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

FORM 10-Q

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

For the quarterly period ended September 30, 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)

	September 30, 2006 (Unaudited)	December 31, 2005
Assets		
Current assets:		
Cash and cash equivalents	$ 1.6	$ 1.3
Marketable securities, including restricted amounts of $8.9 and $23.0, respectively	8.9	24.2
Receivables from Palco	7.6	4.5
Prepaid timber harvesting costs	5.8	6.0
Other current assets	1.8	1.5
Total current assets	25.7	37.5
Timber and timberlands, net of accumulated depletion of $302.4 and $298.1, respectively	212.3	219.5
Property and equipment, net of accumulated depreciation of $24.9 and $22.6, respectively	30.3	29.3
Deferred financing costs	9.5	10.5
Restricted cash, marketable securities and other investments	4.3	2.5
Intangible assets	2.2	2.9
	$ 284.3	$ 302.2
Liabilities and Member Deficit		
Current liabilities:		
Payables to Palco	$ 1.5	$ 1.1
Accrued interest	11.4	23.8
Deferred revenue	4.0	–
Other accrued liabilities	2.4	2.4
Short-term borrowings and current maturities of long-term debt, excluding $7.3 and $11.1, respectively, of repurchased Timber Notes held in the SAR Account	74.3	49.4
Total current liabilities	93.6	76.7
Long-term debt, less current maturities and excluding $37.0 and $44.3, respectively, of repurchased Timber Notes held in the SAR Account	643.1	669.6
Other noncurrent liabilities	0.2	0.4
Total liabilities	736.9	746.7
Contingencies (See Note 5)		
Member deficit	(452.6)	(444.5)
	$ 284.3	$ 302.2

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

SCOTIA PACIFIC COMPANY LLC

STATEMENTS OF INCOME (LOSS)
(In millions of dollars)

	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
	(Unaudited)			
Log sales to Palco	$ 23.6	$ 25.7	$ 46.6	$ 59.2
Operating expenses:				
General and administrative	5.8	8.2	15.2	22.3
Depletion, depreciation and amortization	3.2	3.3	7.3	8.8
Gain on sale of timberlands	(4.1)	–	(9.1)	–
	4.9	11.5	13.4	31.1
Operating income	18.7	14.2	33.2	28.1
Other income (expense):				
Interest and other income	0.2	1.1	0.6	2.3
Interest expense	(14.0)	(14.1)	(41.9)	(41.6)
	(13.8)	(13.0)	(41.3)	(39.3)
Net income (loss)	$ 4.9	$ 1.2	$ (8.1)	$ (11.2)

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

SCOTIA PACIFIC COMPANY LLC

STATEMENTS OF CASH FLOWS
(In millions of dollars)

	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
	(Unaudited)	
Cash flows from operating activities:		
Net loss	$ (8.1)	$ (11.2)
Adjustments to reconcile net loss to net cash used for operating activities:		
Depletion, depreciation and amortization	7.3	8.8
Gain on sale of timberlands	(9.1)	–
Amortization of deferred financing costs	1.0	1.0
Increase (decrease) in cash resulting from changes in:		
Receivables from Palco	(3.1)	(7.3)
Prepaid timber harvesting costs	0.2	(0.2)
Payables to Palco	0.4	0.4
Accrued interest	(12.4)	(12.8)
Deferred revenue	4.0	–
Other accrued liabilities	–	0.6
Other	(0.3)	(0.6)
Net cash used for operating activities	(20.1)	(21.3)
Cash flows from investing activities:		
Sales and maturities of marketable securities	122.9	108.7
Purchases of marketable securities	(121.7)	(107.6)
Net proceeds from sale of assets	13.1	–
Net proceeds from restricted cash	12.2	9.1
Capital expenditures	(4.4)	(4.8)
Net cash provided by investing activities	22.1	5.4
Cash flows from financing activities:		
Principal payments on Timber Notes and other timber related debt	(18.2)	(15.6)
Borrowings under line of credit agreement, net	16.5	31.4
Net cash provided by (used for) financing activities	(1.7)	15.8
Net increase in cash and cash equivalents	0.3	(0.1)
Cash and cash equivalents at beginning of period	1.3	0.5
Cash and cash equivalents at end of period	$ 1.6	$ 0.4
Supplemental disclosure of cash flow information:		
Interest paid, net of interest paid in respect of the Timber Notes held in the SAR Account	$ 53.3	$ 53.4

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 September 30, 2006, the results of operations for the three months and nine months ended September 30, 2006 and 2005, and the cash flows for the nine months ended September 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

Future Harvest Levels

The Company has conducted extensive reviews and analyses of its assets, operations and future prospects. As a result of these extensive reviews and analyses, the Company has concluded that, in the absence of significant regulatory relief and accommodations, its future annual timber harvest levels and cash flows from operations for at least the next several years will be substantially below both historical harvest levels and the minimum levels necessary in order to allow it to satisfy its debt service obligations in respect of the Timber Notes. The Company has previously disclosed that its estimated average annual harvest levels over the ten-year period beginning in 2006 is estimated to be approximately 100 million board feet per year. This harvest level reflects the Company's estimate of the cumulative impact of ongoing regulatory limitations, watershed prescriptions, the requirements of the HCP and other matters and is based on a number of assumptions that may or may not prove to be accurate. Actual harvest levels may even be lower, depending on the outcome of various assumptions.

Regulatory Matters

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. 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 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.

On May 8, 2006, the North Coast Water Board adopted the Freshwater and Elk River WWDRs. The decision allows harvesting in these two watersheds, up to approximately 50% of the applicable CDF Harvest Limit, once the staff of the North Coast Water Board reviews and enrolls THPs submitted by the Company. The North Coast Water Board's decision also allowed the enrollment of additional THPs, bringing the total to approximately 75% of the CDF Harvest Limit for these two watersheds, upon approval of a monitoring and reporting program by the Executive Officer of the North Coast Water Board staff. The monitoring and reporting program was approved on September 29, 2006, allowing enrollment by the staff of the North Coast Water Board of the additional THPs for these two watersheds planned for harvest in 2006. This monitoring and reporting program will also govern future THPs in these two watersheds. However, there can be no assurance that additional THPs in these two watersheds will ultimately be enrolled or harvested as planned in 2006 or future years. 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. 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.

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 interest payment shortfalls, the Company initiated the Land Sale Program to sell certain timberland properties, as well as various non-timberland properties, such as ranchlands and recreational areas. The Company expects that all of the net proceeds from sales under the Land Sale Program will be available to pay interest on the Timber Notes, in accordance with the Timber Notes Indenture. During the first nine months of 2006, the Company sold properties available under the program for $13.1 million. The aggregate estimated market value of the remaining properties included in the Land Sale Program should cover the Company's expected future interest payment shortfalls, and the sale of enough of these properties to cover the expected future interest payment shortfalls should not materially reduce estimated average annual harvest levels over the next decade. There can be no assurance that the marketing efforts for the Land Sale Program properties will be successful or that the resulting proceeds, if any, will be sufficient to cover the Company's expected future interest payment shortfalls. The properties included in the Land Sale Program may change from time to time.

In an effort to address the Company's 2006 operating cash shortfalls, the Company and MGI consummated three timber/log purchases that provided the Company an aggregate of $8.1 million of additional liquidity 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. In July 2006, the Company also requested that Palco make an early payment of $2.1 million, in respect of certain logs that had already been delivered to and purchased by Palco from the Company. Palco approved and delivered the early log payment, which was used to pay the Company's expenses, including a portion of the interest due in respect of the July 2006 Timber Notes payment date.

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, $10.2 million of funds from the Land Sale Program, 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.

As noted above, the Company also expects to continue to incur substantial interest payment shortfalls over at least the next several years. The failure of the Company 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 Scotia sawmill.

On July 18, 2006, Palco and Britt, as Borrowers, closed on the New Palco Term Loan, a five-year $85.0 million secured term loan, and the New Palco Revolving Credit Facility, a five-year $60.0 million secured asset-based revolving credit facility, and terminated the Old Palco Revolving Credit Facility and the Old Palco Term Loan. 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 $32.5 million of loan proceeds were used for general corporate purposes. As of September 30, 2006, $84.6 million was outstanding under the New Palco Term Loan, $10.8 million was outstanding under the New Palco Revolving Credit Facility, and the maximum remaining availability under the New Palco Revolving Credit Facility was $36.5 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.

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 specified minimum levels of EBITDA throughout the life of the facilities and specified minimum fixed charge coverage ratios and maximum leverage ratios commencing December 31, 2007. 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 various required asset sales, 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 the maturity date. 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. There can be no assurance that Palco will be able to meet these financial covenants in future periods. 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 and are each secured by a security interest in the stock of Palco held by MGI, and substantially all of the assets of the Borrowers (other than Palco's equity interest in the Company).

The Borrowers did not meet the required minimum EBITDA maintenance covenant for the three month period ended September 30, 2006, due to an unplanned severance charge and a legal settlement. The Borrowers expect the lenders to issue a limited waiver of the default through December 14, 2006. Until such time as the default is resolved, amounts outstanding under the New Palco Term Loan and the New Palco Revolving Credit Facility have been classified as a current liability in MAXXAM's consolidated financial statements. Additionally, the Borrowers have notified the lenders that changing market conditions and other factors will likely impact the Borrowers' ability to comply with the financial covenants in future periods. The Borrowers are evaluating various cost-cutting initiatives to improve profitability, but there can be no assurance that these efforts will generate sufficient liquidity to enable the Borrowers to comply with the financial covenants in future periods . The Borrowers are pursuing discussions with the lenders in an effort to amend the New Palco Term Loan and the New Palco Revolving Credit Agreements to reflect these changing market conditions and other factors; however, there can be no assurance that the Borrowers will be successful in their efforts. In the event that the Borrowers are unable to improve profitability or amend the two facilities as needed, they may be forced to take extraordinary actions.

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 facilities' 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 has 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.

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 and classification 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.

Fair Value Measurements

In September 2006, the FASB issued SFAS No. 157, which is intended to increase consistency and comparability in fair value measurements by defining fair value, establishing a framework for measuring fair value and expanding disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company will adopt SFAS 157 on January 1, 2008, and has not yet determined the impact, if any, on its 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):

	September 30, 2006	December 31, 2005
Amounts held in the SAR Account:		
Current portion of restricted marketable securities and other investments	$ 8.9	$ 23.0
Long-term portion of restricted marketable securities and other investments [(1)]	41.3	52.9
Less: Amounts attributable to Timber Notes held in SAR Account [(1)]	(41.3)	(52.9)
Total amounts held in the SAR Account	8.9	23.0
Other amounts restricted under the Timber Notes Indenture	4.3	2.5
Total restricted cash, cash equivalents, marketable securities and other investments	$ 13.2	$ 25.5

(1) This amount represents the aggregate amount price paid by the Company for the Class A-1 and Class A-2 Timber Notes held in the SAR Account. The Class A-2 Timber Notes held in the SAR Account were sold in October 2006, and the net proceeds from the sale of approximately $30.2 million were deposited in the SAR Account.

Amounts in the SAR Account, including the Timber Notes held in the SAR Account, are being held by the Trustee to support principal payments on the Timber Notes. See Note 4 for further discussion of the SAR Account.

4. Debt

Principal amounts of outstanding debt consist of the following (in millions):

	September 30, 2006	December 31, 2005
Line of Credit, due as described below	$ 47.8	$ 31.3
6.55% Class A-1 Timber Notes due July 20, 2028	7.3	36.6
7.11% Class A-2 Timber Notes due July 20, 2028	243.2	243.2
7.71% Class A-3 Timber Notes due July 20, 2028	463.3	463.3
Total Principal Outstanding	761.6	774.4
Less: Current Maturities	(81.6)	(60.5)
Class A-1 Timber Notes held in the SAR Account, at par value[(1)]	(2.8)	(13.9)
Class A-2 Timber Notes held in the SAR Account, at par value[(1) (2)]	(41.5)	(41.5)
	$ 635.7	$ 658.5

(1) The Timber Notes Indenture provides that a Timber Note does not cease to be outstanding because the Company holds the instrument. Consequently, the Company is required to pay and has paid interest and principal on the Timber Notes held in the SAR Account.

(2) The Class A-2 Timber Notes held in the SAR Account were sold in October 2006.

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 September 30, 2006, the maximum availability under the Line of Credit was $53.5 million, and outstanding borrowings were $47.8 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, $10.2 million of funds from the Land Sale Program, 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 payment 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 Timber Notes 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 Timber Notes 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 Timber Notes Indenture, which appointment became effective May 1, 2006. Deutsche Bank National Trust Company resigned effective August 25, 2006 and the Company appointed Bank of New York as successor Trustee, which appointment became effective August 25, 2006.

SAR Account

Amounts on deposit in the SAR Account are used on each Timber Notes payment date to make principal payments on the Timber Notes in accordance with Scheduled Amortization. However, if the amount on deposit in the SAR Account on a Timber Notes payment date is less than what is needed to reduce outstanding principal in accordance with Scheduled Amortization, only the amount on deposit in the SAR Account is required to be paid as a principal payment on the Timber Notes.

At September 30, 2006, the SAR Account balance was $50.2 million (consisting of $41.3 million of Timber Notes held in the SAR Account and $8.9 million in marketable securities). On October 11, 2006, the Company completed a private placement of the $41.5 million par value of Class A-2 Timber Notes held in the SAR Account at a sales price of $750 per $1,000 principal amount, plus accrued interest from July 20, 2006. The net proceeds of approximately $30.2 million were deposited into the SAR Account. The Company expects that cash and marketable securities on deposit in the SAR Account will not be sufficient to cover all of the Scheduled Amortization on the January 20, 2008, Timber Notes payment date and beyond.

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"), in October 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 imposing 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 has 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. Those requirements 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 have significantly increased operating costs; future additional requirements 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 cleanup 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 that could extend over a number of years. Additional orders for other watersheds (should they be issued) may also result in further cost increases.

On May 8, 2006, the North Coast Water Board adopted the Freshwater and Elk River WWDRs. The decision allows harvesting in these two watersheds, up to approximately 50% of the applicable CDF Harvest Limit, once the staff of the North Coast Water Board reviews and enrolls THPs submitted by the Company. The North Coast Water Board's decision also allowed the enrollment of additional THPs, bringing the total to approximately 75% of the CDF Harvest Limit for these two watersheds, upon approval of a monitoring and reporting program by the Executive Officer of the North Coast Water Board staff. The monitoring and reporting program was approved on September 29, 2006, allowing enrollment by the staff of the North Coast Water Board of the additional THPs for these two watersheds planned for harvest in 2006. This monitoring and reporting program will also govern future THPs in these two watersheds. However, there can be no assurance that additional THPs in these two watersheds will ultimately be enrolled or harvested as planned in 2006 or future years. 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. 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.

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 that 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, 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.

On April 28, 2006, the Court denied separate motions for summary judgment that had been filed by the Palco Companies and the plaintiff. On June 30, 2006, the plaintiff filed a motion for partial summary judgment seeking to establish the Palco Companies' liability and the Palco Companies filed a new motion for summary judgment asserting that the plaintiff lacks standing to maintain the lawsuit. A hearing on these motions was held on October 3, 2006, and the Court took the matter under submission.

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 timber companies' historical reliance upon 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* and *Cave actions* 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* with the Claims Board. 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 Income (Loss) and Member Deficit

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

	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Net income (loss)	$ 4.9	$ 1.2	$ (8.1)	$ (11.2)
Other comprehensive income:				
Net change in fair value of available-for-sale investments	–	–	–	0.2
Total comprehensive income (loss)	$ 4.9	$ 1.2	$ (8.1)	$ (11.0)

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

	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Balance at beginning of period	$ (444.5)	$ (431.6)
Comprehensive loss	(8.1)	(11.0)
Balance at end of period	$ (452.6)	$ (442.6)

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 Report. 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. 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.

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.

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," and Item 3. "Legal Proceedings" of the Form 10-K and Item 1A. "Risk Factors"in this Form 10-Q and Note 5 (under "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 September 30, 2006			Three Months Ended September 30, 2005		
	MBFE	Price $/MBFE	Revenues	MBFE	Price $/MBFE	Revenues
Redwood	20,400	$ 1,004	$ 20.5	21,900	$ 952	$ 20.8
Douglas fir	4,500	616	2.8	7,200	640	4.7
Other	900	391	0.3	600	404	0.2
	25,800	916	$ 23.6	29,700	865	$ 25.7

	Nine Months Ended September 30, 2006			Nine Months Ended September 30, 2005		
	MBFE	Price $/MBFE	Revenues	MBFE	Price $/MBFE	Revenues
Redwood	41,800	$ 993	$ 41.5	55,000	$ 892	$ 49.0
Douglas fir	7,600	614	4.7	16,200	605	9.9
Other	1,300	381	0.4	1,700	189	0.3
	50,700	921	$ 46.6	72,900	812	$ 59.2

For the three months ended September 30, 2006, the Company experienced an overall 8.2% decrease in revenues and a 13.1% decrease in sales volume compared to the three months ended September 30, 2005. The decrease in revenue is attributable to the decline in harvest levels, partially offset by a 5.9% increase in the average realized price of logs.

For the nine months ended September 30, 2006, the Company experienced an overall 21.3% decrease in revenues and a 30.5% decrease in sales volume compared to the nine months ended September 30, 2005. The decrease in revenue is attributable to the decline in harvest levels, partially offset by a 13.4% increase in the average realized price of logs.

Operating Income and Net Loss

The Company generated operating income of $18.7 million and $33.2 million for the third quarter of 2006 and the nine months ended September 30, 2006, respectively. These results include a gain of $4.1 million and $9.1 million, respectively, from the sale of certain properties. The Company's operating results for the first nine months 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 equity income of approximately $1.0 million in the third quarter of 2005 and $2.1 million for the nine months ended September 30, 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.

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 in this Form 10-Q 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 Timber Notes Indenture, the purchase price is deemed to be at fair market value. If the purchase price equals or exceeds the SBE Price, but is less than the structuring price, then the Company is required to engage an independent forestry consultant to confirm that the purchase price reflects fair market value. In 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 9.7% 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 first half of 2005. In June 2006, the State Board of Equalization issued the Harvest Value Schedule for the second half of 2006. The prices published in that schedule reflected a 4.0% 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.

Future Harvest Levels

The Company has conducted extensive reviews and analyses of its assets, operations and future prospects. As a result of these extensive reviews and analyses, the Company has concluded that, in the absence of significant regulatory relief and accommodations, its future annual timber harvest levels and cash flows from operations for at least the next several years will be substantially below both historical harvest levels and the minimum levels necessary in order to allow it to satisfy its debt service obligations in respect of the Timber Notes. The Company has previously disclosed that its estimated average annual harvest levels over the ten-year period beginning in 2006 is estimated to be approximately 100 million board feet per year. This harvest level reflects the Company's estimate of the cumulative impact of ongoing regulatory limitations, watershed prescriptions, the requirements of the HCP and other matters and is based on a number of assumptions that may or may not prove to be accurate. Actual harvest levels may even be lower, depending on the outcome of various assumptions.

Regulatory Matters

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. 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 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.

On May 8, 2006, the North Coast Water Board adopted the Freshwater and Elk River WWDRs. The decision allows harvesting in these two watersheds, up to approximately 50% of the applicable CDF Harvest Limit, once the staff of the North Coast Water Board reviews and enrolls THPs submitted by the Company. The North Coast Water Board's decision also allowed the enrollment of additional THPs, bringing the total to approximately 75% of the CDF Harvest Limit for these two watersheds, upon approval of a monitoring and reporting program by the Executive Officer of the North Coast Water Board staff. The monitoring and reporting program was approved on September 29, 2006, allowing enrollment by the staff of the North Coast Water Board of the additional THPs for these two watersheds planned for harvest in 2006. This monitoring and reporting program will also govern future THPs in these two watersheds. However, there can be no assurance that additional THPs in these two watersheds will ultimately be enrolled or harvested as planned in 2006 or future years. 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. 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.

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 interest payment shortfalls, the Company initiated the Land Sale Program to sell certain timberland properties, as well as various non-timberland properties, such as ranchlands and recreational areas. The Company expects that all of the net proceeds from sales under the Land Sale Program will be available to pay interest on the Timber Notes, in accordance with the Timber Notes Indenture. During the first nine months of 2006, the Company sold properties available under the program for $13.1 million. The aggregate estimated market value of the remaining properties included in the Land Sale Program should cover the Company's expected future interest payment shortfalls, and the sale of enough of these properties to cover the expected future interest payment shortfalls should not materially reduce estimated average annual harvest levels over the next decade. There can be no assurance that the marketing efforts for the Land Sale Program properties will be successful or that the resulting proceeds, if any, will be sufficient to cover the Company's expected future interest payment shortfalls. The properties included in the Land Sale Program may change from time to time.

In an effort to address the Company's 2006 operating cash shortfalls, the Company and MGI consummated three timber/log purchases that provided the Company an aggregate of $8.1 million of additional liquidity 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. In July 2006, the Company also requested that Palco make an early payment of $2.1 million, in respect of certain logs that had already been delivered to and purchased by Palco from the Company. Palco approved and delivered the early log payment, which was used to pay the Company's expenses, including a portion of the interest due in respect of the July 2006 Timber Notes payment date.

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, $10.2 million of funds from the Land Sale Program, 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.

As noted above, the Company also expects to continue to incur substantial interest payment shortfalls over at least the next several years. The failure of the Company 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 Scotia sawmill.

On July 18, 2006, Palco and Britt, as Borrowers, closed on the New Palco Term Loan, a five-year $85.0 million secured term loan, and the New Palco Revolving Credit Facility, a five-year $60.0 million secured asset-based revolving credit facility, and terminated the Old Palco Revolving Credit Facility and the Old Palco Term Loan. 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 $32.5 million of loan proceeds were used for general corporate purposes. As of September 30, 2006, $84.6 million was outstanding under the New Palco Term Loan, $10.8 million was outstanding under the New Palco Revolving Credit Facility, and the maximum remaining availability under the New Palco Revolving Credit Facility was $36.5 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.

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 specified minimum levels of EBITDA throughout the life of the facilities and specified minimum fixed charge coverage ratios and maximum leverage ratios commencing December 31, 2007. 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 various required asset sales, 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 the maturity date. 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. There can be no assurance that Palco will be able to meet these financial covenants in future periods. 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 and are each secured by a security interest in the stock of Palco held by MGI, and substantially all of the assets of the Borrowers (other than Palco's equity interest in the Company).

The Borrowers did not meet the required minimum EBITDA maintenance covenant for the three month period ended September 30, 2006, due to an unplanned severance charge and a legal settlement. The Borrowers expect the lenders to issue a limited waiver of the default through December 14, 2006. Until such time as the default is resolved, amounts outstanding under the New Palco Term Loan and the New Palco Revolving Credit Facility have been classified as a current liability in MAXXAM's consolidated financial statements. Additionally, the Borrowers have notified the lenders that changing market conditions and other factors will likely impact the Borrowers' ability to comply with the financial covenants in future periods. The Borrowers are evaluating various cost-cutting initiatives to improve profitability, but there can be no assurance that these efforts will generate sufficient liquidity to enable the Borrowers to comply with the financial covenants in future periods . The Borrowers are pursuing discussions with the lenders in an effort to amend the New Palco Term Loan and the New Palco Revolving Credit Agreements to reflect these changing market conditions and other factors; however, there can be no assurance that the Borrowers will be successful in their efforts. In the event that the Borrowers are unable to improve profitability or amend the two facilities as needed, they may be forced to take extraordinary actions.

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 facilities' 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 has 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 $4.4 million for the first nine months of 2006 and are expected to be between $3.5 million and $4.0 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 timberland properties, as well as various non-timberland properties, such as ranchlands and recreational areas. 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 require the Borrowers to complete transactions under the Palco Asset Sale Program in accordance with certain established deadlines. There can be no assurance that these marketing efforts will be successful or that regulatory approvals will be obtained to enable Palco to timely complete required asset sales.

There has been a substantial decline in the market prices of Douglas-fir logs and lumber and Palco's and Britt's future operating results will be negatively impacted by this development.

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 September 30, 2006, there were $47.8 million in borrowings outstanding under all variable rate facilities. Based on the amount of borrowings outstanding under these facilities as of September 30, 2006, a 2.0% change in interest rates effective from the beginning of the year would have resulted in an increase or decrease in interest expense for the period of $0.5 million.

ITEM 4. CONTROLS AND PROCEDURES

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

As of the end of the period covered by this report, our management carried out an evaluation, under the supervision and with the participation of the Company's management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on the evaluation, our management, including our Chief Executive Officer and Chief Financial Officer, concluded that the Company's disclosure controls and procedures were effective as of September 30, 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 adopted WWDRs for the Freshwater and Elk River watersheds. This decision allows harvesting in these two watersheds once THPs are reviewed and enrolled by the staff of the North Coast Water Board. In addition, the Executive Officer of the North Coast Water Board has approved a monitoring and reporting program, which has the effect of allowing enrollment by the staff of the North Coast Water Board of additional THPs for these two watersheds. 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 total maximum discharge limits 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 Orders, which are aimed at addressing existing sediment production sites through cleanup actions in the Elk River watershed, and has initiated the process which could result in similar orders for other watersheds. The Elk River Orders have 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, which provides regional water quality control boards with additional authority related to the approval of THPs on land within impaired watersheds. Implementation of this law could, however, result in delays in obtaining approvals of THPs, lower harvest levels, 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. Moreover, ballot initiatives relating to the Company's operations are commenced from time to time.

The Company has removed, amended and/or has added several new items under "Risk Factors-Risks related to Our Liquidity and Capital Resources", as follows:

The Company's annual cash flows from operations are expected to be substantially below the minimum levels necessary to satisfy its debt service obligations over at least the next several years.

The Company expects that its cash flows from operations, together with funds available under the Line of Credit, will be insufficient, by a substantial amount, to pay the interest on the Timber Notes in 2007. The Company also expect to incur principal and interest shortfalls for at least the next several years. Failure to pay interest on the Timber Notes when due would constitute an event of default under the Timber Notes Indenture. We do not expect that the amounts on deposit in the SAR Account as of the January 20, 2008, Timber Notes payment date will be sufficient to pay the Timber Notes in accordance with Scheduled Amortization.

Amounts on deposit in the SAR Account will not be sufficient to pay the Timber Notes in accordance with Scheduled Amortization in 2008 and beyond.

Amounts on deposit in the SAR Account are used on each Timber Notes payment date, as needed, to make principal payments on the Timber Notes in accordance with Scheduled Amortization. If the amount on deposit in the SAR Account on a Timber Notes payment date is less than what is needed to reduce outstanding principal in accordance with Scheduled Amortization, only the amount on deposit in the SAR Account is required to be paid as a principal payment on the Timber Notes.

The risk, *Palco is highly leveraged and is currently in default under its debt facilities*, has been amended as follows:

As noted elsewhere in this Form 10-Q, Palco and Britt expect the lenders to issue a limited waiver through December 14, 2006, of a default under their term and revolving credit facilities. Unless the default is permanently waived or the facilities are amended, or MGI exercises the right that it has under the two facilities to cure the default, the lenders would be entitled, upon expiration of the 30-day waiver period, to exercise a variety of rights and remedies, such as reducing the amount of funds available for borrowing under the New Palco Revolving Credit Facility, declaring any or all loans and other amounts owed under the New Palco Term Loan and the New Palco Revolving Credit Facility to be immediately due and payable, and exercising all rights to collateral.

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

The risk, *Palco may not be able to timely complete required asset sales has been added,* as follows:

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 or delay certain asset sales beyond the deadlines established under Palco's new credit facilities.

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:

* 31.1 Section 302 Certification of Chief Executive Officer

* 31.2 Section 302 Certification of Chief Financial Officer

* 32.1 Section 906 Certification of Chief Executive Officer

* 32.2 Section 906 Certification of Chief Financial Officer

* Included with this filing

SIGNATURE

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

SCOTIA PACIFIC COMPANY LLC

Date: November 14, 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 that 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 200,000 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 Orders: Clean up and abatement orders 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

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

MGI: MAXXAM Group Inc., an indirect 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 amended

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 amended

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: Reserve account titled the Scheduled Amortization Reserve Account that holds funds 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"

SFAS No. 157: SFAS No. 157, "Fair Value Measurements"

State Water Board: California State Water Resources Control Board

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

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 Timber Notes 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