
**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, 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**

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 if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. **Yes** **No**

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. **Yes** **No**

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. **:**

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange 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 (“**Company**”), a 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, (“**Class A-1 Notes**”), 7.11% Series B Class A-2 Timber Collateralized Notes due 2028 (“**Class A-2 Notes**”) and 7.71% Series B Class A-3 Timber Collateralized Notes due 2028 (“**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,” “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 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 significantly and adversely affected by, among other things, the failure of the California North Coast Regional Water Quality Control Board (“**North Coast Water Board**”) to release for harvest a number of the Company’s timber harvesting plans (“**THPs**”) even though the plans have already been approved by the other government agencies which review the Company’s THPs and are in compliance with its habitat conservation plan. See “–Regulatory and Environmental Factors–Water Quality” and 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, “Business–General” above and Item 1A. “Risk Factors” below 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 virtually contiguous commercial timberlands in Humboldt County along the northern California coast (“**Company Timber Property**”), (ii) the timber and related harvesting rights (“**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 these timber properties, including timber type, site productivity class, wildlife and botanical data, geological information, roads, rivers and streams (subject to certain rights of concurrent use by Palco) and (iv) certain other assets. Substantially all of the Company’s assets are pledged 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.”**

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”** or **“second 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 Company Timber is comprised of 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.

Redwood is commercially available only along the northern coast of California and possesses certain unique characteristics that permit it to be sold at a premium to many other wood products. Such characteristics include its natural beauty, superior ability to retain paint and other finishes, dimensional stability and innate resistance to decay, insects and chemicals. Typical applications include exterior siding, trim and fascia for both residential and commercial construction, outdoor furniture, decks, planters, retaining walls and other specialty applications. Redwood also has a variety of industrial applications because of its chemical resistance and because it does not impart any taste or odor to liquids or solids.

Upper grade redwood lumber, which is derived primarily from larger diameter logs and is characterized by an absence of knots and other defects, little to no sapwood, and a tighter grain, is used primarily in distinctive interior and exterior applications. Common grade redwood lumber has many of the same aesthetic and structural qualities of redwood uppers, but has some knots, sapwood and a coarser grain. Such lumber is commonly used for construction purposes, including outdoor structures such as decks and fencing.

Douglas-fir lumber 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. Upper grade Douglas-fir lumber is derived primarily from larger diameter Douglas-fir timber and is used principally in finished carpentry applications. Common grade Douglas-fir lumber is used for a variety of general construction purposes and is somewhat interchangeable with common grades of other whitewood species, although the strength of Douglas-fir makes it more desirable in certain applications.

The Company and Palco engage in extensive efforts to supplement the natural regeneration of timber and increase the amount of timber on the Company Timberlands. The Company and Palco are 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”). Reforestation of redwood timber generally is accomplished through redwood sprouts from the stumps of 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 2005, 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 and Palco are 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 occurs as a result of operations that comply 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 (see “–Regulatory and Environmental Factors–Environmental Plans”), the federal and state governments approved a sustained yield plan (**“SYP”**) and a comprehensive multi-species

habitat conservation plan (“**HCP**”), and together with the SYP, the (“**Environmental Plans**”) in respect of substantially all of the Company Timberlands.

In connection with two lawsuits filed against the Company and Palco, a California trial court invalidated the SYP and the incidental take permits issued by California in connection with the Environmental Plans (“**California Permits**”). However, Palco appealed this decision, and in December 2005, the appeals court reversed the trial court’s ruling. See Item 3. “Legal Proceedings.” for further information regarding this matter. As a result of these cases, the Company from October 2002 until March 2005 obtained review and approval of its THPs under an 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 Palco). An approved Option A plan is an alternative to obtaining approval of a sustained yield plan. Palco’s Option A plan (“**Option A Plan**”) was approved by the CDF in March 2005. The Company is currently relying upon its Option A Plan to obtain THP approvals, and will likely continue to do so in the future.

Operation of Company Timberlands

The Company, Palco, and Salmon Creek (collectively, the “**Palco Companies**”) are parties to several agreements between or among themselves, including the Master Purchase Agreement, the Services Agreement, and Additional Services Agreement, a Reciprocal Rights Agreement, and an Environmental Indemnification Agreement (see below).

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 information contained in GIS. 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 (“**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 (see below) 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 applicable stumpage price for each species of timber and category thereof pursuant to 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 Item 7. “Management’s Discussion and Analysis of Financial Condition and Results of Operations–Financial Condition and Financing and Investing Activities” for recent

developments regarding Palco's financial condition and "–Financial Condition and Financing and Investing Activities–Timber Note Payments" for a description of a recent Lump Sum Sale of certain Company Timber by the Company to MGI.

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 ("**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. The Company also 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 is required to provide certain services to Palco pursuant to an additional services agreement ("**Additional Services Agreement**"). These services include (i) assisting Palco in operating, maintaining and harvesting 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 accounting principles generally accepted in the United States.

The Palco Companies are also parties to a reciprocal rights agreement ("**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, the Company and Palco are parties to an environmental indemnification agreement ("**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, "Business–General" above and Item IA. "Risk Factors" below for cautionary information with respect to such forward-looking statements.

The ability to harvest Company Timber depends 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, 2006, the Company employed 85 persons, 77 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, “Business—General” above and Item 1A. “Risk Factors” below for cautionary information with respect to such forward-looking statements.

General

The businesses of the Company and Palco are 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 these Companies business. The California Forest Practice Act (“**Forest Practice Act**”) and related regulations adopted by the California Board of Forestry and Fire Protection (“**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 will not exceed the maximum sustainable production of their timberlands over time. See “—Timber and Timberlands” above.

The federal Endangered Species Act (“**ESA**”) and California Endangered Species Act (“**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 (“**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 (“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 and related 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

In March 1999, the Palco Companies consummated the Headwaters Agreement (“**Headwaters Agreement**”) with the United States and California. Pursuant to the agreement, approximately 5,600 acres of timberlands owned by the Palco Companies 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 the Environmental Plans. In connection with approval of the Environmental Plans, the California Permits and federal incidental take permits (“**Federal Permits,**” and together with the California 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. In October 2003, a California trial court entered a judgment invalidating the SYP and the California Permits. Palco appealed this decision and in December 2005 the appeals court reversed the trial court’s ruling. See Item 3. “Legal Proceedings–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 (containing 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 areas 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. Since then watershed analysis has been completed and prescriptions approved for three additional watersheds: Van Duzen in January 2004, Lower Eel-Eel Delta in March 2004, and Elk River in November 2005. The Freshwater, Van Duzen, Lower Eel, and Elk River 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 harvesting activities on some potential landslide-prone areas in lieu of no-harvest restrictions. This effectively reduced both constrained acreage and operational restrictions of the HCP in these watersheds. The analysis for a fifth watershed, Upper Eel is being submitted for agency and public review, and prescriptions for this watershed are being developed.

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 required more time than originally anticipated. Accordingly, the Palco Companies continue to work with the government agencies to establish appropriate timelines and to streamline watershed analyses on the remaining portions of Company Timberlands to ensure that such studies are time and cost efficient and 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.

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 and/or reduce operating costs while still meeting the obligations of the Environmental Plans.

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, Palco has conducted, and expects to be able to continue to conduct, some harvesting during these periods. An adaptive management change (see above) 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 465 miles of roads have been stormproofed consistent with the HCP schedule.

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 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 watershed-wide waste discharge requirements (“**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. 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 the process of establishing TMDLs 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 2007 for these two watercourses. The Company’s scientists are actively working with North Coast Water Board staff to ensure that these TMDLs recognize and incorporate the environmental protection measures of the HCP. The final TMDL requirements applicable to the Company Timber Property 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 winter periods since 2002, the Company and Palco have been required to submit reports on sediment discharges and erosion control practices to the North Coast Water Board 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 these 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 additional delays in THP approvals.

The North Coast Water Board has also issued a clean up and abatement order for the Elk River watershed (“**Elk River Order**”), 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 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 Resources Control Board (“**State Water Board**”) was denied. Palco has appealed the decision of the State Water Board in state court, but has held such appeal in abeyance until a decision was reached by the California Supreme Court on the *THP No. 520 lawsuit* (see Item 3. “Legal Proceedings–Timber Harvest Litigation”). Now that the California

Supreme Court has reached a decision, Palco is in the process of considering whether or not to pursue its appeal of the Elk River Order.

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 herein are expected to result in reduced harvest levels 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 the Company's 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 harvest limit established by the CDF for these two watersheds ("**CDF Harvest Limit**"). 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 ("**State Water Board Order**"), 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.

On July 14, 2005, Palco and The Company filed an action entitled *The Pacific Lumber Company and Scotia Pacific Company LLC v. State Water Resources Control Board, et al.* in (No. CV050516) in Humboldt County Superior Court ("**State Water Board action**") appealing the State Water Board Order. The companies' appeal requested both a stay of the State Water Board Order and a writ of mandate seeking reversal of the State Water Board Order. Following a December 8, 2005, hearing on the companies' requests, the state court denied the request for a stay, but granted a hearing on the request for a writ of mandate. A hearing on the writ of mandate was held on February 6, 2006 and Palco and the Company await the court's decision.

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, Palco and the Company 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 alleged defects in the proposed WWDRs and the North Coast Water Board's hearing procedures. Palco and the Company requested a preliminary injunction to prevent the North Coast Water Board from taking any further action until their petition is heard. The Court denied the preliminary injunctions following a hearing on November 9, 2005, and Palco and the Company subsequently dismissed the case.

On February 17, 2006, the North Coast Water Board held a status conference to determine a timetable for consideration and approval of WWDRs in the Freshwater and Elk River watersheds. Although a formal timetable has not been published, it appears likely that WWDRs will not be approved before May 2006. Such a timetable would further reduce 2006 harvest levels.

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 Timber Property are classified as sediment-impaired, implementation of this law could result in additional 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* described in Item 3. "Legal Proceedings—Timber Harvest 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 2005, Palco was granted a Timber Operator's License for 2006-2007.

ITEM 1A. RISK FACTORS

Risks Related to Our Liquidity and Capital Resources

We are highly leveraged and our debt service requirements are substantial.

As of December 31, 2005, our indebtedness totaled \$774.4 million, consisting of approximately \$743.1 million principal amount of Timber Notes and approximately \$31.3 million aggregate principal amount of indebtedness under our Line of Credit ("**Line of Credit**"). Our annual interest payments on its Timber Notes are approximately \$54.0 million.

Our annual cash flows from operations are expected to be substantially below the minimum levels necessary to satisfy our debt service obligations over at least the next several years.

We expect that our cash flows from operations, together with funds available under the Line of Credit, will be insufficient, by a substantial amount, to pay the interest on the Timber Notes due on the July 20, 2006, payment date. We also expect to incur principal and interest shortfalls for at least the next several years. Failure to pay interest on the Timber Notes when due would constitute an event of default under the Indenture.

If our efforts to address its liquidity issues are unsuccessful, we may default on interest payments on the Timber Notes.

To avoid defaulting on interest payments on our Timber Notes, we must successfully implement one or more strategies beyond the ordinary course of business, such as the following:

- *Restructure the Timber Notes to decrease our minimum payment obligations.* In 2005, we devoted considerable resources in an attempt to restructure the Timber Notes. Those efforts were unsuccessful, and we do not currently expect to restructure our required minimum payments on the Timber Notes through negotiations with holders of the Timber Notes.
- *Obtain significant regulatory relief and accommodations in order to increase our harvest levels and ease our regulatory costs.* Various regulatory actions have substantially reduced our timber harvest and increased our costs, reducing cash flows from operations. We may not be able to obtain any significant regulatory relief or accommodations.
- *Further reduce our expenditures, by laying off employees and shutting down operations.* We have already eliminated a substantial portion of the personnel and operations we believe can be eliminated consistent with performing our obligations under the Indenture and otherwise. As a result, we have very limited capacity to further reduce operating costs.
- *Avoid incurring new liquidity, cash flow or operational problems as a result of regulatory, litigation or other developments.* We cannot control or predict the results of its pending, or potential additional future, regulatory and litigation proceedings and matters.
- *Seek and obtain other timely sources of liquidity, such as from asset sales.* Our efforts to seek other sources of liquidity, most importantly through our Company Land Sale Program (as defined in Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations—Financial Condition and Investing and Financing Activities—Liquidity Issues."), may not be completed in time or at sufficient levels to enable us to generate the cash required in order to avoid defaulting on the Timber Notes and the Line of Credit. Regulatory approvals will be required in connection with our Company Land Sale Program, and these approvals may not be timely received.

If our efforts to increase our cash flow are unsuccessful or untimely, we may default on the Timber Notes and the Line of Credit or seek protection by filing under the U.S. Bankruptcy Code (“**Bankruptcy Code**”). In that event, all principal, interest and other amounts related to the Timber Notes may become immediately due and payable and the Line of Credit debt may also be accelerated. If these accelerations occur, the trustee for the Timber Notes may exercise all rights under the Indenture and related security documents, including applying funds to pay accelerated amounts, and selling the Company Timber and other assets and using the proceeds to pay accelerated amounts

Amounts on deposit in the SAR Account may not be sufficient to fund anticipated Timber Notes amortization in January 2007.

Amounts on deposit in the SAR Account are used on each Timber Notes payment date, as needed, to make principal payments on the Timber Notes sufficient to reduce outstanding principal to an amount specified by the Indenture. We anticipate that the amount needed to reduce the principal of the Timber Notes to the specified amount on the January 20, 2007, Timber Notes payment date will be approximately \$21.7 million. We project that the SAR Account will at that time contain approximately \$8.0 million, together with the amount of cash, if any, realized by that date from sale of the approximately \$55.4 million (face amount) of Timber Notes held in the SAR Account (at December 31, 2005). We may not be able to sell these Timber Notes by January 2007 because, among other things, the Timber Notes are thinly traded instruments. Even if we are able to sell these Timber Notes, the net proceeds are currently expected to be significantly less than their face amount. If the amount on deposit in the SAR Account on a Timber Notes payment date is less than what is needed to reduce outstanding principal to the amount specified by the Indenture, only the lesser amount on deposit in the SAR Account is required to be paid as a principal payment on the Timber Notes.

Our high level of debt could similarly have important negative consequences, including:

- limiting our ability to use operating cash flow in other areas of our business because we must dedicate a substantial portion of these funds to service our debt;
- increasing our vulnerability to general adverse economic and industry conditions; and
- limiting our ability to respond to adverse government regulation and litigation developments.

Any of these or other factors could further exacerbate our liquidity difficulties.

We may not be able to sell our logs to third parties.

Although it is currently contemplated that all or substantially all of our revenues will be derived from the sale of logs to Palco, should Palco be unable to continue to purchase all of our logs due to its financial difficulties (see below), we would need to seek third party purchasers. Such purchasers may not be available or, if available, such purchasers may not acquire sufficient quantities of logs on terms that would allow us to generate cash flow sufficient to fund our cash needs, including amounts due in respect of the Timber Notes.

Risks Related to Palco’s Liquidity and Capital Resources

Palco is highly leveraged and is currently in default under its debt facilities.

Palco, from whom the Company currently derives substantially all of its revenue, is highly leveraged. Moreover, due to financial covenant breaches, Palco and Britt are currently in default under their \$35.0 million term loan agreement (“**Palco Term Loan**”) and their \$30.0 million revolving credit facility (“**Palco Revolving Credit Facility**”). Palco and Britt may be unable to obtain waivers of these defaults from the lenders under the two facilities, which are secured by a security interest in the stock of Palco held by MGI and liens on substantially all of the assets of Palco and Britt, except for Palco’s equity interest in us. Without waivers of these defaults, the lenders may exercise a variety of rights and remedies, such as reducing the amount of funds available for borrowing under the Palco Revolving Credit Facility, declaring any or all loans and other amounts owed under the Palco Term Loan and the Palco Revolving Credit Facility to be immediately due and payable, and exercising all rights to collateral.

Palco may be adversely affected by an inability to obtain additional liquidity or timely complete asset sales.

In an effort to reduce its overall debt load, Palco is in the process of marketing certain assets (“**Palco Asset Sale Program**”) and seeking other sources of liquidity. Palco may not be able to obtain additional liquidity and may not be able to timely complete the Palco Asset Sale Program. Regulatory approvals required to complete the program could delay receipt of liquidity from the program.

Palco's high levels of debt and covenant restrictions increase the difficulty of operating its business.

Palco's high level of debt and covenant restrictions under the Palco Term Loan and Palco Revolving Credit Facility could have a variety of important negative consequences, including:

- limiting Palco's ability to borrow additional amounts for working capital, capital expenditures, debt service requirements, execution of its operating strategies or other purposes;
- increasing Palco's vulnerability to general adverse economic and industry conditions;
- limiting Palco's ability to capitalize on business opportunities, such as purchasing additional log inventories from third parties, and to react to competitive pressures and adverse government regulation and litigation developments; and
- limiting Palco's ability, or increasing the costs, to refinance indebtedness.

Palco's need to purchase third party logs will increase its working capital requirements

Palco expects that it will in the future be required to increase the percentage of logs it purchases from third parties. These purchases may not be available, or may be available on terms that are not acceptable or are significantly adverse to Palco. Palco's working capital needs are likely to increase substantially during 2006 and beyond to accommodate these increased purchases of third party logs. Palco may not be able to obtain this additional working capital, given its liquidity problems.

Risks Related to Regulatory Matters

Regulatory and legislative actions have the power to limit our harvest levels and require us and Palco to incur additional costs and have other adverse consequences.

The following regulatory and legislative actions, among others, are now having, or have the potential to have, material adverse impacts on us and Palco:

- The North Coast Water Board has failed to release for harvest a number of our previously-approved THPs, reducing current and projected harvest levels significantly. Continued failure of the North Coast Water Board to release THPs for harvest would worsen the cash flow difficulties of us and Palco.
- The final TMDL requirements applicable to the Company Timber Property may require aquatic protection measures that are different from or in addition to those in the HCP or that result from the watershed analysis process provided for in the HCP. These requirements may further reduce our cash flows and those of Palco.
- The North Coast Water Board has issued the Elk River Order, which is aimed at addressing existing sediment production sites through clean up actions in the Elk River watershed, and has initiated the process which could result in similar orders for other watersheds. The Elk River Order has resulted in increased costs that could extend over a number of years, and additional orders for other watersheds could have similar effects.
- The North Coast Water Board has imposed requirements for certain mitigation and erosion control practices in several watersheds within the Company Timber Property. The requirements imposed to date have significantly increased operating costs. Additional requirements imposed in the future could further increase costs and cause delays in THP approvals.
- 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 further significant adverse impact on our current and future harvest levels and the cash flows of both the Company and Palco.
- We are uncertain of the operational and financial effects that will ultimately result from Senate Bill 810. Implementation of this law could, however, result in delays in obtaining approvals of THPs, lower harvest levels and increased costs and additional protection measures beyond those contained in the HCP.
- The designation of a species as endangered or threatened under the ESA or the CESA can significantly reduce our harvest levels if that species inhabits the Company Timber or if the habitat of the Company Timber is deemed favorable to the species. While the HCP covers 17 different species, it is possible that additional species could be designated as endangered or threatened under both the ESA and the CESA

- Laws, regulations and related judicial decisions and administrative interpretations dealing with our industry are subject to change and new laws and regulations are frequently introduced concerning the California timber industry. From time to time, bills are introduced or ballot initiatives commenced relating to our operations.

Risks Related to Litigation

Litigation proceedings could result in adverse effects on us.

Both we and Palco are involved in a variety of pending legal proceedings. Some of these legal proceedings, were they to be decided against us or Palco, could have an adverse effect upon us, which effect could under certain circumstances be materially adverse to our financial condition, results of operations, or liquidity. Moreover, additional legal proceedings could be filed against us or Palco, further increasing litigation costs and subjecting the companies to potential adverse decisions. See Item 3. “Legal Proceedings–Litigation.”

Risks Related to the Timber Industry

Adverse weather conditions restrict Palco’s ability to harvest timber and deliver logs to its log decks and customers, adversely affecting our cash flows and those of Palco.

Wet weather conditions restrict Palco’s ability to harvest using efficient logging methods and deliver timber. Palco’s use of inefficient logging methods, such as helicopter logging, decreases our revenues, and increases Palco’s costs and reduces its operating margins.

The cyclical nature of our business and Palco’s business could adversely affect our results of operations.

Historically, log and lumber prices have been subject to significant price fluctuations. The demand for logs and lumber is affected primarily by the level of new construction activity and, to a lesser extent, remodeling and repair activity, and other industrial uses. These activities are, in turn, subject to fluctuations due to, among other factors:

- changes in domestic and international economic conditions;
- interest rates;
- population growth and changing demographics; and
- seasonal weather cycles (e.g., dry summers, wet winters) and other weather driven events.

Decreases in the level of residential construction activity or repair and remodeling activity generally reduce demand for logs and wood products. In addition, timber owners generally increase production volumes for logs and products during favorable price environments. Such increased production, however, when coupled with declines in demand for these products in general, could lead to oversupply and lower prices.

The ability to harvest timber may be subject to other limitations which could adversely affect our operations.

In addition to the limitations resulting from regulatory requirements and litigation proceedings described above, there are many factors that could restrict the ability to harvest the Company Timber, including:

- damage by fire, insect infestation, or disease;
- prolonged drought;
- flooding from the Eel River;
- natural disasters, such as earthquakes;
- timber growth cycles;
- weather conditions and
- availability of contract loggers.

We do not maintain insurance coverage with respect to damage to the Company Timber.

Competition in the forest products business could materially adversely affect our net sales and our market share.

Palco's business is highly competitive, competing primarily on the basis of:

- price;
- service;
- product availability; and
- product quality.

Palco's lumber products compete not only with other wood products which are oftentimes less expensive but with metals, masonry, plastic and other construction materials made from non-renewable resources. Competitive considerations, such as total industry production and competitors' pricing, as well as the price of other construction products, affect the sales prices for Palco's lumber products. Competition in the common grade redwood and Douglas-fir lumber market is intense, and Palco compete with numerous large and small lumber producers. An increase in the amount of competition that Palco faces could have a material adverse effect on our revenues.

The loss of key customers would reduce Palco's cash flows.

Palco has one customer that accounted for 16% of its revenues in 2005. The loss of key customers would adversely impact Palco's cash flows.

Other Risk Factors

Uninsured claims and litigation could adversely impact our operating results

We have insurance coverage against a variety of operating hazards including business interruption, liability and other losses to the extent deemed prudent by our management and to the extent insurance is available, but the nature and amount of that insurance may not be sufficient to fully cover liabilities arising out of pending and future claims and litigation. Our insurance has deductibles or self-insured retentions and contains certain coverage exclusions. Insurance does not provide complete protection against losses and risks, and our results of operations would be adversely affected by unexpected claims not covered by insurance.

We depend on our management and employees.

Our success is largely dependent on the skills, experience, efforts and availability of our management and employees. The loss of the services of one or more members of our senior management or of numerous employees with critical skills or the unionization of our workforce could have a negative effect on our business, financial conditions, results of operations or growth. Given the severe operating problems we face, we may find it even more difficult to retain employees, especially in view of our remote location relative to large population centers.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

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

ITEM 3. LEGAL PROCEEDINGS

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

The following describes certain legal proceedings in which the Company or Palco are involved. The Company and Palco are also involved in various claims, lawsuits and other proceedings not discussed herein which relate to a wide variety of matters. Uncertainties are inherent in the final outcome of those and the below-described matters, and it is presently impossible to determine the resolution of these matters or the actual costs that ultimately may be incurred.

Timber Harvesting Litigation

Various pending judicial and administrative proceedings could adversely affect the ability of the Palco Companies to implement the HCP, implement certain approved THPs, or carry out other operations, as discussed below. Certain pending matters are described below. See Item 1. “Business–Regulatory and Environmental Factors–Water Quality” for a description of additional legal proceedings involving the Company. The Services Agreement generally 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.* (“**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 and sought, among other things, 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* (“**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 the trial, the Court in October 2003 entered a judgment invalidating the SYP and the California Permits and in September 2004 granted the plaintiffs’ request for reimbursement of an aggregate of \$5.8 million in attorneys’ fees and other expenses. The Palco Companies and the State of California appealed both decisions. In December 2005, the appellate court reversed the trial court’s decision invalidating the SYP, and on January 11, 2006, the appellate court denied plaintiffs’ petition for rehearing. The plaintiffs have appealed the appellate court’s decision to the California Supreme Court, which has not yet indicated whether it will review the matter. The defendants’ appeal of the trial court’s award of attorneys fee and expenses is still pending at the appellate court.

In July 2001, an action entitled *Environmental Protection Information Association v. Pacific Lumber, Scotia Pacific Company LLC* (No. C01-2821)(“**Bear Creek lawsuit**”) was filed in the U.S. District Court for the Northern District of California, 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. In October 2003, the Court upheld the validity of an EPA regulation that exempts harvesting and other forestry activities from certain discharge requirements. Both state and federal agencies, along with Palco 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 that 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 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. The plaintiff has also filed a motion for summary judgment seeking to establish Palco’s liability for discharging storm water without a permit. A hearing on the two summary judgment motions was held on March 6, 2006, and the parties are awaiting a decision.

Should the Court’s October 2003 decision ultimately become final and be held to apply to all of the Company’s timber operations, 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. The Company believes that civil penalties should not 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 Timber Property will not reach levels harmful to the environment. While the impact of a conclusion to this case that upholds the October 2003 ruling may be adverse, the Company does not believe that such an outcome should 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.* (“**Cook action**”) and *Steve Cave, et al. v. Gary Clark, et al.* (“**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. 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). On October 13, 2005, an action entitled *Edyth Johnson, et al v. Charles E. Hurwitz, an individual; MAXXAM Inc. et al.* (No. DR040720) was filed in Humboldt County Superior Court (“**Johnson action**”) and contains allegations similar to the *Cave* and *Cook actions*. 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) (“**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 harvest of 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, an action entitled *Environmental Protection Information Center v. U.S. Fish & Wildlife Service, NOAA Fisheries, et al.* (No. C04-4647) was filed in the U.S. District Court for the Northern District of California (“**EPIC-USFWS/NOAA lawsuit**”). 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 the Company and 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 February 6, 2006, plaintiffs voluntarily dismissed the remaining claims.

On August 8, 2005, an action entitled *Center for Biological Diversity v. California Department of Fish and Game, et al.* (No. 05CS01166) was filed in Sacramento County Superior Court against the California Department of Fish and Game (“**CDFG**”) and the Palco Companies seeking to overturn and prevent CDFG and the Palco Companies from taking any action to implement or rely upon certain CDFG “Consistency Determinations” issued in February 2005. Following various court proceedings, this case was voluntarily dismissed by the plaintiff in January 2006.

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 (“**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. Palco appealed the decision of the appellate court to the California Supreme Court. On January 30, 2006, the California Supreme Court issued a decision denying Palco’s appeal and upholding the appellate court’s decision. The adverse outcome of the *THP No. 520 lawsuit* confirms the authority the regional and state water boards and their staffs have been exercising over harvesting from the Company Timberlands, resulting in controls and limitations beyond those provided for by the Environmental Plans.

In December 2005, the Company and Palco filed a claim (the “**Claim**”) with the California Victim Compensation and Government Claims Board (the “**Claims Board**”) against the North Coast Water Board, the State Water Board and the State of California (Claim No. G558159). The Claim alleges that the defendants have substantially impaired the contractual and legal rights of the Company and Palco under the Headwaters Agreement and the related permits, authorizations and approvals. The Claim also alleges that the actions of the defendants have caused the companies substantial damages, but does not specify an amount. While the Claims Board has indicated that it is investigating the matter, it failed to approve or deny the claim by the statutory deadline. As a result, the Claim is by operation of law treated as having been denied, and the Company and Palco may now file a claim for damages in California state court. The Company and Palco are considering how best to proceed with respect to this matter.

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 2005.

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”, Item 1A. “Risk Factors” and below for cautionary information with respect to such forward-looking statements.

The Company’s business is becoming increasingly unpredictable due to regulatory constraints and ongoing litigation challenges and is somewhat seasonal, its net sales having historically been higher in the months of April through November than in the months December through March. Management expects that the Company’s revenues and cash flows will continue to be unpredictable and somewhat seasonal. Accordingly, the Company’s results for any one quarter are not necessarily indicative of results to be expected for the full year.

Regulatory and environmental matters as well as legal actions have had and are expected to continue to have a significant adverse effect on the Company’s operations. See Item 1. “Business–Regulatory and Environmental Factors” and Note 7 for information regarding these matters. Regulatory compliance and related litigation have caused and are expected to continue to cause delays in approval of THPs and delays in harvesting on THPs once they are approved. This has resulted and is expected to continue to result in a significant decline in harvest and increased costs related to timber harvest litigation.

The cash flows of the Company and Palco, from whom the Company derives substantially all of its revenues, have both been adversely impacted by the failure of the North Coast Water Board to release for harvest a number of already-approved THPs. Management has concluded that, in the absence of significant regulatory relief and accommodations, the Company's annual timber harvest levels and cash flows from operations will for at least several years be substantially below historical levels. The Company projects that without additional liquidity its cash flows from operations, together with funds available under its line of credit ("**Line of Credit**"), will be inadequate, by a substantial amount, to pay the entire amount of interest due on the July 20, 2006, payment date on its Timber Notes. The Company also expects to incur interest shortfalls for at least the next several years after the July 20, 2006, payment date.

Palco and Britt are in default under their \$35.0 million term loan agreement ("**Palco Term Loan**") and their \$30.0 million asset-based revolving credit facility ("**Palco Revolving Credit Facility**"). Palco estimates that without necessary amendments to these credit agreements and/or sufficient additional liquidity, its cash flow from operations, together with funds available under the Palco Revolving Credit Facility, will not provide sufficient liquidity to fund its current level of operations for the next several years. For further information, see "**Financial Condition and Investing and Financing Activities.**"

To the extent that the Company is unable to generate sufficient liquidity from the Company Land Sale Program (see "**Financial Condition and Investing and Financing Activities—Liquidity Issues**") or other sources, the Company expects that it will be forced to take extraordinary actions, which may include: laying off employees, shutting down various operations, and seeking protection by filing under the Bankruptcy Code. In the event that Palco is unable to secure the necessary liquidity to fund its expected future working capital shortfalls, it would be forced to take extraordinary actions, which may include: further reducing expenditures by laying off employees, shutting down various operations, and seeking protection by filing under the Bankruptcy Code.

Furthermore, there can be no assurance that other pending legal, regulatory and environmental matters or future governmental regulations, additional litigation or legislation, judicial or administrative decisions, adverse weather conditions, or low lumber or log prices, will not also have material adverse effects on the Company's financial condition, results of operations or liquidity. See Item 1. "**Business—Regulatory and Environmental Factors,**" Item 3. "**Legal Proceedings—Timber Harvest Litigation**" and Note 7 for further information regarding regulatory and legislative matters and legal proceedings.

Results of Operations

This section contains statements which constitute "forward-looking statements" within the meaning of the PSLRA. See this Item, Item 1. "Business—General", and Item 1A. "Risk Factors" 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 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% decrease for small Douglas-fir logs from the prices published for the second half of 2004.

In June 2005, the State Board of Equalization adopted the new Harvest Value Schedule for the second half of 2005. The prices published in that schedule reflected a 4.2% increase in the SBE Price for small redwood logs and no change for small Douglas-fir logs from the prices published for the first half of 2005.

In December 2005, the State Board of Equalization adopted the new Harvest Value Schedule for the first half of 2006. The prices published in that schedule reflected a 5.3% increase in the SBE Price for small redwood logs and a 5.6% decrease for small Douglas-fir logs from the prices published for the second half of 2005.

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 Palco

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

	Years Ended December 31,								
	2005			2004			2003		
	MBFEs	Average Price \$/MBFE	Revenues	MBFEs	Average Price \$/MBFE	Revenues	MBFEs	Average Price \$/MBFE	Revenues
Redwood . . .	75,200	\$ 899	\$ 67.5	73,000	\$ 757	\$ 55.3	96,900	\$ 667	\$ 64.7
Douglas-fir	20,200	599	12.1	21,200	505	10.7	18,100	446	8.1
Other	2,100	215	0.5	1,900	233	0.4	2,200	227	0.5
	<u>97,500</u>	<u>821</u>	<u>\$ 80.1</u>	<u>96,100</u>	<u>691</u>	<u>\$ 66.4</u>	<u>117,200</u>	<u>625</u>	<u>\$ 73.3</u>

The increase in log sales for 2005 versus 2004 was due primarily to the increase in SBE prices discussed above. The Company's average realized price in 2005 increased by 19% over 2004.

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.

Operating Income and Net Loss

Operating income increased from \$34.4 million in 2004 to \$40.0 million in 2005 and net losses decreased from \$19.8 million in 2004 to \$13.1 million in 2005 principally due to the increase in SBE prices discussed above, partially offset by advisor fees from the Company's efforts to restructure the Timber Notes during 2005.

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 lower operating income, and lower returns on investments (see also Note 3).

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, Item 1. "Business-General" and Item 1A. "Risk Factors" 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 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 legal actions have had and are expected to continue to have a significant adverse effect on the Company’s operations and liquidity. See Item 1. “Business–Regulatory and Environmental Factors” and Note 7 for information regarding these matters. The ability to harvest Company Timber depends in large part upon the Company’s ability to obtain regulatory approval of THPs. The Company has experienced difficulties and delays in the approval of its THPs as the result of regulatory and litigation challenges, and expects these challenges to persist. Moreover, the Company expects to continue to experience further difficulties, limitations and delays in Palco being able to harvest on previously-approved THPs due to, among other things, the actions by the North Coast Water Board described below. The foregoing matters have resulted in declines in the Company’s actual and expected harvest levels and cash flows. Additionally, as a result of the foregoing matters, Palco has experienced a significant increase in the cost of logging operations and increased costs related to timber harvest litigation. These matters have severely and negatively impacted the historical cash flows of both the Company and Palco. These adverse effects are expected to continue.

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 is likely to impose or seek 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 herein are expected to result in reduced harvest and less predictability in the future regarding the mix of logs available for sale by the Company to Palco.

The North Coast Water Board for some time failed to release for harvest a number of the Company’s THPs that had already been approved by the other governmental agencies which approve the Company’s THPs. The North Coast Water Board subsequently allowed harvesting on a portion of the approved THPs; however, the State Water Board later disallowed harvesting on a portion of the THPs that had been released by the North Coast Water Board. The unreleased and disallowed THPs in the Freshwater and Elk River watersheds represented a significant portion of the harvest that was planned for 2005. These unreleased and disallowed THPs, as well as additional THPs in the Freshwater and Elk River watersheds, also represent a significant portion of the harvest planned for 2006.

On February 17, 2006, the North Coast Water Board held a status conference to determine a timetable for consideration of approval of WWDRs in the Freshwater and Elk River watersheds. Although a formal timetable has not been published, it appears likely that WWDRs in these two watersheds will not be approved before May 2006; such a timetable would further reduce 2006 annual harvest levels.

Future Harvest Levels

The Company has conducted extensive reviews and analyses of its assets, operations and future prospects. As a result of these extensive reviews and analyses, management has concluded that, in the absence of significant regulatory relief and accommodations, the Company’s future annual timber harvest levels and cash flows from operations will for at least the next several 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 to be approximately 100 million board feet per year. This harvest level reflects management’s estimate of the cumulative impact of ongoing regulatory limitations, prescriptions, and other actions and is based upon a number of assumptions that may or may not prove to be accurate. Actual harvest levels may even be lower, depending on the outcome of various assumptions

Liquidity Issues

During 2005, the Company devoted significant management resources, and spent approximately \$6.1 million, on efforts to restructure the Timber Notes consistent with management expectations as to future harvest levels and cash flows. These efforts were unsuccessful and have been largely abandoned. The Company currently does not expect that

it will be able to restructure its required minimum payments on the Timber Notes through negotiations with holders of the Timber Notes. Accordingly, additional liquidity will be needed to avoid an event of default under the Indenture.

As a result of the material and ongoing harvesting restrictions discussed above, the Company estimates that its cash flows from operations, together with funds available under its Line of Credit with a group of banks pursuant to which the Company may borrow to pay interest on its Timber Notes (see below), will be insufficient, by a substantial amount, to pay the interest on the Timber Notes due on the July 20, 2006, payment date. The Company also expects to incur interest shortfalls for at least the next several years after the July 20, 2006, payment date. The failure of the Company to pay all of the required amounts of interest on the Timber Notes when due would constitute an event of default under the Indenture.

In an effort to address expected cash shortfalls, and avoid an event of default under the Indenture, the Company is seeking to sell certain non-timberland properties such as ranchlands and recreational areas, as well as some timberlands (“**Company Land Sale Program**”). There can be no assurance that these marketing efforts will be successful.

To the extent that the Company is unable to generate sufficient liquidity from the Company Land Sale Program or other sources, the Company expects that it will be forced to take extraordinary actions, which may include: laying off employees, shutting down various operations, and seeking protection by filing under the Bankruptcy Code.

Timber Note Payments

In the event of a failure to pay interest or principal on the Timber Notes in full when due, the trustee under the Indenture (“**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 (see Note 6) or by Palco to perform its covenants or agreements under the Services Agreement (see Note 6), which failure in the case of certain covenants or agreements 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 Timber Property and Company Timber Rights and other assets and using the proceeds thereof to pay accelerated amounts. In the event that the Company was to seek protection by filing under 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 would be subject to the rights of the Company under the Bankruptcy Code if it sought protection by filing under the Bankruptcy Code.

The Line of Credit allows the Company to borrow up to one year's interest on the Timber Notes. On June 20, 2003, the Line of Credit was extended to July 7, 2006. 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 Timber Notes 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, 2005, the maximum availability under the Line of Credit was \$55.4 million, and outstanding borrowings were \$31.3 million. At January 31, 2006, the maximum availability under the Line of Credit was \$54.1 million, after giving effect to principal payments made on the January 20, 2006, Timber Notes payment date and there were \$54.9 million in borrowings outstanding under this facility.

On the January 20, 2005 Timber Notes payment date, the Company used funds available under the Line of Credit to fund the payment. Prior to the July 20, 2005, Timber Notes payment date, the Company requested that Palco make an early payment, equal to an expected \$2.2 million cash 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 interest due. As the January 20, 2006, Timber Notes payment date approached, it became apparent that there would be a cash shortfall of \$2.3 million. In January 2006, the Company and MGI consummated a “Lump Sum Sale” (as such term is defined in the Indenture) of specified Company Timber. In accordance with the Indenture, the specified Company Timber was released from the liens securing the Indenture and purchased by MGI. The cash purchase price of \$2.3 million paid in the Lump Sum Sale,

was calculated using the applicable SBE Prices for the first half of 2006, and provided the Company the additional funds needed to pay all of the interest due on the January 20, 2006, Timber Notes payment date.

At December 31, 2005, the SAR Account balance was \$75.9 million (including \$52.9 million of Timber Notes held in the SAR Account and \$23.0 million in cash), all of which is restricted for future principal payments on the Timber Notes. The SAR Account net cash balance of \$23.0 million is sufficient to cover the Scheduled Amortization in 2006, but will not be sufficient to cover Scheduled Amortization on the January 20, 2007, Timber Note payment date and beyond. Accordingly, the Company's ability to make the Scheduled Amortization payments on the Timber Notes beyond 2006 is dependent upon the Company's ability to sell all or a portion of the Timber Notes held in the SAR Account. No assurance can be given that the Company will be successful in its efforts to sell the Timber Notes held in the SAR Account before the January 20, 2007, Timber Notes payment date or as to the proceeds that might result from any such sale.

Accordingly, the Company will require substantial additional funds in order to meet its debt service requirements for the next year. The Company's ability to meet such requirements will be adversely affected (a) if the Company is unsuccessful in its efforts to (i) generate sufficient cash flows from the Company Land Sale Program, (ii) sell a portion of its Timber Notes holdings, or (iii) obtain additional funding, or (b) if Palco is unable to obtain sufficient additional liquidity to continue to purchase and pay for logs as they are purchased from the Company.

With respect to long-term liquidity, until such time as the Company has adequate cash flows from operations, there can be no assurance that the Company will be able to meet its working capital, capital expenditure and debt service obligations. Liquidity, capital resources, and results of operations in the long-term may continue to be adversely affected by the same factors affecting short-term cash flows from operations, as discussed above.

Palco Liquidity Issues

Palco and Britt are currently in default under the Palco Term Loan and the Palco Revolving Credit Facility. Palco estimates that, without necessary amendments to the Palco Term Loan and the Palco Revolving Credit Facility and/or sufficient additional liquidity, its cash flows from operations, together with funds available from the Palco Revolving Credit Facility, will not provide sufficient liquidity to fund Palco's current level of operations for the next several years. As of December 31, 2005, \$34.7 million was outstanding under the Palco Term Loan, \$24.0 million was outstanding under the Palco Revolving Credit Facility, and \$10.2 million of letters of credit were outstanding under the Palco Revolving Credit Facility. The Palco Revolving Credit Facility and Palco Term Loan are each secured by a security interest in the stock of Palco held by MGI, and substantially all of the assets of Palco (other than Palco's equity interest in the Company).

Without waivers of the defaults under the Palco Term Loan and the Palco Revolving Credit Facility, the lenders may take any or all of the following actions: reduce the amount of funds available for borrowing under the Palco Revolving Credit Facility; refuse to make new loans or to issue new letters of credit under the Palco Revolving Credit Facility; declare any or all loans and other amounts owed under the agreement to be immediately due and payable; require Palco and Britt to cash collateralize all outstanding letters of credit under the Palco Revolving Credit Facility; or pursue their other rights and remedies under the Palco Term Loan, Palco Revolving Credit Facility and related security agreements.

In an effort to reduce its overall debt level, Palco is in the process of marketing certain assets ("**Palco Asset Sale Program**") and seeking other sources of liquidity. The Palco Term Loan and the Palco Revolving Credit Facility each contain provisions requiring that the net cash proceeds from the asset sales be used to prepay amounts outstanding under the two facilities. Accordingly, proceeds generated from the Palco Asset Sale Program would not be available to fund working capital needs until the Palco Term Loan is paid in full. There can be no assurance that these marketing efforts will be successful or that Palco will be successful in securing sufficient additional liquidity.

In the event that Palco is unable to secure the necessary liquidity to fund its expected future working capital shortfalls, it would be forced to take extraordinary actions, which may include, among other things: further reducing expenditures by laying off employees, shutting down various operations, and seeking protection by filing under the Bankruptcy Code.

Palco will require additional funds in order to meet its working capital and capital expenditure requirements for the next several years. Palco's ability to meet such requirements will be adversely affected should Palco be unsuccessful in its efforts to (i) meet planned production rates at a new sawmill that Palco completed in 2005, (ii) obtain waivers of default from its term and revolving credit lenders, and (iii) obtain sufficient additional liquidity from the Palco Asset Sale Program or from other sources. Furthermore, Palco's cash flows from operations may be adversely affected by

diminished availability of smaller logs from the Company or other third parties, lower lumber prices, adverse weather conditions, pending or future legal, legislative, regulatory and environmental matters, or continued increased funding requirements for its pension plan. The percentage of the logs purchased from third parties that Palco uses in its lumber operations is expected to increase. Under the Master Purchase Agreement, Palco is required to pay for logs purchased from the Company by the 20th day of the following month, whereas the payment for logs purchased from third parties are generally due upon delivery. Accordingly, Palco's working capital needs are likely to increase substantially during 2006 and beyond absent favorable regulatory action affecting the Company's THPs.

With respect to long-term liquidity, until such time as Palco is able to obtain or generate sufficient liquidity, there can be no assurances that Palco will be able to meet its working capital, capital expenditure and debt service obligations. Liquidity, capital resources and results of operations in the long-term may continue to be adversely affected by the same factors affecting short-term cash flows from operations, as discussed above.

Off-Balance Sheet Arrangements

The Company does not have any off-balance sheet financing or unconsolidated special purpose entities. The Company does not use derivatives for any of its treasury or risk management activities.

Contractual Obligations

The following table presents information with respect to the Company's contractual obligations as of December 31, 2005 (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⁾	\$ 719.0	\$ 49.4	\$ 51.5	\$ 42.5	\$ 575.6
Interest due on long-term debt obligations ⁽²⁾	381.7	51.2	97.6	91.1	141.8
Total	<u>\$ 1,100.7</u>	<u>\$ 100.6</u>	<u>\$ 149.1</u>	<u>\$ 133.6</u>	<u>\$ 717.4</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, 2025, 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.

Gain and Loss Contingencies

The Company is involved in various claims, lawsuits and other proceedings discussed in Note 7. Such litigation involves uncertainty as to possible gains and 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 (including related estimated legal fees) 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. The Company recognizes gain contingencies when realization is assured. 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 gains and 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 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 Timber. 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. This facility bears interest at either the prime interest rate or LIBOR plus a specified percentage point spread. As of December 31, 2005, there were \$31.3 million of borrowings outstanding under the Line of Credit. Based on the amount of borrowings outstanding under the Line of Credit during 2005, the impact of a 1% change in interest rates effective from the beginning of the year would have resulted in an increase or decrease in annual interest expense of \$0.4 million.

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 sheets of Scotia Pacific Company LLC, (a Delaware limited liability company (the “**Company**”) and a wholly owned subsidiary of The Pacific Lumber Company (“**Palco**”), as of December 31, 2005 and 2004, and the related statements of loss and of cash flows for each of the three years in the period ended December 31, 2005. 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 audits 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, 2005 and 2004, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2005, 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, 2005, the cash flows of the Company and Palco have been adversely affected by delays in obtaining regulatory approvals to harvest timber and other difficulties. Palco was in default under its term loan and revolving credit facility. The Company has estimated that without additional liquidity from external sources such as asset sales, the Company will be unable to pay the entire amount of interest due in July 2006 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 in paying the interest on its timber notes and Palco in meeting its loan agreement covenants raise substantial doubts about the ability of the Company 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, 2006

SCOTIA PACIFIC COMPANY LLC

BALANCE SHEETS
(In millions of dollars)

	December 31,	
	2005	2004
Assets		
Current assets:		
Cash and cash equivalents	\$ 1.3	\$ 0.5
Marketable securities, including restricted amounts of \$23.0 and \$25.1, respectively	24.2	28.2
Receivables from Palco	4.5	3.3
Prepaid timber harvesting costs	6.0	6.2
Other current assets	1.5	1.1
Total current assets	37.5	39.3
Timber and timberlands, net of accumulated depletion of \$298.1 and \$290.1, respectively	219.5	225.1
Property and equipment, net of accumulated depreciation of \$22.6 and \$19.6, respectively	29.3	28.1
Deferred financing costs, net	10.5	11.8
Restricted cash, marketable securities and other investments	2.5	9.2
Intangible assets	2.9	3.8
	\$ 302.2	\$ 317.3
Liabilities and Member Deficit		
Current liabilities:		
Payables to Palco	\$ 1.1	\$ 1.5
Accrued interest	23.8	23.8
Other accrued liabilities	2.4	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	49.4	33.8
Total current liabilities	76.7	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	0.4	0.2
Total liabilities	746.7	748.9
Contingencies (See Note 7)		
Member deficit	(444.5)	(431.6)
	\$ 302.2	\$ 317.3

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

SCOTIA PACIFIC COMPANY LLC

STATEMENTS OF LOSS
(In millions of dollars)

	Years Ended December 31,		
	2005	2004	2003
Log sales to Palco	\$ 80.1	\$ 66.4	\$ 73.3
Operating expenses:			
General and administrative	28.3	20.6	21.5
Depletion, depreciation and amortization	11.9	11.4	13.1
Gain on sales of timberlands and other assets	(0.1)	-	(8.3)
	40.1	32.0	26.3
Operating income	40.0	34.4	47.0
Other income (expense):			
Gain (loss) on repurchases of debt	-	(0.3)	0.7
Interest and other income	2.6	1.3	3.9
Interest expense	(55.7)	(55.2)	(56.9)
	(53.1)	(54.2)	(52.3)
Net loss	\$ (13.1)	\$ (19.8)	\$ (5.3)

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

SCOTIA PACIFIC COMPANY LLC

STATEMENTS OF CASH FLOWS
(In millions of dollars)

	Years Ended December 31,		
	2005	2004	2003
Cash flows from operating activities:			
Net loss	\$ (13.1)	\$ (19.8)	\$ (5.3)
Adjustments to reconcile net loss to net cash used in operating activities:			
Gain on sales of timberlands and other assets	(0.1)	–	(8.3)
Loss (gain) on repurchases of debt	–	0.3	(0.7)
Depletion, depreciation and amortization	11.9	11.4	13.1
Amortization of deferred financing costs	1.3	1.3	1.4
Increase (decrease) in cash resulting from changes in:			
Receivables from Palco	(1.2)	1.6	(2.3)
Prepaid timber harvesting costs	0.2	(0.6)	1.7
Payables to Palco	(0.4)	0.6	0.1
Accrued interest	–	(0.7)	(0.4)
Other accrued liabilities	0.5	(0.5)	0.3
Other	(0.2)	(0.2)	(0.4)
Net cash used in operating activities	(1.1)	(6.6)	(0.8)
Cash flows from investing activities:			
Proceeds from sales of assets	–	–	11.4
Net changes in restricted cash and marketable securities	10.9	13.0	13.8
Capital expenditures	(6.5)	(7.8)	(7.7)
Net cash provided by investing activities	4.4	5.2	17.5
Cash flows from financing activities:			
Principal payments on Timber Notes and other timber related debt	(15.6)	(17.2)	(16.6)
Borrowings under line of credit agreement, net	13.1	18.2	–
Net cash provided by (used in) financing activities	(2.5)	1.0	(16.6)
Net increase (decrease) in cash and cash equivalents	0.8	(0.4)	0.1
Cash and cash equivalents at beginning of period	0.5	0.9	0.8
Cash and cash equivalents at end of period	\$ 1.3	\$ 0.5	\$ 0.9
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	\$ 54.4	\$ 54.6	\$ 56.0

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 (“**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 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 (“**Timber Notes**”). Concurrent with the closing in July 1998 (“**Closing**”) of the Timber Notes offering, Scotia Pacific Holding Company (“**SPHC**”) 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; (collectively, 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.

The Company owns, and the obligations of the Company under the Timber Notes are secured by, (i) approximately 204,000 acres of virtually contiguous commercial timberlands in Humboldt County along the northern California coast (the “**Company Timber Property**”), (ii) the timber and related harvesting rights (“**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 containing information on numerous aspects of these timber properties, including timber type, site productivity class, wildlife and botanical data, geological information, roads, rivers and streams (subject to certain rights of concurrent use by Palco) and (iv) certain other assets. Substantially all of the Company’s assets are pledged 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.**”

Consistent with the Company’s purpose and pursuant to the terms of the indenture governing the Timber Notes (“**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 interest and principal 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 are inherent in such estimates; 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 legal actions have had and are expected to continue to have a significant adverse effect on the Company's operations and liquidity. See Note 7 for information regarding these matters. The ability to harvest Company Timber depends in large part upon the Company's ability to obtain regulatory approval of its timber harvesting plans ("THPs"). The Company has experienced difficulties and delays in the approval of its THPs as the result of regulatory and litigation challenges, and expects these challenges to persist. Moreover, the Company expects to continue to experience further difficulties, limitations and delays in Palco being able to harvest on previously-approved THPs due to, among other things, the actions by the North Coast Water Board described below. The foregoing matters have resulted in declines in the Company's actual and expected harvest levels and cash flows. Additionally, as a result of the foregoing matters, Palco has experienced a significant increase in the cost of logging operations and increased costs related to timber harvest litigation. These matters have severely and negatively impacted the historical cash flows of both the Company and Palco. These adverse 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 or seek to 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 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 herein are expected to result in reduced harvest and less predictability in the future regarding the mix of logs available for sale by the Company to Palco.

The North Coast Water Board for some time failed to release for harvest a number of the Company's THPs that had already been approved by the other governmental agencies which approve the Company's THPs. The North Coast Water Board subsequently allowed harvesting on a portion of the approved THPs; however, the State Water Board later disallowed harvesting on a portion of the THPs that had been released by the North Coast Water Board. The unreleased and disallowed THPs in the Freshwater and Elk River watersheds represented a significant portion of the harvest that was planned for 2005. These unreleased and disallowed THPs, as well as additional THPs in the Freshwater and Elk River watersheds, also represent a significant portion of the harvest planned for 2006.

On February 17, 2006, the North Coast Water Board held a status conference to determine a timetable for consideration of approval of WWDRs in the Freshwater and Elk River watersheds. Although a formal timetable has not been published, it appears likely that WWDRs in these two watersheds will not be approved before May 2006; such a timetable would further reduce 2006 annual harvest levels.

Future Harvest Levels

The Company has conducted extensive reviews and analyses of its assets, operations and future prospects. As a result of these extensive reviews and analyses, management has concluded that, in the absence of significant regulatory relief and accommodations, the Company's future annual timber harvest levels and cash flows from operations will for at least the next several 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 to be approximately 100 million board feet per year. This harvest level reflects management's estimate of the cumulative impact of ongoing regulatory limitations, prescriptions, and other actions and is based upon a number of assumptions that may or may not prove to be accurate. Actual harvest levels may even be lower, depending on the outcome of various assumptions.

Liquidity Issues

During 2005, the Company devoted significant management resources, and spent approximately \$6.1 million on efforts to restructure the Timber Notes consistent with management expectations as to future harvest levels and cash flows. These efforts were unsuccessful and have been largely abandoned. The Company currently does not expect that it will be able to restructure its required minimum payments on the Timber Notes through negotiations with holders of the Timber Notes. Accordingly, additional liquidity will be needed to avoid an event of default under the Indenture.

As a result of the material and ongoing harvesting restrictions, the Company estimates that its cash flows from operations, together with funds available under an agreement ("**Line of Credit**") with a group of banks pursuant to which the Company may borrow to pay interest on its Timber Notes (see below), will be insufficient, by a substantial amount, to pay the interest on the Timber Notes due on the July 20, 2006, payment date. The Company also expects to incur interest shortfalls for at least the next several years after the July 20, 2006, payment date. The failure of the

Company to pay all of the required amounts of interest on the Timber Notes when due would constitute an event of default under the Indenture.

In an effort to address expected cash shortfalls, and avoid an event of default under the Indenture, the Company is seeking to sell certain non-timberland properties such as ranchlands and recreational areas, as well as certain timberlands (“**Company Land Sale Program**”). There can be no assurance that these marketing efforts will be successful.

To the extent that the Company is unable to generate sufficient liquidity from the Company Land Sale Program or other sources, the Company expects that it will be forced to take extraordinary actions, which may include: laying off employees, shutting down various operations, and seeking protection by filing under the Bankruptcy Code.

Timber Note Payments

In the event of a failure to pay interest or principal on the Timber Notes in full when due, the trustee under the Indenture (“**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 (see Note 6) or by Palco to perform its covenants or agreements under the Services Agreement (see Note 6), which failure in the case of certain covenants or agreements 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 Timber Property and Company Timber Rights and other assets and using the proceeds thereof to pay accelerated amounts. In the event that the Company was to seek protection by filing under the U.S. Bankruptcy Code (“**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 would be subject to the rights of the Company under the Bankruptcy Code if it sought protection by filing under the Bankruptcy Code.

The Line of Credit allows the Company to borrow up to one year’s interest on the Timber Notes. On June 20, 2003, the Line of Credit was extended to July 7, 2006. 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 Timber Notes 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, 2005, the maximum availability under the Line of Credit was \$55.4 million, and outstanding borrowings were \$31.3 million. At January 31, 2006, the maximum availability under the Line of Credit was \$54.1 million, after giving effect to principal payments made on the January 20, 2006, Timber Notes payment date and there were \$54.9 million in borrowings outstanding under this facility.

On the January 20, 2005, Timber Notes payment date, the Company used funds available under the Line of Credit to fund the payment. Prior to the July 20, 2005, Timber Notes payment date, the Company requested that Palco make an early payment, equal to an expected \$2.2 million cash 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 interest due. As the January 20, 2006, Timber Notes payment date approached, it became apparent that there would be a cash shortfall of \$2.3 million. In January 2006, the Company and MGI consummated a “Lump Sum Sale” (as such term is defined in the Indenture) of specified Company Timber. In accordance with the Indenture, the specified Company Timber was released from the liens securing the Timber Notes and purchased by MGI. The cash purchase price of \$2.3 million paid in the Lump Sum Sale, was calculated using the SBE Prices (see Note 6) for the first half of 2006, and provided the Company the additional funds needed to pay all of the interest due on the January 20, 2006, Timber Notes payment date.

At December 31, 2005, the balance in the Scheduled Amortization Reserve Account (“**SAR Account**” –see Note 5) was \$75.9 million (including \$52.9 million of Timber Notes held in the SAR Account and \$23.0 million in cash), all of which is restricted for future principal payments on the Timber Notes. The SAR Account net cash balance of \$23.0 million is sufficient to cover the Scheduled Amortization (see “Timber Notes” section under Note 5) in 2006, but will not be sufficient to cover the Scheduled Amortization on the January 20, 2007, Timber Note payment date and beyond.

Accordingly, the Company's ability to make the Scheduled Amortization (see Note 5) payments on the Timber Notes beyond 2006 is dependent upon the Company's ability to sell all or a portion of the Timber Notes held in the SAR Account. No assurance can be given that the Company will be successful in its efforts to sell the Timber Notes held in the SAR Account before the January 20, 2007, Timber Notes payment date or as to the proceeds that might result from any such sale.

Palco Liquidity Issues

Palco and Britt are currently in default under their \$35.0 million term loan agreement ("**Palco Term Loan**") and \$30.0 million revolving credit facility ("**Palco Revolving Credit Facility**"). Palco estimates that, without necessary amendments to the Palco Term Loan and the Palco Revolving Credit Facility and/or sufficient additional liquidity, its cash flows from operations, together with funds available from the Palco Revolving Credit Facility, will not provide sufficient liquidity to fund Palco's current level of operations for the next several years. As of December 31, 2005, \$34.7 million was outstanding under the Palco Term Loan, \$24.0 million was outstanding under the Palco Revolving Credit Facility, and \$10.2 million of letters of credit were outstanding under the Palco Revolving Credit Facility. The Palco Revolving Credit Facility and Palco Term Loan are each secured by a security interest in the stock of Palco held by MGI, and substantially all of the assets of Palco (other than Palco's equity interest in the Company).

Without waivers of the defaults under the Palco Term Loan and the Palco Revolving Credit Facility, the lenders may take any or all of the following actions: reduce the amount of funds available for borrowing under the Palco Revolving Credit Facility; refuse to make new loans or to issue new letters of credit under the Palco Revolving Credit Facility; declare any or all loans and other amounts owed under the agreement to be immediately due and payable; require Palco and Britt to cash collateralize all outstanding letters of credit under the Palco Revolving Credit Facility; or pursue their other rights and remedies under the Palco Term Loan, Palco Revolving Credit Facility and related security agreements.

In an effort to reduce its overall debt level, Palco is in the process of marketing certain assets ("**Palco Asset Sale Program**") and seeking other sources of liquidity. The Palco Term Loan and the Palco Revolving Credit Facility each contain provisions requiring that the net cash proceeds of specified asset sales be used to prepay amounts outstanding under the two facilities. Accordingly, proceeds generated from the Palco Asset Sale Program would not be available to fund working capital needs until the Palco Term Loan is paid in full. There can be no assurance that these marketing efforts will be successful or that Palco will be successful in securing sufficient additional liquidity.

In the event that Palco is unable to secure the necessary liquidity to fund its expected future working capital shortfalls, it would be forced to take extraordinary actions, which may include: further reducing expenditures by laying off employees, shutting down various operations, and seeking protection by filing under the Bankruptcy Code.

Palco will require additional funds in order to meet its working capital and capital expenditure requirements for the next several years. Palco's ability to meet such requirements will be adversely affected should Palco be unsuccessful in its efforts to (i) meet planned production rates at a new sawmill that Palco completed in 2005, (ii) obtain waivers of default from its term and revolving credit lenders, and (iii) obtain sufficient additional liquidity from the Palco Asset Sale Program or from other sources. Furthermore, Palco's cash flows from operations may be adversely affected by diminished availability of smaller logs from the Company or other third parties, lower lumber prices, adverse weather conditions, pending or future legal, legislative, regulatory and environmental matters, or continued increased funding requirements for its pension plan. The percentage of the logs purchased from third parties that Palco uses in its lumber operations is expected to increase. Under the Master Purchase Agreement, Palco is required to pay for logs purchased from the Company by the 20th day of the following month, whereas payment for logs purchased from third parties are generally due upon delivery. Accordingly, Palco's working capital needs are likely to increase substantially during 2006 and beyond absent favorable regulatory action affecting the Company's THPs.

With respect to long-term liquidity, until such time as Palco is able to obtain or generate sufficient liquidity, there can be no assurances that Palco will be able to meet its working capital, capital expenditure and debt service obligations. Liquidity, capital resources and results of operations in the long-term may continue to be adversely affected by the same factors affecting short-term cash flows from operations, as discussed above.

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.

Available-for-Sale Securities

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, net of tax, reported in other comprehensive income (loss), a separate component of members' deficit. Realized gains and losses and declines in value judged to be other-than-temporary on available-for-sale securities are included in investment and interest income. Interest and dividends on securities classified as available-for-sale are also included in investment and interest 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 multi-species habitat conservation plan ("HCP") and the Company's sustained yield plan "SYP," and together with the HCP, the "Environmental Plans", 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,	
	2005	2004
SYP/HCP	\$ 8.3	\$ 8.3
Less: Accumulated amortization	(5.4)	(4.5)
	<u>\$ 2.9</u>	<u>\$ 3.8</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, 2005, 2004 and 2003, was \$0.9 million per year. The estimated amortization expense for 2006 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 are recorded at historical cost. 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.

Gain and Loss Contingencies

The Company is involved in various claims, lawsuits, environmental matters and other proceedings including those discussed in Note 7. Such matters involve uncertainty as to possible losses and potential gains 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 (including related estimated legal fees) 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. The Company recognizes gain contingencies when realization is considered possible. 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).

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, 2005 and 2004, are reflected in Palco's financial statements.

Reclassifications

Certain reclassifications have been made to prior years' financial statements to be consistent with the current year's presentation. This includes the reclassification of: (i) proceeds from restricted cash from financing activities to investing activities in the Statements of Cash Flows, and (ii) restricted cash from cash and cash equivalents to restricted cash and marketable securities in the Balance Sheets and in the Statements of Cash Flows.

2. Significant Acquisitions and Dispositions

In November 2003, the Company and Palco 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

Cash equivalents consist of highly liquid money market instruments with original maturities of three months or less. As of December 31, 2005 and 2004, carrying amounts of the Company's cash equivalents approximated fair value.

Marketable Securities

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. Amounts invested in auction rate securities are classified as marketable securities.

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

	<u>December 31,</u>	
	<u>2005</u>	<u>2004</u>
Cost	\$ 27.6	\$ 15.9
Estimated fair value	27.6	15.8

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, 2005, as follows (in millions):

	<u>Years Ended December 31,</u>		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
Gross realized gains	\$ -	\$ 0.4	\$ 0.3
Gross realized losses	(0.4)	(0.2)	-

Net adjustments to unrealized holding gains (losses) on available-for-sale securities, included as a separate component of member deficit were \$0.2 million, (\$0.6) million, and (\$0.4) million in 2005, 2004 and 2003, respectively. Gross unrealized losses on investment securities at December 31, 2005, were not material and there were no investment securities in an unrealized loss position for twelve months or more.

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):

	<u>December 31,</u>	
	<u>2005</u>	<u>2004</u>
Current assets:		
Marketable securities, restricted:		
Amounts held in SAR Account	\$ 23.0	\$ 25.1
Long-term restricted cash, cash equivalents, marketable securities and other investments:		
Amounts held in SAR Account	52.9	68.5
Other amounts restricted under the Indenture	2.5	2.5
Less: Amounts attributable to Timber Notes held in SAR Account	(52.9)	(61.8)
	<u>2.5</u>	<u>9.2</u>
Total restricted cash, cash equivalents, marketable securities and other investments	<u>\$ 25.5</u>	<u>\$ 34.3</u>

Amounts in the SAR Account, which is a reserve account used to support principal payments on the Timber Notes, 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.

Investments in Limited Partnerships

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, 2005, there were no investments in limited partnerships. As of December 2004, these investments amounted to \$16.0 million.

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, 2005, as follows (in millions):

	<u>Years Ended December 31,</u>		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
Earnings from investments in partnerships	\$ 2.0	\$ 0.5	\$ 2.2

4. Property and Equipment

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

	Estimated Useful Lives	December 31,	
		2005	2004
Logging roads	15 years	\$ 49.6	\$ 45.4
Other	5 – 15 years	2.3	2.3
		51.9	47.7
Less: accumulated depreciation		(22.6)	(19.6)
		<u>\$ 29.3</u>	<u>\$ 28.1</u>

Depreciation expense for the years ended December 31, 2005, 2004 and 2003 was \$2.9 million, \$2.6 million and \$2.2 million, respectively.

5. Debt

Timber Notes

In July 1998, the Company issued \$867.2 million aggregate principal amount of Timber Notes, which are due 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. The Indenture permits the Company to have outstanding up to \$75.0 million of non-recourse indebtedness to acquire additional timberlands, as well as to issue additional timber notes provided certain conditions are met (including repayment or redemption of the remaining \$36.6 million of Class A-1 Timber Notes and that the remaining Timber Notes meet certain ratings standards). 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"**).

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 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, on or after January 20, 2014, any amounts then remaining in the SAR Account would be used to amortize the Class A-3 Timber Notes. Funds may 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, 2005, the amount held in the SAR Account was \$45.4 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 following table presents (in millions) the amortization of the Timber Notes outstanding (excluding \$55.4 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:		
2006	\$ —	\$ 18.2
2007	—	26.5
2008	11.6	25.0
2009	8.7	19.6
2010	13.3	22.8
Thereafter	654.1	575.6
	<u>\$ 687.7</u>	<u>\$ 687.7</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 previously 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.

On the Note Payment Date in January 2005, the Company used the funds available under the Line of Credit to pay the \$28.5 million of interest due (\$26.3 million net of interest due in respect of Timber Notes held in the SAR Account). The Company also repaid \$17.1 million of principal on the Timber Notes, an amount equal to Scheduled Amortization (\$10.6 million net of principal in respect of Timber Notes held in the SAR Account) 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 a \$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 in the SAR Account). The Company also repaid \$8.0 million of principal on the Timber Notes, an amount equal to Scheduled Amortization (\$5.0 million net of principal in respect of Timber Notes held in the SAR Account) using funds held in the SAR Account.

On the Note Payment Date in January 2006, the Company used its existing cash resources, all of the remaining funds available under the Company Line of Credit, and the additional funds made available from a \$2.3 million timber purchase by MGI, to pay all of the \$27.7 million of interest due (\$25.8 million net interest due in respect of Timber Notes held in the SAR Account). The Company also repaid \$19.3 million of principal on the Timber Notes an amount equal to Scheduled Amortization (\$11.9 million net of principal in respect of Timber Notes held in the SAR Account) 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. During 2005, there were no repurchases of Timber Notes.

At December 31, 2005, the SAR Account balance was \$75.9 million (including \$52.9 million of Timber Notes held in the SAR Account and \$23.0 million in cash), all of which is restricted for future principal payments on the Timber Notes. The SAR Account net cash balance of \$23.0 million is sufficient to cover Scheduled Amortization in 2006, but will not be sufficient to cover Scheduled Amortization on the January 20, 2007, Timber Note payment date and beyond. Accordingly, the Company's ability to make the Scheduled Amortization payments on the Timber Notes beyond 2006 is dependent upon the Company's ability to sell all or a portion of the Timber Notes held in the SAR Account. No assurance can be given that the Company will be successful in its efforts to sell its Timber Note held in the SAR before the January 20, 2007, Timber Notes payment date or as to the proceeds that might result from any such sale.

In the event of a failure to pay interest or principal on the Timber Notes in full when due, 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, which failure in the case of certain covenants or agreements 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 Timber Property and Company Timber Rights and other assets and using the proceeds thereof to pay accelerated amounts. In the event that the Company was to seek protection by filing under 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 would be subject to the rights of the Company under the Bankruptcy Code if it sought protection by filing under the Bankruptcy Code.

As of December 31, 2005 and 2004, the estimated fair value of debt, including current maturities, was \$564.1 million and \$591.2 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.

Line of Credit

The Line of Credit allows the Company to borrow up to one year's interest on the aggregate outstanding principal balance of the Timber Notes. On June 20, 2003, the Line of Credit was extended to July 7, 2006. 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, 2005, the maximum availability under the Line of Credit was \$55.4 million, and outstanding borrowings were \$31.3 million. At January 31, 2006, the maximum availability under the Line of Credit was \$54.1 million, after giving effect to principal payments made on the January 20, 2006 Note Payment Date, and there were \$54.9 million in borrowings outstanding.

Borrowings under the Line of Credit generally bear interest at the Base Rate (as defined in the agreement) plus 0.25% or at LIBOR plus 1.0% (at any time the borrowings have not been continually outstanding for more than six months). As discussed further in Note 1, the Company is experiencing financial difficulties due to regulatory restrictions on its ability to harvest. As a result, the Company may not have adequate availability under the Company Line of Credit and existing resources to pay the entire amount of interest due on the Timber Notes on July 20, 2006. Such a failure to pay interest would constitute an event of default under the Indenture.

As discussed further in Note 1, the Company is experiencing financial difficulties due to regulatory restrictions on its ability to harvest and other factors. As a result, the Company may not have adequate funds to pay the entire amount of interest due on the Timber Notes in July 2006. Such an event would constitute an event of default under the Indenture.

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 therefore 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 (“**SBE Price**”) as set forth in the most recent schedule published periodically by the California State Board of Equalization (“**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 2005 versus 2004. In December 2005, the State Board of Equalization adopted the new Harvest Value Schedule for the first half of 2006. The prices published in that schedule reflected a 5.3% increase in the SBE Price for small redwood logs and a 5.6% decrease for small Douglas-fir logs from the prices published for the second half of 2005.

The Company and Palco also entered into a services agreement at the time of Closing (“**Services Agreement**”), pursuant to which Palco provides a variety of operational, management and related services in respect of the Company Timberlands not provided by 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, 2005, 2004, and 2003, \$10.3 million, \$10.9 million, and \$10.6 million, respectively, was recorded under the Services Agreement.

7. Contingencies

The following describes certain legal proceedings in which the Company or Palco are involved. The Company and Palco are also involved in various claims, lawsuits and other proceedings not discussed herein which relate to a wide variety of matters. Uncertainties are inherent in the final outcome of those and the below-described matters, and it is presently impossible to determine the resolution of these matters or the actual costs that ultimately may be incurred.

Various pending judicial and administrative proceedings could adversely affect the ability of the Company to implement the HCP, implement certain approved THPs, or carry out other operations, as discussed below. Certain pending matters are described below. The Services Agreement generally 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.

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 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 incidental take permits issued by California pursuant to the HCP (“**California Permits**”), although that decision was reversed in December 2005. As a result of an earlier stay order issued in this case and the trial court’s judgment, Palco from October 2002 until March 2005 obtained review and approval of its THPs under an 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 Palco). An approved Option A plan is an alternative to obtaining approval of a sustained yield plan. Palco’s Option A plan (“**Option A Plan**”) was approved by the CDF in March 2005. The Company is currently relying upon its Option A Plan to obtain THP approvals, and will likely continue to do so in the future.

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 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 Environmental Plans 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 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 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. 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 the process of establishing TMDLs 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 2007 for these two watercourses. The Company’s scientists are actively working with North Coast Water Board staff to ensure that 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 winter periods since 2002, the Company and Palco have been required to submit reports on sediment discharges and erosion control practices to the North Coast Water Board 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 these 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 additional delays in THP approvals.

The North Coast Water Board has also issued a clean up and abatement order for the Elk River watershed (“**Elk River Order**”), 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 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 Resources Control Board (“**State Water Board**”) was denied. Palco has appealed the decision of the State Water Board in state court, but has held such appeal in abeyance until a decision was reached by the California Supreme Court on the *THP No. 520 lawsuit* (see “–Contingencies”). Now that the California Supreme Court has reached a decision, Palco is in the process of considering whether or not to pursue its appeal of the Elk River Order.

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 herein 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 the Company’s 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 harvest limit established by the CDF for these two watersheds

(“**CDF Harvest Limit**”). 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 (“**State Water Board Order**”), 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.

On July 14, 2005, Palco and the Company filed an action entitled *The Pacific Lumber Company and Scotia Pacific Company LLC v. State Water Resources Control Board, et al.* in (No. CV050516) in Humboldt County Superior Court (“**State Water Board action**”) appealing the State Water Board Order. The companies’ appeal requested both a stay of the State Water Board Order and a writ of mandate seeking reversal of the State Water Board Order. Following a December 8, 2005, hearing on the companies’ requests, the state court denied the request for a stay, but granted a hearing on the request for a writ of mandate. A hearing on the writ of mandate was held on February 6, 2006 and Palco and the Company await the court’s decision.

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, Palco and the Company 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 alleged defects in the proposed WWDRs and the North Coast Water Board’s hearing procedures. The Company and Palco requested a preliminary injunction to prevent the North Coast Water Board from taking any further action until their petition is heard. The Court denied the preliminary injunctions following a hearing on November 9, 2005, and the Company and Palco subsequently dismissed the case.

On February 17, 2006, the North Coast Water Board held a status conference to determine a timetable for consideration and approval of WWDRs in the Freshwater and Elk River watersheds. Although a formal timetable has not been published, it appears likely that WWDRs will not be approved before May 2006. Such a timetable would further reduce 2006 harvest levels.

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 additional 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* described below.

Contingencies

Timber Harvest Litigation

A California state court had invalidated the SYP in connection with two lawsuits filed against Palco, as described below, which decision was appealed and was reversed December 12, 2005. 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.

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.* (“**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 California Endangered Species Act and the California Environmental Quality Act, and challenged, among other things, the validity and legality of the SYP and the California Permits and sought, among other things, 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* (“**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 the trial, the Court in October 2003 entered a judgment invalidating the SYP and the California Permits and in September 2004 granted the plaintiffs’ request for reimbursement of an aggregate of \$5.8 million in attorneys’ fees and other expenses. The Palco Companies and the State of California appealed both decisions. In December 2005,

the appellate court reversed the trial court's decision invalidating the SYP, and on January 11, 2006, the appellate court denied plaintiffs' petition for rehearing. The plaintiffs have appealed the appellate court's decision to the California Supreme Court, which has not yet indicated whether it will review the matter. The defendants' appeal of the trial court's award of attorneys fee and expenses is still pending at the appellate court.

In July 2001, an action entitled *Environmental Protection Information Association v. Pacific Lumber, Scotia Pacific Company LLC* (No. C01-2821) ("**Bear Creek lawsuit**") was filed in the U.S. District Court for the Northern District of California, 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. In October 2003, the Court upheld the validity of an EPA regulation that exempts harvesting and other forestry activities from certain discharge requirements. Both state and federal agencies, along with Palco 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 that 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 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. The plaintiff has also filed a motion for summary judgment seeking to establish Palco's liability for discharging storm water without a permit. A hearing on the two summary judgment motions was held on March 6, 2006, and the parties are awaiting a decision.

Should the Court's October 2003 decision ultimately become final and be held to apply to all of the Company's timber operations, 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. The Company believes that civil penalties should not 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 Timber Property will not reach levels harmful to the environment. While the impact of a conclusion to this case that upholds the October 2003 ruling may be adverse, the Company does not believe that such an outcome should 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.* ("**Cook action**") and *Steve Cave, et al. v. Gary Clark, et al.* ("**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. 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). On October 13, 2005, an action entitled *Edyth Johnson, et al v. Charles E. Hurwitz, an individual; MAXXAM Inc. et al.* (No. DR040720) was filed in Humboldt County Superior Court ("**Johnson action**") and contains allegations similar to the *Cave* and *Cook actions*. 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) ("**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 harvest of 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, an action entitled *Environmental Protection Information Center v. U.S. Fish & Wildlife Service, NOAA Fisheries, et al.* (No. C04-4647) was filed in the U.S. District Court for the Northern District of California (“**EPIC-USFWS/NOAA lawsuit**”). 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 the Company and 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 February 6, 2006, plaintiffs voluntarily dismissed the remaining claims.

On August 8, 2005, an action entitled *Center for Biological Diversity v. California Department of Fish and Game, et al.* (No. 05CS01166) was filed in Sacramento County Superior Court against the California Department of Fish and Game (“**CDFG**”) and the Palco Companies seeking to overturn and prevent CDFG and the Palco Companies from taking any action to implement or rely upon certain CDFG “Consistency Determinations” issued in February 2005. Following various court proceedings, this case was voluntarily dismissed by the plaintiff in January 2006.

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 (“**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. Palco appealed the decision of the appellate court to the California Supreme Court. On January 30, 2006, the California Supreme Court issued a decision denying Palco’s appeal and upholding the appellate court’s decision. The adverse outcome of the *THP No. 520 lawsuit* confirms the authority the regional and state water boards and their staffs have been exercising over harvesting from the Company Timberlands, resulting in controls and limitations beyond those provided for by the Environmental Plans.

In December 2005, the Company and Palco filed a claim (the “**Claim**”) with the California Victim Compensation and Government Claims Board (the “**Claims Board**”) against the North Coast Water Board, the State Water Board and the State of California (Claim No. G558159). The Claim alleges that the defendants have substantially impaired the contractual and legal rights of the Company and Palco under the Headwaters Agreement and the related permits, authorizations and approvals. The Claim also alleges that the actions of the defendants have caused the companies substantial damages, but does not specify an amount. While the Claims Board has indicated that it is investigating the matter, it failed to approve or deny the claim by the statutory deadline. As a result, the Claim is by operation of law treated as having been denied, and the Company and Palco may now file a claim for damages in California state court. The Company and Palco are considering how best to proceed with respect to this matter.

8. Comprehensive Loss and Member Deficit

Comprehensive loss includes the following (in millions):

	<u>Years Ended December 31,</u>		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
Net loss	\$ (13.1)	\$ (19.8)	\$ (5.3)
Other comprehensive loss:			
Change in value of available-for-sale investments	<u>0.2</u>	<u>(0.6)</u>	<u>(0.4)</u>
Total comprehensive loss	<u>\$ (12.9)</u>	<u>\$ (20.4)</u>	<u>\$ (5.7)</u>

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

	<u>Years Ended December 31,</u>		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
Balance at beginning of period	\$ (431.6)	\$ (411.2)	\$ (405.5)
Comprehensive loss	<u>(12.9)</u>	<u>(20.4)</u>	<u>(5.7)</u>
Balance at end of period	<u>\$ (444.5)</u>	<u>\$ (431.6)</u>	<u>\$ (411.2)</u>

9. Quarterly Financial Information (Unaudited)

Summary quarterly financial information for the years ended December 31, 2005 and 2004 is as follows (in millions):

	<u>Three Months Ended</u>			
	<u>March 31</u>	<u>June 30</u>	<u>September 30</u>	<u>December 31</u>
2005:				
Log sales to Palco	\$ 16.1	\$ 17.4	\$ 25.7	\$ 20.9
Operating income	6.9	7.0	14.2	11.9
Net income (loss)	(6.6)	(5.8)	1.2	(1.9)
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)

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, 2005.

Changes in Internal Control over Financial Reporting

Since September 30, 2005, 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 2005 and 2004 by Deloitte & Touche LLP, the Company's independent registered public accounting firm:

	Years Ended December 31,	
	2005	2004
Audit Fees ⁽¹⁾	\$ 122,800	\$ 95,170
Audit-Related Fees ⁽²⁾	20,000	15,500
Tax Fees	—	—
All Other Fees	—	—
Total	<u>\$ 142,800</u>	<u>\$ 110,670</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.

⁽²⁾ Consists of professional services rendered for agreed-upon procedures reports.

The Company is an indirect wholly owned subsidiary of MAXXAM. As such, the Audit Committee of MAXXAM's Board of Directors ("**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 registered public accounting firm. 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 registered public accounting firm 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	26
Balance Sheets at December 31, 2005 and 2004	27
Statements of Loss for the Years Ended December 31, 2005, 2004 and 2003	28
Statements of Cash Flows for the Years Ended December 31, 2005, 2004 and 2003	29
Notes to Financial Statements	30

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, 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 14, 2006

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 14, 2006

By: J. KENT FRIEDMAN
J. Kent Friedman
Manager

Date: March 14, 2006

By: EZRA G. LEVIN
Ezra G. Levin
Manager

Date: March 14, 2006

By: ROBERT E. MANNE
Robert E. Manne
Manager

Date: March 14, 2006

By: PAUL N. SCHWARTZ
Paul N. Schwartz
Manager

Date: March 14, 2006

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

Date: March 14, 2006

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

Date: March 14, 2006

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

INDEX OF EXHIBITS

<u>Exhibit Number</u>	<u>Description</u>
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; " 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; " 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; " 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)

<u>Exhibit Number</u>	<u>Description</u>
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 (“CDFG”), the CDF and Pacific Lumber, Salmon Creek Corporation and the Company (incorporated herein by reference to Exhibit 99.3 to the Company’s Form 8-K dated March 19, 1999; “ 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)
10.12	Letter agreement, dated March 24, 2005, between the Company and Bingham McCutchen (incorporated herein by reference to Exhibit 10.1 to the Company’s Current Report on Form 8-K filed June 9, 2005; the “ Company June 9, 2005 Form 8-K ”)
10.13	Letter agreement, dated May 1, 2005, among the Company, Houlihan Lokey and Bingham McCutchen (incorporated herein by reference to Exhibit 10.2 to the Company June 9, 2005 Form 8-K)
*10.14	Agreement for Lump Sum Purchase of Company Timber, dated January 10, 2006, between the Company and MGI
*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