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

FORM 10-Q

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

For the quarterly period ended June 30, 2006

Commission File Number 333-63825

SCOTIA PACIFIC COMPANY LLC
(Exact name of Registrant as Specified in its Charter)

Delaware (State or other jurisdiction of incorporation or organization)	**68-0414690** (I.R.S. Employer Identification Number)
P. O. Box 712 **125 Main Street, 2nd Floor** **Scotia, California** (Address of Principal Executive Offices)	**95565** (Zip Code)

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

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes ☒ No ☐

Indicate by check mark whether the Registrant is 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 ☒

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

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SCOTIA PACIFIC COMPANY LLC

BALANCE SHEETS
(In millions of dollars)

	June 30, 2006	December 31, 2005
	(Unaudited)	
Assets		
Current assets:		
Cash and cash equivalents	$ 1.4	$ 1.3
Marketable securities, including restricted amounts of $13.1 and $23.0, respectively	13.1	24.2
Receivables from Palco	8.9	4.5
Prepaid timber harvesting costs	6.6	6.0
Assets held for sale	1.7	–
Other current assets	1.0	1.5
Total current assets	32.7	37.5
Timber and timberlands, net of accumulated depletion of $300.2 and $298.1, respectively	214.7	219.5
Property and equipment, net of accumulated depreciation of $24.1 and $22.6, respectively	29.1	29.3
Deferred financing costs	9.8	10.5
Restricted cash, marketable securities and other investments	2.7	2.5
Intangible assets	2.4	2.9
	$ 291.4	$ 302.2
Liabilities and Member Deficit		
Current liabilities:		
Payables to Palco	$ 1.0	$ 1.1
Accrued interest	24.0	23.8
Deferred revenue	3.7	–
Other accrued liabilities	2.0	2.4
Short-term borrowings and current maturities of long-term debt, excluding $9.0 and $11.1, respectively, of repurchased Timber Notes held in the SAR Account	64.9	49.4
Total current liabilities	95.6	76.7
Long-term debt, less current maturities and excluding $39.1 and $44.3, respectively, of repurchased Timber Notes held in the SAR Account	653.1	669.6
Other noncurrent liabilities	0.2	0.4
Total liabilities	748.9	746.7
Contingencies (See Note 5)		
Member deficit	(457.5)	(444.5)
	$ 291.4	$ 302.2

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

SCOTIA PACIFIC COMPANY LLC

STATEMENTS OF LOSS
(In millions of dollars)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
		(Unaudited)		
Log sales to Palco	$ 14.2	$ 17.4	$ 23.0	$ 33.5
Operating expenses:				
General and administrative	5.0	7.7	9.4	14.2
Depletion, depreciation and amortization	2.3	2.7	4.1	5.4
Gain on sale of timberlands	(4.3)	–	(5.0)	–
	3.0	10.4	8.5	19.6
Operating income	11.2	7.0	14.5	13.9
Other income (expense):				
Interest and other income	0.2	0.9	0.4	1.2
Interest expense	(13.9)	(13.7)	(27.9)	(27.5)
	(13.7)	(12.8)	(27.5)	(26.3)
Net loss	$ (2.5)	$ (5.8)	$ (13.0)	$ (12.4)

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

SCOTIA PACIFIC COMPANY LLC

STATEMENTS OF CASH FLOWS
(In millions of dollars)

	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005
	(Unaudited)	
Cash flows from operating activities:		
Net loss	$ (13.0)	$ (12.4)
Adjustments to reconcile net loss to net cash used for operating activities:		
Depletion, depreciation and amortization	4.1	5.4
Gain on sale of timberlands	(5.0)	–
Amortization of deferred financing costs	0.5	0.7
Increase (decrease) in cash resulting from changes in:		
Receivables from Palco	(4.4)	(4.0)
Prepaid timber harvesting costs	(0.6)	(0.5)
Payables to Palco	(0.1)	(0.6)
Accrued interest	0.2	(0.2)
Deferred revenue	3.7	–
Other accrued liabilities	(0.4)	1.0
Other	0.6	0.6
Net cash used for operating activities	(14.4)	(10.0)
Cash flows from investing activities:		
Sales and maturities of marketable securities	110.1	63.6
Purchases of marketable securities	(108.9)	(62.6)
Net proceeds from sale of assets	6.9	–
Net proceeds from restricted cash	9.7	7.4
Capital expenditures	(2.2)	(3.1)
Net cash provided by investing activities	15.6	5.3
Cash flows from financing activities:		
Principal payments on Timber Notes and other timber related debt	(12.0)	(10.6)
Borrowings under line of credit agreement, net	10.9	15.6
Net cash provided by (used for) financing activities	(1.1)	5.0
Net increase in cash and cash equivalents	0.1	0.3
Cash and cash equivalents at beginning of period	1.3	0.5
Cash and cash equivalents at end of period	$ 1.4	$ 0.8
Supplemental disclosure of cash flow information:		
Interest paid	$ 27.4	$ 27.1

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

SCOTIA PACIFIC COMPANY LLC

CONDENSED NOTES TO FINANCIAL STATEMENTS

1. Basis of Presentation

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

The financial statements included herein are unaudited; however, they include all adjustments of a normal recurring nature which, in the opinion of management, are necessary for a fair presentation of the financial position of the Company at June 30, 2006, the results of operations for the three months and six months ended June 30, 2006 and 2005, and the cash flows for the six months ended June 30, 2006 and 2005. The Company is a wholly owned subsidiary of Palco, which is a wholly owned subsidiary of MGI. MGI is an indirect wholly owned subsidiary of MAXXAM.

Liquidity and Cash Resources

Regulatory and environmental matters as well as legal actions have had and are expected to continue to have a significant adverse effect on the Company's operations and liquidity. The ability to harvest Company Timber depends in large part upon the Company's ability to obtain regulatory approval of its 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 being able to harvest on previously-approved THPs due to, among other things, actions by the North Coast Water Board (see below). The foregoing matters have resulted in declines in actual and expected harvest levels and cash flows, significant increases in the cost of logging operations and increased costs related to timber harvest litigation, all of which 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 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. THPs in these two watersheds represent a significant portion of the harvest planned in 2006 and for the next several years. As harvesting activities on the Company Timberlands cannot readily be moved between watersheds due to, among other things, historic harvest patterns, adjacency restrictions, and the age classes of trees, development of WWDRs and the other matters described in the "Regulatory and Environmental Factors" section of Note 5 have in the past and are expected to continue to result in reduced harvest and less predictability in the future regarding the mix of logs available for sale by the Company to Palco which negatively impacts cash flow.

As the WWDRs had not yet been formulated for the Freshwater and Elk River watersheds, 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. On May 8, 2006, the North Coast Water Board adopted WWDRs for the Freshwater and Elk River watersheds, which has the effect of allowing harvesting in these two watersheds to begin once THPs are enrolled, up to approximately 50% of the CDF Harvest Limit for these two watersheds. Additional THPs, bringing the total to approximately 75% of the CDF Harvest Limit for these two watersheds, may be enrolled upon approval by the Executive Officer of the North Coast Water Board's staff of a monitoring plan, which has been submitted by Palco. While certain THPs related to these two watersheds have been enrolled and harvesting has begun, there can be no assurance that additional THPs related to these two watersheds will ultimately be enrolled or harvested as planned in 2006 or in future years as, among other things, Palco's monitoring plan has not been approved. The North Coast Water Board's adoption of these WWDRs has been appealed to the State Water Board, but the appeals are being held in abeyance in order to see how the implementation of the WWDRs proceeds. While the Company continues to project that its annual harvest level over the ten-year period beginning 2006 will be approximately 100 million board feet, this projection is significantly below historical annual harvest levels, and actual harvest levels may be even lower, depending on the ultimate outcome of various assumptions.

Liquidity Update

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 the next several years, be substantially below both historical levels and the minimum levels necessary to allow the Company to satisfy its debt service obligations in respect of the Timber Notes.

In an effort to address the expected future cash shortfalls, the Company initiated the Land Sale Program whereby it is seeking to sell certain non-timberland properties such as ranchlands and recreational areas, as well as certain timberlands. During the first half of 2006, $6.9 million of properties were sold and an additional $4.6 million of properties were sold in July 2006 (of which $3.3 million was received prior to the July 2006 Timber Notes payment date). There can be no assurance that the marketing efforts in respect of the remaining properties will be successful.

Due to regulatory constraints and adverse weather conditions during the first half of 2006, harvest levels were lower than planned resulting in liquidity shortfalls. The Company and MGI consummated three timber/log purchases that provided the Company an aggregate of $8.1 million of additional liquidity ($4.4 million as of June 30, 2006 and $3.7 million in July 2006) to pay its expenses, including interest due in respect of the Timber Notes on the Timber Notes payment dates in January 2006 and July 2006 as discussed below.

On the Timber Notes payment date in January 2006, 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 $2.3 million timber/log purchase by MGI, to pay all of the $27.7 million of interest due ($25.8 million net of 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 ($11.9 million net of principal in respect of Timber Notes held in the SAR Account), an amount equal to Scheduled Amortization, using funds held in the SAR Account.

As previously announced, the Company's estimates indicated that its cash flows from operations, together with funds available under the Line of Credit and other available funds, would be insufficient, by a substantial amount, to pay the entire amount of interest due on the July 20, 2006, Timber Notes payment date. As the July 20, 2006, Timber Notes payment date approached, it became apparent the Company's estimates would prove correct and that the remaining cash shortfall as of such Timber Notes payment date, after consideration of the funds made available from the Land Sale Program and the MGI timber/log purchases discussed above, would be approximately $2.1 million. Based upon review of its existing alternatives, the Company requested that Palco make an early payment, equal to the $2.1 million shortfall, in respect of certain logs that had already been delivered to and purchased by Palco. Palco approved and delivered the early log payment.

On the Timber Notes payment date in July 2006, the Company used its existing cash resources, all of the remaining funds available under the Line of Credit, the additional funds made available from the Land Sale Program of $10.2 million, a $3.7 million timber/log purchase by MGI, and the $2.1 million early log payment by Palco to pay all of the $27.1 million of interest due ($25.4 million net of interest due in respect of Timber Notes held in the SAR Account). The Company also repaid $10.0 million of principal on the Timber Notes ($6.2 million net of principal in respect of Timber Notes held in the SAR Account), an amount equal to Scheduled Amortization, using funds held in the SAR Account.

The Company also expects to incur substantial interest shortfalls over at least the next several years. The failure to pay all of the interest on the Timber Notes when due would constitute an event of default under the Timber Notes Indenture. There can be no assurance that the Company will be able to generate sufficient additional liquidity to fund the expected future cash shortfalls. To the extent that the Company is unable to generate sufficient liquidity from the 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.

Palco Liquidity Update

As of December 31, 2005, and June 30, 2006, Palco and Britt were in default under the Old Palco Term Loan and the Old Palco Revolving Credit Facility due to financial covenant breaches. In the first half of 2006, additional liquidity was needed at Palco and Palco borrowed an aggregate of $20.0 million from MGI to meet its cash shortfalls. Palco's liquidity shortfalls during the first half of 2006 resulted primarily from reduced log supply from the Company and operational inefficiencies related to the large log processing line at Palco's new Scotia sawmill.

On July 18, 2006, Palco and Britt, as Borrowers, closed on the New Palco Term Loan, a new five-year $85.0 million secured term loan, and the New Palco Revolving Credit Facility, a new five-year $60.0 million secured asset-based revolving credit facility. The New Palco Term Loan was fully funded at closing. The New Palco Term Loan and the New Palco Revolving Credit Facility required MGI to provide a $10.0 million subordinated loan to the Borrowers, which was also funded at closing. The Borrowers used approximately (i) $34.0 million of the New Palco Term Loan to pay off the Old Palco Term Loan; (ii) $22.5 million of the New Palco Term Loan to pay off the Old Palco Revolving Credit Facility and cash collateralize previously existing letters of credit; and (iii) $6.0 million to pay transaction costs. The remaining funds at closing of $32.5 million will be used for general corporate purposes. The Borrowers terminated the Old Palco Revolving Credit Facility and the Old Palco Term Loan. The Borrowers have not made any borrowings under the New Palco Revolving Credit Facility to date, although they currently have availability in excess of $20.0 million.

The amount available for borrowings under the New Palco Revolving Credit Facility is normally the sum of 85% of the Borrowers' eligible accounts receivable plus the lesser of (i) 80% of the book value of Borrowers' eligible inventory or (ii) 85% of the net orderly liquidation value of such inventory. However, during each period from October 15 through January 15, the amount available for borrowing under the New Palco Revolving Credit Facility is the sum of 95% of Borrowers' eligible accounts receivable plus the lesser of (i) 90% of the book value of Borrowers' eligible inventory or (ii) 95% of the net orderly liquidation value of such inventory. The amount available under the New Palco Revolving Credit Facility may not exceed $60.0 million, subject to limitations such as the ability of the lender to establish reasonable reserves.

The New Palco Term Loan bears interest at the rate of LIBOR plus 8.75%. Loans under the New Palco Revolving Credit Facility bear interest at the rate of LIBOR plus 2.75% or prime plus 0.75%, at the Borrowers' option; however, incremental borrowings made during the period from October 15 through January 15, bear interest at the rate of LIBOR plus 4.50% or prime plus 2.50%, as applicable. The New Palco Revolving Credit Facility matures on July 18, 2011.

Both the New Palco Term Loan and the New Palco Revolving Credit Facility contain substantially identical restrictive covenants that limit the Borrowers' ability to incur debt, grant liens, make investments, pay dividends, make capital expenditures or merge or consolidate, and require the Borrowers' to maintain a minimum level of EBITDA, along with a minimum fixed charge coverage ratio and maximum leverage ratio throughout the life of the loans. The operating cash flow estimates used to establish the EBITDA maintenance covenant are subject to a number of assumptions about future operating cash flows and actual results could differ materially from these estimates. The New Palco Term Loan also requires the Borrowers to repay a substantial portion of the outstanding principal of the New Palco Term Loan with the net proceeds from the Palco Asset Sale Program, including the real property associated with Palco's former Fortuna and Carlotta sawmills, and Palco-owned homes to be sold after certain milestones have been met. Any remaining principal balance of the New Palco Term Loan is due on July 18, 2011. Accordingly, continued compliance with these new debt facilities is dependent on Palco's ability to meet its EBITDA projections and timely complete required asset sales. The New Palco Term Loan and the New Palco Revolving Credit Facility contain customary events of default and customary remedies with respect to the occurrence of an event of default.

The New Palco Term Loan and New Palco Revolving Credit Facility each include prepayment premiums of 3%, 2% and 1% that will be payable in connection with any prepayment of the New Palco Term Loan or reduction or termination of the New Palco Revolving Credit Facility during the first, second and third years, respectively. Under the New Palco Term Loan and New Palco Revolving Credit Facility, Palco is permitted to invest up to $5.0 million in the Company. No such investment had been made or committed to be made by Palco, and there can be no assurance that Palco would in the future determine or be able to make any such investment in whole or part.

Reclassifications

Certain reclassifications have been made to prior years' financial statements to be consistent with the current year's presentation. Cash held in brokerage accounts has been reclassified from marketable securities to cash and cash equivalents in the Balance Sheets and in the Statements of Cash Flows.

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 consolidated 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 and related assumptions; accordingly, actual results could differ from these estimates.

Risks and uncertainties are inherent with respect to the ultimate outcome of the matters discussed in Note 5. The results of a resolution of such uncertainties could have a material effect on the Company's financial position, results of operations or liquidity.

2. New Accounting Standards

Exchanges of Nonmonetary Assets

In December 2004, the FASB issued SFAS No. 153. SFAS No. 153 is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. The adoption of SFAS No. 153 on January 1, 2006, did not have an impact on the Company's financial statements.

Accounting Changes and Error Corrections

In May 2005, the FASB issued SFAS No. 154, which changes the requirements applicable to accounting for and reporting of a change in accounting principle. SFAS No. 154 requires retrospective application of a change in accounting principle to prior periods' financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of SFAS No. 154 on January 1, 2006, did not have an impact on the Company's financial statements.

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

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

	June 30, 2006	December 31, 2005
Amounts held in SAR Account:		
Current portion of restricted marketable securities and other investments	$ 13.1	$ 23.0
Long-term portion of restricted marketable securities and other investments	45.8	52.9
Less: Amounts attributable to Timber Notes held in SAR Account	(45.8)	(52.9)
Total amounts held in SAR Account	13.1	23.0
Other amounts restricted under the Indenture	2.7	2.5
Total restricted cash, cash equivalents, marketable securities and other investments	$ 15.8	$ 25.5

4. Debt

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 May 18, 2006, the Line of Credit was extended to July 6, 2007. At or near the completion of such extension, the Company intends to request that the Line of Credit be extended for an additional period of not less than 364 days. If not extended, the Company may draw upon the full amount available. The amount drawn would, to the extent of available funds, 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 June 30, 2006, the maximum availability under the Line of Credit was $54.1 million, and outstanding borrowings were $42.2 million.

Timber Notes

On the Timber Notes payment date in January 2006, 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 $2.3 million timber/log purchase by MGI, to pay all of the $27.7 million of interest due ($25.8 million net of 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 ($11.9 million net of principal in respect of Timber Notes held in the SAR Account), an amount equal to Scheduled Amortization, using funds held in the SAR Account.

On the Timber Notes payment date in July 2006, the Company used its existing cash resources, all of the remaining funds available under the Line of Credit, the additional funds made available from the Land Sale Program of $10.2 million, a $3.7 million timber/log purchase by MGI and a $2.1 million early log payment by Palco, to pay all of the $27.1 million of interest due ($25.4 million net of interest due in respect of Timber Notes held in the SAR Account). The Company also repaid $10.0 million of principal on the Timber Notes ($6.2 million net of principal in respect of Timber Notes held in the SAR Account), an amount equal to Scheduled Amortization, using funds held in the SAR Account.

As discussed further in Note 1, the Company is experiencing financial difficulties due to regulatory restrictions on harvesting and other factors. As a result, the Company expects to incur substantial interest shortfalls over at least the next several years. Such an event would constitute an event of default under the Timber Notes Indenture. 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. If such accelerations of Timber Notes and/or advances under the Line of Credit occur, the Trustee may exercise all rights under the Indenture and related security documents, including applying funds to pay accelerated amounts, and selling the Company Timberlands and the Company Timber Rights and other assets and using the proceeds thereof to pay accelerated amounts. In the event that the Company were to seek protection by filing under the Bankruptcy Code, all amounts related to the Timber Notes would become immediately due and payable under the Indenture and all advances under the Line of Credit 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.

U.S. Bank, the Trustee under the Timber Notes Indenture, resigned effective May 1, 2006. The Company appointed Deutsche Bank National Trust Company as successor Trustee under the Indenture, which appointment was accepted and became effective May 1, 2006.

At June 30, 2006, the SAR Account balance was $58.9 million (consisting of $45.8 million of Timber Notes held in the SAR Account and $13.1 million in cash and marketable securities), all of which is restricted for future principal payments on the Timber Notes. Such cash and marketable securities will not be sufficient to cover the Scheduled Amortization on the January 20, 2007, Timber Notes payment date and beyond. Accordingly, the Company's ability to make Scheduled Amortization payments on the Timber Notes in 2007 and beyond from the SAR Account 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 Debt Facilities

At December 31, 2005, and June 30, 2006, Palco and Britt were in default under the Old Palco Term Loan and the Old Palco Revolving Credit Facility due to financial covenant breaches. The existence of the defaults required Palco to pay interest on amounts borrowed under the Old Palco Term Loan at a per annum rate 2% higher than the rate at which interest would be owed if no default existed. As of June 30, 2006, $33.4 million was outstanding under the Old Palco Term Loan and $19.5 million, consisting of borrowings of $9.3 million and outstanding letters of credit of $10.2 million, was outstanding under the Old Palco Revolving Credit Facility.

On July 18, 2006, Palco and Britt, as Borrowers, closed on the New Palco Term Loan and the New Palco Revolving Credit Facility. See Note 1, "*Liquidity and Cash Resources- Palco Liquidity Update*", for a description of these two new facilities.

5. Regulatory and Environmental Factors and Contingencies

Regulatory and Environmental Factors

Regulatory and environmental matters and litigation have had a significant adverse effect on the Company's business, which is subject to a variety of California and federal laws and regulations, as well as the HCP, dealing with timber harvesting practices, threatened and endangered species and habitat for such species, air and water quality and other matters. Compliance with such laws and regulations also plays a significant role in the Company's business.

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 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 would not exceed the average annual growth level at the end of the 100-year planning period. These regulations 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 (see "–Contingencies–Timber Harvest Litigation"), on October 31, 2003, the California trial court hearing the *EPIC-SYP/Permits lawsuit* entered a judgment invalidating the SYP and the California Permits, although an appellate court reversed that decision in December 2005. The plaintiffs appealed the appellate court's decision to the California Supreme Court, which has indicated it will review the matter. As a result of an earlier stay order and the trial court's judgment, 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. The Company's Option A plan was approved by the CDF in March 2005. The Company is currently relying upon the Option A Plan to obtain THP approvals, and will likely continue to do so in the future.

The 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 Palco Companies primarily in four areas: efforts by the EPA and the North Coast Water Board to establish TMDLs in watercourses that have been declared to be water quality impaired; actions by the North Coast Water Board to impose waste discharge reporting requirements in respect of watersheds on the Company Timberlands and in some cases, clean-up or preventive measures; actions by the North Coast Water Board during the THP approval process which impose certain operational requirements on individual THPs; and the development of WWDRs by the North Coast Water Board and its staff 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 until at least 2010. The EPA has issued reports dealing with TMDLs on three 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. Presently, the North Coast Water Board is in the process of establishing the TMDL requirements applicable to two other watercourses, Freshwater and Elk River, 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 and could further restrict harvesting on the Company Timberlands.

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 to 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 the Elk River Orders, which are aimed at addressing existing sediment production sites through clean up actions. The North Coast Water Board has also initiated the process that 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 Orders have resulted in increased costs to Palco that could extend over a number of years. Additional orders for other watersheds (should they be issued), may also result in further cost increases.

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 various other matters described herein are expected to result in reduced harvest levels in 2006 and beyond.

As WWDRs had not yet been formulated for the Freshwater and Elk River watersheds, 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 January and February 2005, the Executive Officer of the staff of the North Coast Water Board enrolled sufficient THPs to allow the harvest of up to 50% of the CDF Harvest Limit for these two watersheds. On March 16, 2005, the North Coast Water Board ordered the enrollment of additional THPs that would allow the harvest of up to 75% of the CDF Harvest Limit for these two watersheds. Following third party appeal of this decision, the State Water Board issued the 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 had the effect of disallowing further harvesting in the Freshwater and Elk River watersheds until WWDRs for these two watersheds were adopted by the North Coast Water Board. On July 14, 2005, the Company and Palco filed the *State Water Board action* requesting both a stay of the State Water Board Order and a writ of mandate reversing the State Water Board Order. The Court subsequently denied the request for a stay, but granted a writ of mandate, thus requiring the State Water Board to set aside its June 16, 2005 order. The Court also remanded the matter to the State Water Board to reconsider whether the North Coast Water Board's enrollment of additional THPs was proper. Further proceedings before the State Board have yet to be scheduled.

While the Court ordered that the State Water Board must take further action before August 1, 2006, it has not done so. In the meantime, on May 8, 2006, the North Coast Water Board adopted WWDRs for the Freshwater and Elk River watersheds, which has the effect of allowing harvesting in these two watersheds to begin once THPs are enrolled, up to approximately 50% of the CDF Harvest Limit for these two watersheds. Additional THPs, bringing the total to approximately 75% of the CDF Harvest Limit for these two watersheds, may be enrolled upon approval by the Executive Officer of the North Coast Water Board's staff of a monitoring plan, which has been submitted by Palco. While certain THPs related to these two watersheds have been enrolled and harvesting has begun, there can be no assurance that additional THPs related to these two watersheds will ultimately be enrolled or harvested as planned in 2006 or in future years as, among other things, Palco's monitoring plan has not been approved. The North Coast Water Board's adoption of these WWDRs has been appealed to the State Water Board, but the appeals are being held in abeyance in order to see how the implementation of the WWDRs proceeds. While the Company continues to project that its annual harvest level over the ten-year period beginning 2006 will be approximately 100 million board feet, this projection is significantly below historical annual harvest levels, and actual harvest levels may be even lower, depending on the ultimate outcome of various assumptions.

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.

Contingencies

Various pending judicial and administrative proceedings, as described below, could affect the Company's and Palco's ability to implement the HCP, implement certain approved THPs, or carry out other operations. The Services Agreement requires Palco to prepare and file on behalf of the Company (at Palco's cost) all pleadings and motions, and otherwise diligently pursue, appeals of any denial, and defense of any challenge to approval, of any THP or the Environmental Plans or similar plan or permit and related matters.

In March 1999, the *EPIC-SYP/Permits lawsuit* was filed. This action alleged, among other things, various violations of the 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. A similar action, the *USWA lawsuit*, was filed on the same day, and the two actions 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. On December 12, 2005, an appellate court reversed the trial court's decision invalidating the SYP and the California Permits. The plaintiffs have appealed the appellate court's decision to the California Supreme Court, which has indicated it will review the matter. The defendants' appeal of the trial court's award of attorneys' fees and expenses is still pending at the appellate court. There can be no assurance that this appeal will be successful.

In July 2001, the *Bear Creek lawsuit* was filed and later amended to add the EPA as a defendant. The lawsuit alleges that harvesting and other forestry activities under certain of the Company's 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 grounds 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. On April 28, 2006, the Court denied both motions. Discovery was completed in May 2006. On June 30, 2006, EPIC filed a motion for partial summary judgment seeking to establish Palco's liability, and Palco filed a motion for summary judgment asserting that EPIC lacks standing to maintain the lawsuit. A hearing on the parties' motions is scheduled for August 21, 2006.

Should the Court's October 2003 decision ultimately become final and be held to apply to all of the timber operations of the Palco Companies, 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 Timberlands 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, the *Cook action* and the *Cave action* were filed, which 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, the *Johnson action* was filed 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 the *Humboldt DA action*. The suit was filed under California's unfair competition law and alleges that the Palco Companies used certain unfair business practices in connection with completion of the Headwaters Agreement, and that this resulted in the harvest of significantly more trees 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 and prior rulings of the Court substantially diminished the exposure of the Palco Companies with respect to this matter.

In December 2005, the Company and Palco filed the *California Headwaters action*. The *California Headwaters action* 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 *California Headwaters action* 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 *California Headwaters action* is by operation of law treated as having been denied, 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.

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 a material adverse effect on the Company's financial condition, results of operations or liquidity.

6. Comprehensive Loss and Member Deficit

Comprehensive loss includes the following (in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	**2005**	**2006**	**2005**
Net loss	$ (2.5)	$ (5.8)	$ (13.0)	$ (12.4)
Other comprehensive income:				
Net change in fair value of available-for-sale investments	–	–	–	0.2
Total comprehensive loss	$ (2.5)	$ (5.8)	$ (13.0)	$ (12.2)

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

	Six Months Ended June 31,	
	2006	**2005**
Balance at beginning of period	$ (444.5)	$ (431.6)
Comprehensive loss	(13.0)	(12.2)
Balance at end of period	$ (457.5)	$ (443.8)

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

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

This Quarterly Report on Form 10-Q contains statements which constitute "forward-looking statements" within the meaning of the PSLRA. These statements appear in a number of places in this section and in Part II, Item 1. "Legal Proceedings." Such statements can be identified by the use of forward-looking terminology such as "believes," "expects," "may," "estimates," "will," "should," "could," "plans," "intends," "projects," "seeks," or "anticipates" or the negative thereof or other variations thereon or comparable terminology, or by discussions of strategy. Readers are cautioned that any such forward-looking statements are not guarantees of future performance and involve significant risks and uncertainties, and that actual results may vary materially from the forward-looking statements as a result of various factors. These factors include the effectiveness of management's strategies and decisions, general economic and business conditions, developments in technology, new or modified statutory, environmental or regulatory requirements, litigation developments, and changing prices and market conditions. This Form 10-Q and the Form 10-K identify other factors which could cause differences between such forward-looking statements and actual results. No assurance can be given that these are all of the factors that could cause actual results to vary materially from the forward-looking statements.

Results of Operations

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

The Company's business has become increasingly unpredictable due to continued regulatory constraints, ongoing litigation challenges and other factors. Additionally, the Company's business is somewhat seasonal, with its net sales having historically been 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 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 adversely affect the Company's operations. See Item 1. "Business–Regulatory and Environmental Factors," and Item 1A. "Risk Factors" of the Form 10-K and in this Form 10-Q and Note 5 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.

The cash flows of the Company and Palco 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 both historical levels and the minimum levels necessary to allow the Company to satisfy its debt service obligations in respect of the Timber Notes. To the extent that the Company is unable to generate sufficient liquidity from the 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.

On July 18, 2006, Palco and Britt closed on the New Palco Term Loan and New Palco Revolving Credit Facility and terminated the Old Palco Term Loan and Old Palco Revolving Credit Facility. For further information, see "–Financial Condition and Investing and Financing Activities."

In addition to the matters described above, there can be no assurance that certain other pending legal, regulatory and environmental matters or future governmental regulations, additional litigation, 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 1A. "Risk Factors," Item 1A. "Risk Factors" in this Form 10-Q and Item 3. "Legal Proceedings" of the

Form 10-K and Note 5 ("Regulatory and Environmental Factors" and "Contingencies–Timber Harvest Litigation") for further information regarding regulatory and legislative matters and legal proceedings relating to the Company's operations.

Log Sales to Palco

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

	Three Months Ended June 30, 2006			Three Months Ended June 30, 2005		
	MBFE	**Price $/MBFE**	**Revenues**	**MBFE**	**Price $/MBFE**	**Revenues**
Redwood	12,700	$ 1,020	$ 12.9	16,800	$ 876	$ 14.7
Douglas fir	1,800	654	1.2	4,500	593	2.7
Other	200	408	0.1	400	111	–
	14,700	966	$ 14.2	21,700	803	$ 17.4

	Six Months Ended June 30, 2006			Six Months Ended June 30, 2005		
	MBFE	**Price $/MBFE**	**Revenues**	**MBFE**	**Price $/MBFE**	**Revenues**
Redwood	21,300	$ 982	$ 21.0	33,100	$ 852	$ 28.2
Douglas fir	3,100	611	1.9	9,000	578	5.2
Other	400	360	0.1	1,100	78	0.1
	24,800	926	$ 23.0	43,200	775	$ 33.5

For the three months ended June 30, 2006, the Company experienced an overall 18.4% decrease in revenues and a 32.2% decrease in sales volume compared to the three months ended June 30, 2005. The decrease in revenue is attributable to the decline in harvest levels, partially offset by a 20.3% increase in the average realized price of logs.

For the six months ended June 30, 2006, the Company experienced an overall 31.3% decrease in revenues and a 42.6% decrease in sales volume compared to the six months ended June 30, 2005. The decrease in revenue is attributable to the decline in harvest levels, partially offset by a 19.5% increase in the average realized price of logs.

Operating Income and Net Loss

The Company generated operating income of $11.2 million and $14.5 million for the second quarter of 2006 and the six months ended June 30, 2006, respectively. These results include a gain of $4.3 million and $5.0 million, respectively, from the sale of certain properties. The Company's operating results for the first half of 2005 include substantial legal and other professional fees relating to the Company's efforts to pursue a negotiated restructuring of the Timber Notes. The Company also had excess cash in 2005 invested that generated earnings of approximately $0.8 million in the second quarter of 2005 and $1.2 million in the first half of 2005.

Financial Condition and Investing and Financing Activities

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

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. The ability to harvest Company Timber depends in large part upon the Company's ability to obtain regulatory approval of its 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 being able to harvest on previously-approved THPs due to, among other things, actions by the North Coast Water Board (see below). The foregoing matters have resulted in declines in actual and expected harvest levels and cash flows, significant increases in the cost of logging operations and increased costs related to timber harvest litigation, all of which 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 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. THPs in these two watersheds represent a significant portion of the harvest planned in 2006 and for the next several years. As harvesting activities on the Company Timberlands cannot readily be moved between watersheds due to, among other things, historic harvest patterns, adjacency restrictions, and the age classes of trees, development of WWDRs and the other matters described in the "Regulatory and Environmental Factors" section of Note 5 have in the past and are expected to continue to result in reduced harvest and less predictability in the future regarding the mix of logs available for sale by the Company to Palco which negatively impacts cash flow.

As the WWDRs had not yet been formulated for the Freshwater and Elk River watersheds, 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. On May 8, 2006, the North Coast Water Board adopted WWDRs for the Freshwater and Elk River watersheds, which has the effect of allowing harvesting in these two watersheds to begin once THPs are enrolled, up to approximately 50% of the CDF Harvest Limit for these two watersheds. Additional THPs, bringing the total to approximately 75% of the CDF Harvest Limit for these two watersheds, may be enrolled upon approval by the Executive Officer of the North Coast Water Board's staff of a monitoring plan, which has been submitted by Palco. While certain THPs related to these two watersheds have been enrolled, and harvesting has begun, there can be no assurance that additional THPs related to these two watersheds will ultimately be enrolled or harvested as planned in 2006 or in future years as, among other things, Palco's monitoring plan has not been approved. The North Coast Water Board's adoption of these WWDRs has been appealed to the State Water Board, but the appeals are being held in abeyance in order to see how the implementation of the WWDRs proceeds. While the Company continues to project that its annual harvest level over the ten-year period beginning 2006 will be approximately 100 million board feet, this projection is significantly below historical annual harvest levels, and actual harvest levels may be even lower, depending on the ultimate outcome of various assumptions.

Liquidity Update

Due to its highly leveraged condition, the Company is more sensitive than less leveraged companies to factors affecting its operations, including low log prices, governmental regulation and litigation affecting timber harvesting operations on the Company Timberlands (see Item 1A. "Risk Factors," of the Form 10-K and Note 5), 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 (see Item 1. "Business–Operation of Company Timberlands" of the Form 10-K) contemplates that all sales of logs by the Company to Palco will be at fair market value (based on stumpage prices) for each species and category of 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. In January 2006, 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. In June 2006, the State Board of Equalization issued a draft version of the Harvest Value Schedule for the second half of 2006. The prices published in that schedule reflected a 4% increase in the SBE Price for small redwood logs and a 6% decrease for small Douglas fir logs from the prices published for the second half of 2005.

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 the next several years be substantially below both historical levels and the minimum levels necessary to allow the Company to satisfy its debt service obligations in respect of the Timber Notes.

In an effort to address the expected future cash shortfalls, the Company initiated the Land Sale Program whereby it is seeking to sell certain non-timberland properties such as ranchlands and recreational areas, as well as certain timberlands. During the first half of 2006, $6.9 million of properties were sold and an additional $4.6 million of properties were sold in July 2006 (of which $3.3 million was received prior to the July 2006 Timber Notes payment date). There can be no assurance that the marketing efforts in respect of the remaining properties will be successful.

Due to regulatory constraints and adverse weather conditions during the first half of 2006 harvest levels were lower than planned resulting in liquidity shortfalls. The Company and MGI consummated three timber/log purchases that provided the Company an aggregate of $8.1 million of additional liquidity ($4.4 million as of June 30, 2006 and $3.7 million in July 2006) to pay its expenses, including interest due in respect of the Timber Notes on the Timber Notes payment dates in January 2006 and July 2006, as discussed below.

On the Timber Notes payment date in January 2006, 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 $2.3 million timber/log purchase by MGI, to pay all of the $27.7 million of interest due ($25.8 million net of 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 ($11.9 million net of principal in respect of Timber Notes held in the SAR Account), an amount equal to Scheduled Amortization, using funds held in the SAR Account.

As previously announced, the Company's estimates indicated that its cash flows from operations, together with funds available under the Line of Credit and other available funds, would be insufficient, by a substantial amount, to pay the entire amount of interest due on the July 20, 2006, Timber Notes payment date. As the July 20, 2006, Timber Notes payment date approached, it became apparent the Company's estimates would prove correct and that the remaining cash shortfall as of such Timber Notes payment date, after consideration of the funds made available from the Land Sale Program and the MGI timber/log purchases discussed above, would be approximately $2.1 million. Based upon review of its existing alternatives, the Company requested that Palco make an early payment, equal to the $2.1 million shortfall, in respect of certain logs that had already been delivered to and purchased by Palco. Palco approved and delivered the early log payment.

On the Timber Notes payment date in July 2006, the Company used its existing cash resources, all of the remaining funds available under the Line of Credit, the additional funds made available from the Land Sale Program of $10.2 million, a $3.7 million timber/log purchase by MGI, and the $2.1 million early log payment by Palco to pay all of the $27.1 million of interest due ($25.4 million net of interest due in respect of Timber Notes held in the SAR Account). The Company also repaid $10.0 million of principal on the Timber Notes ($6.2 million net of principal in respect of Timber Notes held in the SAR Account), an amount equal to Scheduled Amortization, using funds held in the SAR Account.

The Company also expects to incur substantial interest shortfalls over at least the next several years. The failure to pay all of the interest on the Timber Notes when due would constitute an event of default under the Timber Notes Indenture. There can be no assurance that the Company will be able to generate sufficient additional liquidity to fund the expected future cash shortfalls. To the extent that the Company is unable to generate sufficient liquidity from the 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.

Palco Liquidity Update

As of December 31, 2005, and June 30, 2006, Palco and Britt were in default under the Old Palco Term Loan and the Old Palco Revolving Credit Facility due to financial covenant breaches. In the first half of 2006, additional liquidity was needed at Palco and Palco borrowed an aggregate of $20.0 million from MGI to meet its cash shortfalls. Palco's liquidity shortfalls during the first half of 2006 resulted primarily from reduced log supply from the Company and operational inefficiencies related to the large log processing line at Palco's new Scotia sawmill.

On July 18, 2006, Palco and Britt, as Borrowers, closed on the New Palco Term Loan, a new five-year $85.0 million secured term loan, and the New Palco Revolving Credit Facility, a new five-year $60.0 million secured asset-based revolving credit facility. The New Palco Term Loan was fully funded at closing. The New Palco Term Loan and the New Palco Revolving Credit Facility required MGI to provide a $10.0 million subordinated loan to the Borrowers, which was also funded at closing. The Borrowers used approximately (i) $34.0 million of the New Palco Term Loan to pay off the Old Palco Term Loan; (ii) $22.5 million of the New Palco Term Loan to pay off the Old Palco Revolving Credit Facility and cash collateralize previously existing letters of credit; and (iii) $6.0 million to pay transaction costs. The remaining funds at closing of $32.5 million will be used for general corporate purposes. The Borrowers terminated the Old Palco Revolving Credit Facility and the Old Palco Term Loan. The Borrowers have not made any borrowings under the New Palco Revolving Credit Facility to date, although they currently have availability in excess of $20.0 million.

The amount available for borrowings under the New Palco Revolving Credit Facility is normally the sum of 85% of the Borrowers' eligible accounts receivable plus the lesser of (i) 80% of the book value of Borrowers' eligible inventory or (ii) 85% of the net orderly liquidation value of such inventory. However, during each period from October 15 through January 15, the amount available for borrowing under the New Palco Revolving Credit Facility is the sum of 95% of Borrowers' eligible accounts receivable plus the lesser of (i) 90% of the book value of Borrowers' eligible inventory or (ii) 95% of the net orderly liquidation value of such inventory. The amount available under the New Palco Revolving Credit Facility may not exceed $60.0 million, subject to limitations such as the ability of the lender to establish reasonable reserves.

The New Palco Term Loan bears interest at the rate of LIBOR plus 8.75%. Loans under the New Palco Revolving Credit Facility bear interest at the rate of LIBOR plus 2.75% or prime plus 0.75%, at the Borrowers' option; however, incremental borrowings made during the period from October 15 through January 15, bear interest at the rate of LIBOR plus 4.50% or prime plus 2.50%, as applicable. The New Palco Revolving Credit Facility matures on July 18, 2011.

Both the New Palco Term Loan and the New Palco Revolving Credit Facility contain substantially identical restrictive covenants that limit the Borrowers' ability to incur debt, grant liens, make investments, pay dividends, make capital expenditures or merge or consolidate, and require the Borrowers' to maintain a minimum level of EBITDA, along with a minimum fixed charge coverage ratio and maximum leverage ratio throughout the life of the loans. The operating cash flow estimates used to establish the EBITDA maintenance covenant are subject to a number of assumptions about future operating cash flows and actual results could differ materially from these estimates. The New Palco Term Loan also requires the Borrowers to repay a substantial portion of the outstanding principal of the New Palco Term Loan with the net proceeds from the Palco Asset Sale Program, including the real property associated with Palco's former Fortuna and Carlotta sawmills, and Palco-owned homes to be sold after certain milestones have been met. Any remaining principal balance of the New Palco Term Loan is due on July 18, 2011. Accordingly, continued compliance with these new debt facilities is dependent on Palco's ability to meet its EBITDA projections and timely complete required asset sales. The New Palco Term Loan and the New Palco Revolving Credit Facility contain customary events of default and customary remedies with respect to the occurrence of an event of default.

The New Palco Term Loan and New Palco Revolving Credit Facility each include prepayment premiums of 3%, 2% and 1% that will be payable in connection with any prepayment of the New Palco Term Loan or reduction or termination of the New Palco Revolving Credit Facility during the first, second and third years, respectively. Under the New Palco Term Loan and New Palco Revolving Credit Facility, Palco is permitted to invest up to $5.0 million in the Company. No such investment had been made or committed to be made by Palco, and there can be no assurance that Palco would in the future determine or be able to make any such investment in whole or part.

In addition to the material adverse effects being experienced by the Company and Palco due to continuing regulatory, environmental and litigation difficulties, there can be no assurance that certain other pending legal, regulatory and environmental matters or future governmental regulations, additional litigation, legislation, judicial or administrative decisions, adverse weather conditions, or low lumber or log prices, will not also have material adverse effects on the financial condition, results of operations or liquidity of the Company's operations. See Note 5 for further discussion of the regulatory and environmental matters and legal proceedings affecting the Company's operations.

Other Matters

Capital expenditures were $2.2 million for the first half of 2006 and are expected to be between $5.4 million and $6.0 million for the remainder of 2006, subject to available cash.

Off-Balance Sheet Arrangements

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

Trends

Harvest levels at the Company are expected to decline significantly, as compared to historical harvest levels, in 2006 and beyond. Consequently, cash flows from the Company's operations will not be sufficient for at least the next several years to allow the Company to satisfy its debt service obligations in respect of its Timber Notes. In an effort to address expected future cash shortfalls, the Company is seeking to sell certain non-timberlands properties such as ranchlands and recreational areas, as well as certain timberlands. Although certain sales have been completed, there can be no assurance that the marketing efforts in respect of the remaining properties will be successful.

Palco has commenced the Palco Asset Sale Program pursuant to which it is marketing certain assets. The New Palco Term Loan and New Palco Revolving Credit Facility also require the Borrowers to timely complete transactions under the Palco Asset Sale Program. There can be no assurance that Palco's marketing efforts will be successful or that regulatory approvals will be obtained to enable Palco to timely complete required asset sales.

Critical Accounting Policies and Estimates

See Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations—Critical Accounting Policies and Estimates" of the Form 10-K for a discussion of the Company's critical accounting policies. There have been no material changes to the Company's critical accounting policies and estimates provided in the Form 10-K.

New Accounting Pronouncements

See Note 2 for a discussion of new accounting pronouncements and their impact on the Company's financial statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company is exposed to changes in interest rates under the Line of Credit. As of June 30, 2006, there were $42.2 million in borrowings outstanding under all variable rate facilities. Based on the amount of borrowings outstanding under these facilities during the six months ended June 30, 2006, a 1.0% change in interest rates effective from the beginning of the year would have resulted in an increase or decrease in interest expense of $0.2 million.

ITEM 4. CONTROLS AND PROCEDURES

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

As of the end of the period covered by this report, our management carried out an evaluation, under the supervision and with the participation of the Company's management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on the evaluation, our management, including our Chief Executive Officer and Chief Financial Officer, concluded that the Company's disclosure controls and procedures were effective as of June 30, 2006.

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

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The information set forth in Note 5 is incorporated herein by reference.

ITEM 1A. RISK FACTORS

Part I, Item 1A of the Company's Form 10-K contains important risk factors that could cause the Company's actual results to differ materially from those projected in any forward-looking statement. Additional risks and uncertainties not currently known or that are currently deemed immaterial may materially adversely impact our business, financial condition or operating results.

The information presented below updates, and should be read in conjunction with, the risk factor information disclosed in the Form 10 K for the year ended December 31, 2005.

The Company has amended and restated the first item under “Risk Factors: Risks Related to Regulatory Matters” to read as follows:

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.

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 in the past 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 the Company and Palco. The North Coast Water Board has adopted WWDRs for the Freshwater and Elk River watersheds, which action has the effect of allowing harvesting in these two watersheds to begin once THPs are enrolled by the Executive Officer of the North Coast Water Board. There can be no assurance that THPs for these two watersheds will ultimately be enrolled or harvested as planned in 2006 or in future years. If there are delays in the enrollment of these THPs, there could be a further significant adverse impact on current and future harvest levels and the cash flows of both the Company and Palco.

- 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 watershed analysis process provided for in the HCP. These requirements may further reduce the harvesting on the Company Timberlands and cash flows of the Company and 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 Timberlands. 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 Company is 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 harvest levels if that species inhabits the Company Timberlands or if the habitat of the Company Timberlands 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 forest products operations 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.

The Company has removed, amended and/or has added several new items under “Risk Factors-Risks related to Palco’s Liquidity and Capital Resources”, as follows:

The risk, *Palco is currently in default under its debt facilities*, has been removed as a risk due to the closing on the New Palco Term Loan and New Palco Revolving Credit Facility on July 18, 2006. The risk, *Palco may be adversely affected by an inability to obtain additional liquidity*, has been removed as a risk due to the closing on the New Palco Term Loan and New Palco Revolving Credit Facility on July 18, 2006.

The risk, *Palco is highly leveraged and debt covenant restrictions increase the difficulty of operating its business*, has been added and amended as follows:

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

- limiting its ability to borrow additional amounts for working capital, capital expenditures, debt service requirements, execution of its operating strategies or other purposes;
- increasing its vulnerability to general adverse economic and industry conditions;
- limiting its 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 its ability, or increasing the costs, to refinance its indebtedness.

Palco may not be able to timely complete required asset sales.

- Palco may not be able to complete the Palco Asset Sale Program in a timely manner. Regulatory approvals required to complete the program could delay receipt of liquidity.

These risk factors and those set forth in the Form 10-K do not represent a comprehensive list of factors that could cause our results to differ from those that are currently anticipated and should be read together with the risk factors and other information set forth in the Form 10-K and in the Company's other filings with the Securities and Exchange Commission.

ITEM 6. EXHIBITS

a. Exhibits:

10.1	Fourth Amendment to Credit Agreement, dated May 18, 2006, among Registrant, Bank of America, N.A., The Bank of Nova Scotia, Keybank National Association, and U.S. Bank National Association (incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on May 23, 2006)
* 31.1	Section 302 Certification of Chief Executive Officer
* 31.2	Section 302 Certification of Chief Financial Officer
* 32.1	Section 906 Certification of Chief Executive Officer
* 32.2	Section 906 Certification of Chief Financial Officer

* Included with this filing

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized, who has signed this report on behalf of the Registrant and as the principal financial and accounting officer of the Registrant.

SCOTIA PACIFIC COMPANY LLC

Date: August 9, 2006

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

Glossary of Defined Terms

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

Bankruptcy Code: The United States Bankruptcy Code

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

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

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

California Headwaters action: The claim filed by the Company and Palco with the Claims Board against the North Coast Water Board, the State Water Board and the State of California (Claim No. G558159) alleging that the defendants have substantially impaired their contractual and legal rights under the Headwaters Agreement

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

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

CDF: California Department of Forestry and Fire Protection

CDF Harvest Limit: Annual harvest limit established by the CDF

Claims Board: The California Victim Compensation and Government Claims Board

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

Company Timber: The timber located on the Company Timberlands.

Company Timberlands: Approximately 204,000 acres of timberlands owned by the Company and the timberlands subject to the Company Timber Rights

Company Timber Rights: The Company's exclusive right to harvest on approximately 12,200 acres of timberlands owned by Palco and Salmon Creek

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

CWA: Federal Clean Water Act

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

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

Environmental Plans: The HCP and the SYP

EPA: Federal Environmental Protection Agency

EPIC-SYP/Permits lawsuit: An action entitled *Environmental Protection Information Association, Sierra Club v. California Department of Forestry and Fire Protection, California Department of Fish and Game, The Pacific Lumber Company, Scotia Pacific Company LLC, Salmon Creek Corporation, et al.* filed in the Superior Court of Humboldt County, California (No. CV990445)

FASB: Financial Accounting Standards Board

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

Form 10-K: Annual Report on Form 10-K of the Company for the fiscal year ended December 31, 2005

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

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

Headwaters Agreement: The agreement among the Company, Palco, Salmon Creek, the United States and California pursuant to which the Palco Companies transferred to the United States government 5,600 acres of timberlands in exchange for $300 million, approximately 7,700 acres of timberlands, and federal and state government-approved habitat conservation and sustained yield plans

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

Johnson action: An action entitled *Edyth Johnson, et al. v. Charles E. Hurwitz, an individual, MAXXAM Inc., et al.* (No. DR040720) filed in the Superior Court of Humboldt County, California

Land Sale Program: The Company's program pursuant to which it is seeking to sell certain timberland and non-timberland properties

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

Master Purchase Agreement: The agreement between the Company and Palco that governs all purchases of logs by Palco from the Company

MAXXAM: MAXXAM Inc.

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

MGI: MAXXAM Group Inc., a wholly owned subsidiary of MGHI

New Palco Revolving Credit Facility: The new five-year $60.0 million secured asset-based revolving credit facility evidenced by the Revolving Credit Agreement dated as of July 18, 2006, among Palco and Britt, as borrowers, and Marathon Structured Finance Fund L.P., as Administrative Agent

New Palco Term Loan: The new five-year $85.0 million secured term loan evidenced by the Term Loan Agreement dated as of July 18, 2006, among Palco and Britt, as borrowers, and Marathon Structured Finance Fund L.P., as Administrative Agent

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

Old Palco Revolving Credit Facility: Revolving credit facility evidenced by the Revolving Credit Agreement dated as of April 19, 2005 among Palco and Britt, as Borrowers, and Credit Suisse First Boston

Old Palco Term Loan: $35.0 million term loan evidenced by the Term Loan Agreement dated as of April 19, 2005 among Palco and Britt, as Borrowers, and The CIT Group/Business Credit, Inc.

Option A Plan: Plan for complying with California's sustained yield requirements, which has been approved by the CDF and is being used by the Palco Companies

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

Palco Asset Sale Program: Palco's process for marketing certain of its assets

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

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

PSLRA: Private Securities Litigation Reform Act of 1995

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

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

State Board of Equalization: The California State Board of Equalization

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

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

SEC: The Securities and Exchange Commission

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

SFAS: Statement of Financial Accounting Standards

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

SFAS No. 154: SFAS No. 154, "Accounting Changes and Error Correction"

State Water Board: California State Water Resources Control Board

State Water Board Order: Order issued by the State Water Board on June 16, 2005

State Water Board action: An action entitled *The Pacific Lumber Company and Scotia Pacific Company LLC v. State Water Resources Control Board, at al.* (No. CV050516) in Humboldt County Superior Court appealing the State Water Board Order

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

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

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

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

Timber Notes Indenture: The indenture governing the Timber Notes

TMDLs: Total maximum daily load limits

Trustee: The trustee under the Indenture

USWA lawsuit: An action entitled *United Steelworkers of America, AFL-CIO, CLC, and Donald Kegley v. California Department of Forestry and Fire Protection, The Pacific Lumber Company, Scotia Pacific Company LLC and Salmon Creek Corporation* (No. CV990452) filed in the Superior Court of Humboldt County, California

WWDRs: Watershed-wide discharge requirements