes in full when due, the Trustee under the Timber Notes Indenture 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 Palco to perform its covenants or agreements under the Master Purchase Agreement or the Services Agreement, 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 Company's Line of Credit occur, the Trustee may exercise all rights under the Timber Notes 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 Bankruptcy Code, all amounts related to the Timber Notes would become immediately due and payable under the Timber Notes Indenture and all advances under the Line of Credit could be accelerated. If Palco were to seek protection by filing under the Bankruptcy Code, all amounts related to Palco's Term Loan and Revolving Credit Facility would become immediately due and payable. The foregoing rights of the Trustee, Noteholders, and Palco's lenders, are subject to the rights of the Company and Palco, respectively, under the Bankruptcy Code.

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 financial condition, results of operations or liquidity. See Note 3 for further discussion regarding regulatory and legislative matters and legal proceedings.

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 SEC. 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 3. The results of a resolution of such uncertainties could have a material effect on the Company's financial position, results of operations and liquidity.

Reclassifications

Certain reclassifications have been made to prior periods' consolidated financial statements to be consistent with the current period's presentation. This includes the reclassification of restricted cash from financing activities to investing activities in the Statement of Cash Flows.

New Accounting Standard

In December 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29. SFAS No. 153 is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. APB Opinion No. 29 provided an exception to this principle for exchanges of similar productive assets. Under APB Opinion No. 29, an exchange of a productive asset was based on the recorded amount of the asset relinquished. SFAS No. 153 eliminated this exception and replaced it with an exception for exchanges of nonmonetary assets that do not have commercial substance. The effective date of the new Statement for the Company is January 1, 2006. Management does not expect that adoption of this Statement will have a material impact on the Company's financial condition, results of operations, or liquidity.

2. Restricted Cash, Cash Equivalents, Marketable Securities and Other Investments

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

	<u>September 30, 2005</u>	<u>December 31, 2004</u>
Amounts held in SAR Account:		
Current portion of restricted marketable securities and other investments	\$ 24.8	\$ 25.1
Long term portion of restricted marketable securities and other investments	49.8	68.5
	<u>74.6</u>	<u>93.6</u>
Less: Amounts attributable to Timber Notes held in SAR Account	(51.8)	(61.8)
Total amounts held in SAR Account	<u>22.8</u>	<u>31.8</u>
Other amounts restricted under the Indenture	2.5	2.5
Total restricted cash, cash equivalents, marketable securities and other investments	<u><u>\$ 25.3</u></u>	<u><u>\$ 34.3</u></u>

3. 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 CDF regulations requiring timber companies to demonstrate sustained yield, i.e. that their projected average annual harvest for any decade within a 100-year planning period will not exceed the average annual growth level at the end of the 100-year planning period. The forest practice rules allow companies which do not have a sustained yield plan to follow alternative procedures to document compliance with the sustained yield requirements. As discussed below, on October 31, 2003, the Court hearing the *EPIC-SYP/Permits lawsuit* entered a judgment invalidating the SYP and the 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 alternative procedures pending approval of the Option A Plan, which is an alternative to a sustained yield plan. The Option A Plan was approved by the CDF in March 2005.

The HCP and related Federal Permits allow incidental "take" of certain federally listed species located on the Company 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 and additional costs required in connection with the implementation of the HCP and SYP, and this work and the additional costs are expected to continue for the foreseeable future.

Water Quality

Laws and regulations dealing with water quality are impacting the Company and Palco primarily in four areas: efforts by the EPA and the North Coast Water Board to establish 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 preventive 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 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 Timberlands. The Company expects this process to continue into 2010. 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.

Beginning with the 2002-2003 winter operating period, the Company and Palco have been required to submit information on sediment discharges and erosion control plans to the North Coast Water Board each year in order to conduct harvesting activities. After consideration of these reports, the North Coast Water Board imposed requirements on Palco to implement additional mitigation and erosion control practices during harvest activities. Reporting and mitigation requirements imposed by the North Coast Water Board and CDF have significantly increased operating costs and will in the future further increase costs or cause delays in THP approvals or harvesting on approved THPs.

The North Coast Water Board has also issued the Elk River Order, which is a clean up and abatement order 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 Palco 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 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 520 lawsuit* discussed below.

The North Coast Water Board in December 2003 directed its staff to formulate WWDRs for the Freshwater and Elk River watersheds on the Company Timberlands. 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, development of WWDRs and the other matters described in this section are expected to result in reduced harvest in the future. The staff of the North Coast Water Board has circulated for public review and comment draft WWDRs for the Freshwater and Elk River watersheds. If these draft WWDRs are approved in their current form, there would likely be a significant adverse impact on current and future harvest levels.

As WWDRs had not been formulated, the North Coast Water Board for some time failed to release for harvest a number of THPs that had already been approved by the other governmental agencies which approve the Company’s THPs. In February 2005, the Executive Officer of the staff of the North Coast Water Board released sufficient THPs to allow the harvest of up to 50% of the CDF Harvest Limit for these two watersheds. On March 16, 2005, the North Coast Water Board ordered the enrollment of additional THPs that would allow the harvest of up to 75% of the CDF Harvest Limit for these two watersheds. Third parties subsequently appealed this decision to the State Water Board. On June 16, 2005, the State Water Board heard this appeal and rendered a decision, which had the effect of disallowing further harvesting on the additional 25% of the CDF Harvest Limit approved by the North Coast Water Board on March 16, 2005. The State Water Board’s decision also has the effect of disallowing further harvesting in the Freshwater and Elk River watersheds until WWDRs for these watersheds are adopted by the North Coast Water Board. Palco has appealed the State Water Board’s June 16, 2005, decision in a California state court. A hearing on the appeal has not yet been scheduled.

On September 2, 2005, the North Coast Water Board set hearings on the draft WWDRs for September 14 and 15, 2005. On September 9, 2005, the Company and Palco filed a petition in California state court seeking an order mandating that the North Coast Water Board not take any further action on the proposed WWDRs. The petition alleges defects in the proposed WWDRs and the North Coast Water Board’s hearing procedures. The Company and Palco also requested a temporary restraining order and preliminary injunction to prevent the North Coast Water Board from taking

any further action until their petition is heard. The temporary restraining order was granted and the preliminary injunction hearing is scheduled for November 9, 2005.

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 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 pending judicial and administrative proceedings, as described below, could affect the Company's and Palco's ability to implement the HCP, implement certain approved THPs, or carry out other operations. 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, 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, 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 Palco Companies to submit a complete and comprehensible SYP. 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 alternative procedures pending approval of the Option A Plan. As noted above, the Option A Plan was approved by the CDF in March 2005. The Palco Companies and the State of California have appealed the October 31, 2003 decision. The appeal was heard by the Court of Appeal on September 16, 2005, and its decision is pending. 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. The Palco Companies and the State of California have also appealed this decision.

In July 2001, 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 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. The Company has recently filed a motion for summary judgment on the ground that it has met the requirements for a storm water pollution prevention permit under a general permit issued by the state of California.

Should the decision ultimately become final and be held to apply to all of Palco's timber 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, the Company believes that 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, the *Cook action* and the *Cave action* were filed, which name the Company, Palco 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 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. On June 14, 2005, the Court dismissed this matter in its entirety. On September 19, 2005, the District Attorney appealed this decision, however, the Company believes that the dismissal ruling has substantially diminished its exposure with respect to this matter.

On November 2, 2004, 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 asserts several claims, including that the Palco Companies 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 Palco Companies to cease certain alleged unlawful activities, as well as restitution and remediation by Palco. On April 22, 2005, pursuant to motions to dismiss filed by the Palco Companies and the federal defendants, the Court dismissed several of the claims, significantly reducing the scope of the case. On September 30, 2005, EPIC filed a motion to prevent the Palco Companies from taking any further action under the HCP and California Permits, including all timber harvesting or related activities. On October 5, 2005, Palco agreed to defer harvesting on one THP pending the resolution of EPIC's motion while EPIC agreed not to pursue additional legal action. A hearing on plaintiff's motion for a preliminary injunction was held November 1, 2005, and the parties are awaiting a decision. The Company does not believe the resolution of this action should result in a material adverse effect on its consolidated financial condition, results of operations or liquidity.

On November 16, 2001, the Company and Palco filed 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, the Company and Palco appealed to the State Water Board, which imposed certain of the requested mitigation measures and rejected others. The Company and Palco filed the *THP No. 520 lawsuit* challenging the State Water Board's decision, and in January 2003, a California state court granted their 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 state 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. The Company and 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. Briefing was completed on April 26, 2005, and a hearing has been set for November 10, 2005.

On August 8, 2005, the CBD filed an action against CDF, Palco, the Company and Salmon Creek seeking to overturn and prevent CDFG and the Company and Palco from taking any action to implement or rely upon Consistency Determinations issued by CDFG in February 2005. The Consistency Determinations were issued as a result of the *EPIC SYP Permits lawsuit*, which overturned the California Permits resulting in the Company having no coverage from the State for the incidental take of coho salmon or the marbled murrelet. CBD alleges that the process followed by CDFG in issuing the Consistency Determinations did not comply with CEQA and that the Federal Permits are out of date because of new information and reliance upon them is therefore improper. A hearing was held in California state court on October 28, 2005, and the Court denied CBD's request for a preliminary injunction.

4. Comprehensive Income (Loss) and Member Deficit

Comprehensive income (loss) includes the following (in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Net income (loss)	\$ 1.2	\$ (2.0)	\$ (11.2)	\$ (14.3)
Other comprehensive income (loss):				
Net change in fair value of available-for-sale investments	—	0.1	0.2	(0.6)
Total comprehensive income (loss)	<u>\$ 1.2</u>	<u>\$ (1.9)</u>	<u>\$ (11.0)</u>	<u>\$ (14.9)</u>

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

	Nine Months Ended September 30,	
	2005	2004
Balance at beginning of period	\$ (431.6)	\$ (411.2)
Comprehensive loss	<u>(11.0)</u>	<u>(14.9)</u>
Balance at end of period	<u>\$ (442.6)</u>	<u>\$ (426.1)</u>

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following should be read in conjunction with the financial statements in Part I, Item 1 of this Report and Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations" and Item 8. "Financial Statements and Supplementary Data" of the Form 10-K. Any capitalized terms used but not defined in this Item are defined in the "Glossary of Defined Terms" contained in Appendix A. Except as otherwise noted, all references to Notes represent the Condensed Notes to Financial Statements included herein.

This Quarterly Report on Form 10-Q contains statements which constitute "forward-looking statements" within the meaning of the PSLRA. These statements appear in a number of places in this section and in Part II, Item 1. "Legal Proceedings." Such statements can be identified by the use of forward-looking terminology such as "believes," "expects," "may," "estimates," "will," "should," "could," "plans," "intends," "projects," "seeks," 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, environmental or regulatory requirements, litigation developments, and changing prices and market conditions. This Form 10-Q and the Form 10-K identify 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.

Results of Operations

This section contains statements which constitute "forward-looking statements" within the meaning of the PSLRA. See the statement in Item 2. above for cautionary information with respect to such forward-looking statements.

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 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 of these restrictions, a substantial majority of the future harvesting on the Company Timberlands can be expected to be concentrated during the period from June through October of each year.

Log Sales to Palco

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

	Three Months Ended September 30, 2005			Three Months Ended September 30, 2004		
	MBFE	Price \$/MBFE	Revenues	MBFE	Price \$/MBFE	Revenues
Redwood	21,900	\$ 952	\$ 20.8	19,900	\$ 811	\$ 16.2
Douglas Fir	7,200	640	4.7	9,800	545	5.3
Other	600	404	0.2	500	351	0.2
	<u>29,700</u>	<u>865</u>	<u>\$ 25.7</u>	<u>30,200</u>	<u>717</u>	<u>\$ 21.7</u>
	Nine Months Ended September 30, 2005			Nine Months Ended September 30, 2004		
	MBFE	Price \$/MBFE	Revenues	MBFE	Price \$/MBFE	Revenues
Redwood	55,000	\$ 892	\$ 49.0	55,200	\$ 762	\$ 42.1
Douglas Fir	16,200	605	9.9	16,500	513	8.5
Other	1,700	189	0.3	1,300	259	0.3
	<u>72,900</u>	<u>812</u>	<u>\$ 59.2</u>	<u>73,000</u>	<u>697</u>	<u>\$ 50.9</u>

For the three months ended September 30, 2005, the Company experienced an overall 18.4% increase in revenues and a 1.7% decrease in sales volume compared to the three months ended September 30, 2004. The increase in revenue is attributable to both the increase in sales volume of redwood logs and an increase in the average realized price of all log types. For the first nine months of 2005, revenues increased 16.3% as a result of price increases.

Operating Income and Net Loss

Despite the increase in revenues, operating income was only slightly higher due to a substantial increase in legal and advisor fees relating to the Company's efforts to restructure the Timber Notes, increased THP costs related to logs sold during the period, severance costs related to a reduction in force and increases in certain forest management costs.

Financial Condition and Investing and Financing Activities

This section contains statements which constitute "forward-looking statements" within the meaning of the PSLRA. See the statement in Item 2. above 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 and financial results, including adverse weather conditions, low log prices, governmental regulation, environmental litigation and general economic conditions. The Company's cash flows from operations are significantly impacted by harvest volumes and log prices.

Regulatory and environmental matters as well as legal actions have played and are expected to continue to play a significant role in the Company's operations. The Company has previously experienced delays in the approval of its THPs as the result of regulatory compliance and litigation challenges, and expects these difficulties to persist. Moreover, the Company expects a recurrence of the additional delays that have recently been experienced in harvesting on previously-approved THPs due to regulatory oversight by the North Coast Water Board (see below). The foregoing matters have in the past adversely affected timber harvest levels and timber harvesting and other costs; these effects are expected to continue. 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 financial condition, results of operations or liquidity of the Company's operations. See Item 1. "Business—Regulatory and Environmental Factors" of the Form 10-K and Note 3 for further discussion of these matters.

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 is likely to 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 on the Company Timberlands. 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, development of WWDRs and the other matters described in the "Water Quality" section of Note 3 are expected to result in reduced harvest in the future. The staff of the North Coast Water Board has circulated for public review and comment draft WWDRs for the Freshwater and Elk River watersheds. If these draft WWDRs are approved in their current form, there would likely be a significant adverse impact on current and future harvest levels.

As WWDRs had not been formulated, the North Coast Water Board for some time failed to release for harvest a number of THPs that had already been approved by the other governmental agencies which approve the Company's THPs. In February 2005, the Executive Officer of the staff of the North Coast Water Board released sufficient THPs to allow the harvest of up to 50% of the CDF Harvest Limit for these two watersheds. On March 16, 2005, the North Coast Water Board ordered the enrollment of additional THPs that would allow the harvest of up to 75% of the CDF Harvest Limit for these two watersheds. Third parties subsequently appealed this decision to the State Water Board. On June 16, 2005, the State Water Board heard this appeal and rendered a decision, which had the effect of disallowing further harvesting on the additional 25% of the CDF Harvest Limit approved by the North Coast Water Board on March 16, 2005. The State Water Board's decision also has the effect of disallowing further harvesting in the Freshwater and Elk River watersheds until WWDRs for these watersheds are adopted by the North Coast Water Board. Palco has appealed the State Water Board's June 16, 2005, decision in a California state court. A hearing on the appeal has not yet been scheduled.

On September 2, 2005, the North Coast Water Board set hearings on the draft WWDRs for September 14 and 15, 2005. On September 9, 2005, the Company and Palco filed a petition in California state court seeking an order mandating that the North Coast Water Board not take any further action on the proposed WWDRs. The petition alleges defects in the proposed WWDRs and the North Coast Water Board's hearing procedures. The Company and Palco also requested a temporary restraining order and preliminary injunction to prevent the North Coast Water Board from taking any further action until their petition is heard. The temporary restraining order was granted and the preliminary injunction hearing is scheduled for November 9, 2005.

The unreleased and disallowed THPs in the Freshwater and Elk River watersheds represented a significant portion of the harvest that had been planned for the first nine months of 2005. The ongoing regulatory, environmental and litigation matters faced by the Company and Palco, exacerbated by the developments described in the previous paragraph, have materially 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. Should the Freshwater-Elk River WWDRs not be approved during 2005 or in the first few months of 2006, or be approved with additional restrictions on harvest, there could be a material adverse impact on the Company's and Palco's future cash flows from operations.

As previously announced, the Company's estimates indicated that its cash flows from operations, together with its Line of Credit and other available funds, would likely be inadequate to pay all of the interest due on the July 20, 2005, payment date for the Timber Notes. As the July 20, 2005, payment date approached, it became apparent that the Company's estimates would prove correct and that the cash shortfall as of the payment date would be approximately \$2.2 million. Based upon a review of its alternatives under the circumstances, consultation with its own legal and financial advisors, and consideration of discussions with the advisors of the Noteholders Committee, the Company requested that Palco make an early payment, equal to the shortfall, in respect of certain logs that had already been delivered to and purchased by Palco from the Company. Palco approved and delivered the early log payment, which allowed the Company to fund the July 20, 2005, cash shortfall and pay all of the \$27.9 million of interest due (\$25.9 million net of interest due in respect of Timber Notes held by the Company).

The Company's ability to pay all of the \$27.7 million of interest due (\$25.8 million net of interest due in respect of Timber Notes held by the Company) on the January 20, 2006, payment date will depend upon many factors, including the Company's harvest levels for the remainder of 2005, cash flows from operations through the January 20, 2006, payment date, together with access to its Line of Credit. At September 30, 2005, the maximum availability under the Line of Credit was \$55.4 million, and borrowings outstanding were \$49.5 million. There can be no assurance that the Company will have sufficient liquidity to make this interest payment.

In March 2005, UBS agreed to assist the Company in seeking to restructure its obligations with respect to the outstanding Timber Notes. The Company has agreed to pay UBS an advisory fee of \$150,000 per month, creditable in full against a success fee of \$5.6 million that would be payable upon consummation of any restructuring transaction prior to July 27, 2006, in addition to agreeing to reimburse certain of UBS's expenses and to indemnify UBS and its affiliates. UBS' engagement expired by its terms on July 27, 2005, and UBS and the Company subsequently extended that engagement, which can be terminated with thirty days notice by either party. In June 2005, the Company agreed to be responsible for certain payments and other obligations of the Noteholder Committee relating to their legal counsel and financial advisors. On September 23, 2005, the Company terminated its agreement to be responsible for further payments, effective immediately in the case of legal counsel and effective October 23, 2005 in the case of the financial advisor. The Company terminated its agreement upon the recommendation of a special committee of independent managers since it concluded that insufficient progress had been made in negotiations with the Noteholder Committee and was advised that holders of less than 15% of Timber Notes (measured by principal amount) had agreed to confidentiality provisions necessary in order to participate in a process intended to lead to a restructuring agreement. The Company continues to evaluate its liquidity alternatives in respect of the January 20, 2006, payment date and beyond.

The Company and UBS have conducted extensive reviews and analyses of the Company's assets, operations and prospects. As a result of these extensive reviews and analyses, management has concluded that, in the absence of significant regulatory relief and accommodations, annual timber harvest levels and cash flows from operations will in future years be substantially below both historical levels and the minimum levels necessary in order to allow the Company to satisfy its debt service obligations in respect of the Timber Notes. Company has announced that its projected average annual harvest level over the ten-year period beginning 2006 is estimated at approximately 100 million board feet per year. This harvest level reflects management's most recent estimate of the cumulative impact of ongoing regulatory limitations, prescriptions, and other actions and is based upon a number of assumptions which may or may not prove to be accurate. Management also determined that reductions must be made to its cost structure in line with these anticipated reductions in harvest levels and cash flows. Accordingly, on August 30, 2005, the Company implemented a restructuring plan reducing its workforce by approximately one third. To the extent that the Company is unable to restructure its Timber Notes consistent with management's expectations as to future harvest levels and cash flows, or secure additional liquidity from external sources, the Company expects that it, and as may be required, Palco, will be forced to take extraordinary actions, which may include: further 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 of December 31, 2004 and March 31, 2005, Palco was in default under the Palco Credit Agreement and obtained limited waivers of the default through April 22, 2005. On April 19, 2005, Palco and Britt, as Borrowers, closed the Revolving Credit Facility and the Term Loan. The Term Loan was fully funded at closing and the Borrowers used approximately \$10.8 million of the funds from the Term Loan to pay off amounts previously borrowed under the Palco Credit Agreement and terminated that facility. As of September 30, 2005, \$34.8 million was outstanding under the Term Loan and \$12.1 million was outstanding under the Revolving Credit Facility. Palco estimates that its cash flow from operations will not provide sufficient liquidity to fund its operations until the fourth quarter of 2006. Accordingly, Palco expects to be dependent on the funds available under the Revolving Credit Facility, and expects additional liquidity will be needed, to fund its working capital and other cash requirements in 2005 and 2006. The Revolving Credit Facility and Term Loan are each secured by a security interest in the stock of Palco and substantially all of the assets of the Borrowers (other than Palco's equity interest in the Company).

As of September 30, 2005, borrowings under the Revolving Credit Facility were limited to the sum of 85% of Palco and Britt's eligible accounts receivable plus 75% of their eligible inventories (up to a maximum of \$30.0 million, subject to limitations such as the ability of the lender to establish reasonable reserves). Both the Term Loan and the Revolving Credit Facility contain EBITDA maintenance covenants that, if not met, could trigger a mandatory prepayment of outstanding borrowings. The operating cash flow estimates used to establish the EBITDA maintenance covenants are subject to a number of assumptions about future operating cash flow and actual results could differ from these estimates. Accordingly, the availability of these funds is largely dependent on Palco's ability to harvest adequate timber from the Company Timberlands and reduce operating costs. Available resources to fund Palco's and Britt's operating needs at September 30, 2005 were \$8.0 million, comprised of the maximum availability under the Revolving Credit Facility of \$7.7 million and unrestricted cash and marketable securities of \$0.3 million.

Subsequent to September 30, 2005, Palco borrowed the maximum available under the Revolving Credit Facility and on October 26, 2005, Palco, Britt and certain of their affiliates entered into the Omnibus Amendment which amended the Term Loan and the Revolving Credit Facility to, among other things, temporarily increase the amount of the Revolving Credit Facility from \$30.0 million to \$35.0 million and temporarily increase the advance rate applicable to the Borrowers' inventory from 75% to 80%. The increase in the inventory advance rate, is subject to satisfactory inventory appraisals, and the amount of the increase in such advances is capped at \$1.5 million. The increase in the amount of the Revolving Credit Facility and the increase in the inventory advance rate will be gradually phased out in January through March 2006. The Omnibus Amendment also revises financial covenants applicable to the Revolving Credit Facility and the Term Loan. MGI furnished cash collateral of \$2.0 million as additional security for the Borrowers' obligations under the Revolving Credit Facility and the Term Loan Facility. This cash collateral will be released on April 1, 2006, so long as the Borrowers have achieved earnings and borrowing availability targets that are to be determined by the Lenders.

Palco's available cash resources, including proceeds from and availability under the Term Loan and Revolving Credit Facility have been primarily utilized during the first nine months of 2005 in the following areas: (i) \$10.8 million was used to pay off amounts previously borrowed under the Palco Credit Agreement; (ii) approximately \$ 6.2 million was used to fund capital expenditures related to Palco's new state-of-the-art sawmill in Scotia, California; (iii) \$9.9 million was used as collateral to secure Palco's workers compensation liabilities; (iv) \$13.5 million was used to build log inventory levels; and (v) the remainder was used to pay advisor fees and to fund working capital shortfalls. Palco's ability to generate sufficient liquidity to fund its short term liquidity needs will depend upon many factors, including Palco's ability to achieve planned production rates at its new sawmill. While production levels at the new sawmill continue to improve, the new sawmill is not yet operating at planned capacity and is not expected to achieve planned production rates for the remainder of 2005. Accordingly, additional liquidity will be needed at Palco to fund working capital requirements in 2005 and 2006, but there can be no assurance that Palco will be able to secure additional liquidity. In the event that Palco were unable to secure the necessary liquidity, it would be forced to take extraordinary actions, which may include: further reducing expenditures by laying off employees and shutting down various operations and seeking protection by filing under the Bankruptcy Code.

On April 21, 2005, Moody's lowered its ratings on the Class A-1 Timber Notes from Baa2 to Ba3; the Class A-2 Timber Notes from Baa3 to B1; and the Class A-3 Timber Notes from Bal to B1. On June 20, 2005, Moody's further lowered its ratings on all classes of the Timber Notes to Caal. S&P announced on April 7, 2005, that it had lowered Palco's credit rating to CCC- (which rating it affirmed on April 28, 2005). As a result of the S&P credit rating actions related to Palco, Palco was required to post a \$9.9 million letter of credit with the State of California to secure its workers compensation liabilities, which reduced Palco's availability under the Revolving Credit Facility by a corresponding amount.

The Company's Line of Credit allows it to borrow up to one year's interest due on the Timber Notes. On June 20, 2003, the Line of Credit was extended to July 7, 2006. At or near the completion of such extension, the Company would 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 were \$18.2 million in borrowings outstanding under the facility. At September 30, 2005, the maximum availability under the Line of Credit was \$55.4 million, and borrowings outstanding were \$49.5 million.

On the note payment date in January 2005, the Company used the funds available under the Line of Credit to pay all of the \$28.5 million of interest due (\$26.3 million net of interest due in respect of Timber Notes held by the Company). The Company also repaid \$17.1 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 2005, the Company used its existing cash resources, all of the remaining funds available under the Line of Credit, and the additional funds made available from the \$2.2 million early log payment by Palco, to pay all of the \$27.9 million of interest due (\$25.9 million net of interest due in respect of Timber Notes held by the Company). The Company also repaid \$8.0 million of principal on the Timber Notes (an amount equal to Scheduled Amortization) using funds held in the SAR Account.

The Master Purchase Agreement between the Company and Palco (see Item 1. "Business—Operation of Company Timberlands" of the Form 10-K) 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 logs. 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 Timber Notes 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. In December 2004, the California State Board of Equalization adopted the new Harvest Value Schedule for the first six months of 2005. The prices published in that schedule (which exceeded the applicable structuring prices) 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. In June 2005, the California State Board of Equalization adopted the new Harvest Value Schedule for the second half of 2005. The prices established in that schedule (which exceed the applicable structuring prices) reflected a 4.2% increase in the SBE Price for small redwood logs from the price published for the first half of 2005. There was no change in the small Douglas-fir log price from the price published for the first half of 2005.

Capital expenditures were \$4.8 million for the first nine months of 2005 and are estimated to be between \$3.5 million and \$4.1 million for the remainder of 2005 (subject to available cash). The Company may purchase additional timberlands from time to time as appropriate opportunities arise.

Off-Balance Sheet Arrangements

The Company does not have any off-balance sheet financing, other than operating leases entered into in the normal course of business, or unconsolidated special purpose entities. The Company does not use derivatives for any of its treasury or risk management activities.

Trends

See Note 3 and Part I, Item 2. "Management's Discussion and Analysis of Financial Conditions and Results of Operations—Financial Condition and Investing and Financing Activities" for information regarding various regulatory, environmental, litigation and other matters which have caused and are expected to continue to cause delays in the approval of the Company's THPs and the ability to harvest on THPs once they are approved, as well as adverse impacts on timber harvest levels and timber harvesting and other costs. Both Palco and the Company are evaluating their liquidity alternatives. There can be no assurance that the Company and/or Palco will have sufficient liquidity to satisfy their debt service obligations and fund their working capital requirements.

The Company has announced that its projected average annual harvest level over the ten-year period beginning 2006 is estimated at approximately 100 million board feet per year. This harvest level reflects management's most recent estimate of the cumulative impact of ongoing regulatory limitations, prescriptions, and other actions.

Critical Accounting Policies and Estimates

See Item 7. “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Critical Accounting Policies” of the Form 10-K for a discussion of the Company’s critical accounting policies. There have been no material changes in the Company’s critical accounting policies and estimates provided in the December 31, 2004 Form 10-K.

New Accounting Pronouncements

See Note 1 for a discussion of a new accounting pronouncement and its potential impact on the Company.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company is exposed to changes in interest rates primarily under the Line of Credit. As of September 30, 2005, there were \$49.5 million in borrowings outstanding under all variable rate facilities. Based on the amount of borrowings outstanding under these facilities during the nine months ended September 30, 2005, a 1.0% change in interest rates effective from the beginning of the year would have resulted in an increase or decrease in interest expense of \$0.3 million.

ITEM 4. CONTROLS AND PROCEDURES

The Company maintains 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 SEC, and that such information is accumulated and communicated to the Company’s management, including its 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 the Company’s management, including 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 September 30, 2005.

There have been no significant changes in the Company’s internal controls or in other factors that could significantly affect the internal controls subsequent to the date the Company completed its evaluation.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The information set forth in Note 3 is incorporated herein by reference.

ITEM 6. EXHIBITS

a. Exhibits:

- * 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

* Included with this filing

SIGNATURE

Pursuant to the requirements 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, who has signed this report on behalf of the Registrant and as the principal financial and accounting officer of the Registrant.

SCOTIA PACIFIC COMPANY LLC

Date: November 9, 2005

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

Glossary of Defined Terms

APB Opinion No. 29: Accounting Principles Board Opinion 29, “Accounting for Nonmonetary Transactions”

Bankruptcy Code: The United States Bankruptcy Code

Bear Creek lawsuit: An action entitled *Environmental Protection Information Association v. Pacific Lumber, Scotia Pacific Company LLC* (No. C01-2821) filed in the U.S. District Court for the Northern District of California

Britt: Britt Lumber Co., Inc., a wholly owned subsidiary of Palco

California Permits: The Permits issued by California pursuant to the HCP

California Senate Bill 810: Bill which became effective January 1, 2004 providing regional water quality control boards with additional authority related to the approval of THPs on land within impaired watersheds

Cave action: An action entitled *Steve Cave, et al. v. Gary Clark, et al.* (No. DR020719) filed in the Superior Court of Humboldt County, California

CBD: Center for Biological Diversity

CDF: California Department of Forestry and Fire Protection

CDF Harvest Limit: Annual harvest limit established by the CDF

CDFG: California Department of Fish and Game

CESA: California Endangered Species Act

Company: Scotia Pacific Company LLC, a limited liability company wholly owned by Palco

Company Timberlands: Approximately 204,000 acres of timberlands owned by the Company

Consistency Determinations: Documents issued by CDFG in February 2005 which stated that as long as Palco continues to follow the requirements of its HCP and has Federal Permits (which were unaffected by the *EPIC SYP/Permits lawsuit*), then Palco meets all requirements under CESA for the incidental take of coho salmon or the marbled murrelet.

Cook action: An action entitled *Alan Cook, et al. v. Gary Clark, et al.* (No. DR020718) filed in the Superior Court of Humboldt County, California

CWA: Federal Clean Water Act

EBITDA: As defined in Section 1.01 of the Revolving Credit Agreement and Term Loan which, among other things, excludes the results of the Company

Elk River Order: Clean up and abatement order issued to Palco by the North Coast Water Board for the Elk River watershed

Environmental Plans: The HCP and the SYP

EPA: Environmental Protection Agency

EPIC: Environmental Protection Information Association

EPIC-SYP/Permits lawsuit: 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.* filed in the Superior Court of Humboldt County, California (No. CV990445)

EPIC-USFWS/NOAA lawsuit: An action entitled *Environmental Protection Information Center v. U.S. Fish & Wildlife Service, NOAA Fisheries, et al.* (No. C04-4647) filed in U.S. Court for the Northern District of California

FASB: Financial Accounting Standards Board

Federal Permits: The Permits issued by the federal government pursuant to the HCP

Form 10-K: Annual Report on Form 10-K of the Company for the fiscal year ended December 31, 2004

Harvest Value Schedule: A schedule setting forth SBE Prices which is published biannually by the California State Board of Equalization for purposes of computing yield taxes on timber sales

HCP: The habitat conservation plan covering multiple species approved in March 1999 in connection with the consummation of the Headwaters Agreement

Headwaters Agreement: The agreement among Palco, the Company, Salmon Creek, the United States and California which provided the framework for the acquisition by the United States and California of the Headwaters Timberlands

Headwaters Timberlands: Approximately 5,600 acres of Palco timberlands consisting of two forest groves commonly referred to as the Headwaters Forest and the Elk Head Springs Forest which were sold to the United States and California in March 1999

Humboldt DA action: A civil suit filed in the Superior Court of Humboldt County, California, by the District Attorney of Humboldt County entitled *The People of the State of California v. Pacific Lumber, Scotia Pacific Holding Company and Salmon Creek Corporation* (No. DR030070)

Indenture: The indenture governing the Timber Notes

Line of Credit: The agreement between a group of lenders and the Company pursuant to which the Company may borrow in order to pay up to one year's interest on the Timber Notes

Master Purchase Agreement: Agreement which governs the sale of logs to Palco by the Company

MAXXAM: MAXXAM Inc.

Mbfe: A concept developed for use in structuring the Timber Notes; under this concept one thousand board feet, net Scribner scale, of old growth redwood timber equates to one Mbfe

MGI: MAXXAM Group Inc., an indirect wholly owned subsidiary of MAXXAM

Moody's: Moody's Investors Service

North Coast Water Board: California North Coast Regional Water Quality Control Board

Noteholders: Holders of the Timber Notes

Noteholder Committee: An ad hoc committee of holders of the Timber Notes

Omnibus Amendment: Amendment to Revolving Credit Facility and Term Loan (and other loan documents) entered into on October 26, 2005

Option A Plan: Plan for complying with California's sustained yield requirements, which has been approved by the CDF

Palco: The Pacific Lumber Company, a wholly owned subsidiary of MGI

Palco Companies: The Company, Palco, and Salmon Creek, collectively

Palco Credit Agreement: Palco's revolving credit facility with a bank providing for borrowings up to \$30.0 million based on certain collateral balances, which was terminated in connection with the closing of the Revolving Credit Facility and Term Loan

Permits: The incidental take permits issued by the United States and California pursuant to the HCP

PSLRA: Private Securities Litigation Reform Act of 1995

Revolving Credit Facility: Revolving credit facility among Palco and Britt, as Borrowers, and Credit Suisse First Boston

S&P: Standard & Poor's Rating Service

Salmon Creek: Salmon Creek LLC, a wholly owned subsidiary of Palco

SAR Account: Funds held in a reserve account titled the Scheduled Amortization Reserve Account and used to support principal payments on the Timber Notes

SBE Price: The applicable stumpage price for a particular species and size of log, as set forth in the most recent Harvest Value Schedule

Scheduled Amortization: The amount of principal which the Company must pay through each Timber Note payment date in order to avoid prepayment or deficiency premiums

SEC: The Securities and Exchange Commission

Services Agreement: Agreement between the Company and Palco under which Palco provides certain operational, management and related services to the Company with respect to the Company Timberlands

SFAS No. 153: "Exchange of Nonmonetary Assets," an amendment of APB Opinion No. 29

State Board of Equalization: The California State Board of Equalization

State Water Board: California State Water Resources Control Board

SYP: The sustained yield plan approved in March 1999 as part of the Headwaters Agreement, and later invalidated by a California state court

take: Adverse impacts on species which have been designated as endangered or threatened

Term Loan: \$35.0 million term loan among Palco and Britt, as borrowers, and the CIT Group/Business Credit, Inc.

THP: Timber harvesting plan required to be filed with and approved by the CDF prior to the harvesting of timber

THP No. 520 lawsuit: An action entitled *The Pacific Lumber Company, et al. v. California State Water Resources Control Board* (No. DR010860) filed in the Superior Court of Humboldt County, California

Timber Notes: The Company's 6.55% Series B Class A-1 Timber Collateralized Notes, 7.11% Series B Class A-2 Timber Collateralized Notes and 7.71% Series B Class A-3 Timber Collateralized Notes due July 20, 2028

TMDLs: Total maximum daily load limits

Trustee: The trustee under the Indenture

UBS: UBS Securities LLC

USWA lawsuit: An 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* (No. CV990452) filed in the Superior Court of Humboldt County, California

WWDRs: Watershed-wide discharge requirements