

The Pacific Lumber Company

Economic White Paper

By:

Robert E. Manne, President and CEO

Gary L. Clark, Vice President of Finance

PALCO
125 Main Street
Scotia, CA 95565

March 2005

Executive summary

PALCO's ability to harvest trees at our approved sustainable level is necessary for the financial survival of the company and the economic well being of Humboldt County.

If we cannot reach a satisfactory resolution to the release of THPs previously approved by CDF and the other HCP regulatory agencies, we anticipate that PALCO will be forced to take extraordinary actions, which may include: reducing expenditures by laying-off employees and shutting down various operations; seeking other sources of liquidity, such as from asset sales; and seeking bankruptcy.

This white paper is written to provide background information and the financial realities at PALCO. We have structured this report to clear up the often heard misleading and false rhetoric about PALCO, the management of our business and our financial history. Over the years a great many myths have grown up around PALCO. This paper is meant to shed some light on the reality of what the men and women of PALCO are all about.

From the acquisition of PALCO in 1986 by MAXXAM, to the Headwaters Agreement of 1996, to the refinancing of 1998, to the signing of our HCP in 1999, to the complete review of our proforma income statement from 1986 to 2004, and the current financial distress of PALCO, we have provided a detailed background to put all of this in perspective.

The majority of the information in this report is available in public records through our standard quarterly and annual SEC filings. In some instances, we have simplified the manner of presentation to make it more understandable.

I. PALCO's has a very positive "economic impact" in the county

Facts:

PALCO started in Humboldt County in 1863 and has a very strong legacy throughout the county and remains one of the largest producers of redwood products in the state of California. We hold the oldest Workers Compensation certificate and the oldest active brand in the state.

PALCO has been a major economic contributor to Humboldt County for many years. We employ approximately 875 employees and provide jobs for over 300 contractors and consultants with a huge downstream economic impact in this county with:

- \$40 million annual payroll (family wage jobs);
- \$22 million in the best benefit package in the county;
- Provides employees with both a pension plan and a 401K matched savings plan;
- \$54 million annually for locally purchased goods and services;
- \$27 million spent with local contractors;
- Providing a subsidized Scotia Day Care Center;
- 275 employee houses provided with reasonable rents;
- PALCO's 32MW bio-mass power plant consumes 700,000 tons/year of green waste (including some from the Bay Area) and provides 22MW of much needed power to PG&E.
- PALCO has even initiated a Small Landowner Assistance Program to help our neighboring ranchers, dairymen, and farmers to get THPs approved by sharing science.
- Every year we donate thousands of dollars to local non-profits and charitable organizations including:
 - Leasing our K-8 School (currently educating nearly 285 students) to the state and local school district for \$1/ year;
 - We provide college scholarships for children of PALCO employees;
 - Financial support for Boy and Girl Scouts;
 - And many other charitable causes throughout the county.

Conclusion: PALCO has been around for over 142 years and plans to stay for another seven generations. If PALCO is put into bankruptcy, Humboldt County will suffer severe economic harm.

II. MAXXAM's acquisition of PALCO in 1986

Facts:

In 1985, PALCO was a public company with its stock trading on the New York Stock Exchange. The majority of the shares were widely held by different mutual funds and other financial investors; and the Murphy family and long time managers held only a small fraction of the shares of stock.

PALCO stock was trading in for \$24-26 per share when MAXXAM offered \$40 per share. PALCO's independent and inside Directors recommended that all shareholders accept the MAXXAM \$40 offer. Over 92% of the voting stock voted to accept that offer.

The acquisition was financed by a combination of public debt, bank credit agreements, and funds made available by the acquired company.

After the acquisition, PALCO refocused itself back to its core forest products business and sold off its non-timber producing revenue sources including its cutting and welding business, moved its corporate headquarter back to Scotia from San Francisco, and sold Central Valley farmland that had been acquired for hunting purposes.

The claim is made that MAXXAM "looted" PALCO's pension plan. That is not true. It is true that the PALCO pension plan was "over funded" by actuarial definitions-not all of the money set aside would be needed to pay for benefits. Annuities were purchased for the benefit of plan participants.

All PALCO retirees have received all their pension payments. It is not true that retirees were denied their pension payments and that PALCO did not honor their pension obligations to retirees. There has never been a PALCO retiree that was:

- Denied a pension payment;
- Did not receive a pension payment due them;
- There has never been any reduction in what was due any retiree.

A lot of rhetoric has been created recently about the Pacific Meridian Report and its purpose and use by PALCO. It seems to be used as a political strategy of distraction. The original report was commissioned in 1986 to accomplish several purposes:

- 1) Update the timberlands inventory which had not been done since the mid 1950s;
- 2) Recalculate the growth rates for the entire forest;
- 3) Provide a new analysis and calculation for the Company's long-term sustained yield based on the new growth rates, inventory, and new purchases;
- 4) Install new technology (arc-info) computers to utilize the information in 1-3 above for future land use and forest management planning;

We have never used this report or any of its alternatives for any other purpose in the management of this Company. PALCO is, however, being managed on more pertinent and timely studies and science including:

- Our Habitat Conservation Plan signed in 1999;
- Our Sustained Yield Plan signed in 1999;
- \$65 million of new science developed over the past six years;
- A new \$1.5 million inventory cruise update completed in 2002;
- Five new comprehensive scientific watershed analysis studies conducted over the last six years;
- A new Option A long-term sustained yield analysis completed in 2005.

Finally, since 1986, PALCO has invested over \$325 million to improve its business in projects focused on forest products and timberland science and forest resources including: \$52 million for a state of the art cogeneration facility; various extensive sawmill upgrades at Britt, Carlotta and Fortuna, and nearly \$30 million for a new Scotia lumber mill and planer.

It has now been 19 years since our new owners acquired PALCO and they are still making significant investments in our future.

Conclusion: PALCO was not a family owned company at the time of the MAXXAM purchase; the new owners have made significant investments in the company since 1986; PALCO retirees have received all their pension payments; MAXXAM has not cut and run.

III. The Headwaters Agreement was unprecedented in this country-Who got what?

Facts:

The “Headwaters Agreement” was a series of agreements and permissions originating back to September 28, 1996, between the United States, the state of California, and The Pacific Lumber Company (PALCO). The agreement included the transfer of the Headwaters and Elkhead Forests to the United States and California for less than appraised value. In exchange, PALCO received a small piece of property and \$300 million, Elk River Timber Company (Sierra Pacific Industries) received \$80 million, the Humboldt County Headwaters Fund received approximately \$22 million. The state of California got an option to purchase two additional PALCO forests in Owl Creek and Grizzly Creek with an estimated value of \$100 million.

PALCO further received federal and state approved:

- Incidental Take Permit for the multi-species Habitat Conservation Plan (HCP);
- State approved Sustained Yield Plan (SYP);
- A federal and state approved “no surprises” guarantee.

The entire transaction closed on March 1, 1999, with full support of the Clinton and Wilson Administrations. PALCO was hesitant to enter into the final Headwaters Transaction because there were no adequate assurances that the Company could harvest timber volumes sufficient to maintain its economic viability. Both the state and federal negotiators gave PALCO economic viability assurances so that the transaction could be closed.

The entire set of agreements was designed to make PALCO the environmental model for the forest products industry in California. PALCO saw the agreement as a means to provide predictability and certainty for timely approval of timber harvest plans, a reliable log supply, and comfort that future investment would be warranted.

But this was just the latest in a long series of PALCO preservation efforts. Since the 1920s, PALCO has donated or sold more than 28,000 acres of old growth forest to the public.

PALCO sold its property for less than its appraised value to achieve peace with its environmental critics. To do so, it agreed to operate all of its lands under the requirements of a Habitat Conservation Plan (“HCP”), which imposes significantly more restrictions on its operations than any other timber company in the state of California.

Monies from the Headwaters Agreement were distributed as follows:

In March of 1999:

- Sierra Pacific Industries received \$80 million;
- PALCO received \$300 million;

- \$169 million went to the SAR (Scheduled Amortization Reserve) account at SCOPAC to provide cash to make the amortization payments on the debt in January and July of each Year. SCOPAC can draw from the SAR if SCOPAC generates insufficient cash from operations to meet scheduled amortization payments.
- \$101 million was used by PALCO to fund capital spending and operating losses.
- \$15 million was used to pay third-party fees and expenses for the agreement.
- \$15 million remained at Salmon Creek for reinvestment.

In 2000-2003:

- PALCO received \$106 million from the sale of Owl Creek and Grizzly to the state of California.
 - \$98 million used by PALCO to fund capital spending and operating losses;
 - \$8 million used by SCOPAC to pay interest on its debt.

Conclusion: The Headwaters Agreement was good the environment, the public at large, the state and federal governments and PALCO. The monies for the Headwaters Agreement stayed within PALCO to fund capital investments and cover operating losses; none of the money went to enrich MAXXXAM.

IV. PALCO's HCP has been great for the environment and tough on PALCO

Facts:

The HCP is a comprehensive scientific and administrative document, designed to provide a framework under which PALCO conducts its forest management and timber harvesting activities. It includes the most stringent environmental restrictions in the state. They are far more restrictive than the standard forest practice rules used by every other timber company in the state.

The HCP requires that PALCO set aside almost 7,000 acres of old growth forests for fifty years. Other areas are off-limits to harvesting as well, places where spotted owls and marbled Murrelets nest, areas prone to landslides, and buffer zones along rivers and streams of up to 170 feet on both sides. As a result of these measures, in the interim, PALCO agreed that 50% of its timberlands and 60% of its volume would be off-limits to harvesting until more detailed science was completed.

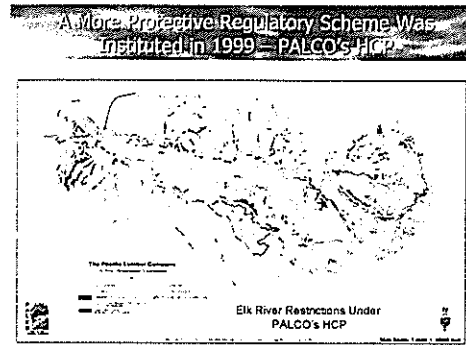
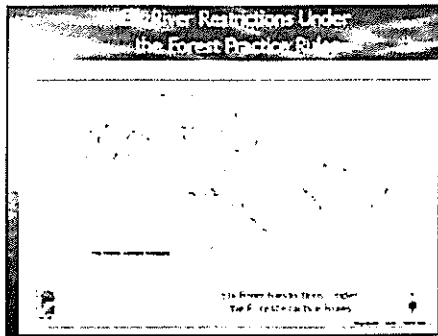
The HCP provides for two scientific processes:

Watershed analysis – As PALCO studies each of the watersheds that comprise its holdings, it gains a better understanding of the habitat they provide for endangered species. Better knowledge of the environment in turn drives improved management of our operations.

Adaptive management – PALCO also studies the effects of its ongoing environmental stewardship. The adaptive management process looks at these results and if science allows it, permits changes to improve the effectiveness and efficiency of PALCO's management.

The state and federal governments further agreed that PALCO would be provided with a streamlined, simplified, "one-stop" approval process and timely approval for all their THPs. Both the White House and the Secretaries of Interior and Commerce further assured PALCO, in writing, that "economic concerns and economic feasibility and viability would be taken into account and balanced with biological necessities."

The environmental protective measures under the standard California State Forest Practice Rules provide one level of protection, but PALCO's HCP is far more protective as is shown below. The protections in ELK River under the standard State Forest Practice Rules and the much more protective measures under the HCP are shown on the right. This is far greater protection than that provided by any other timber company in the state of California.



PALCO has also earned certification from the Sustainable Forestry Initiative® program, an independent, third party audit that verified that PALCO is practicing principled, sustainable forestry on its timberlands. Lead auditor Mike Ferrucci noted: "PALCO is doing a remarkable job of practicing sustainable forestry by using and promoting responsible practices, protecting special sites, and by investing in science to drive continual improvement in their forest management practices."

Finally, when PALCO sold over 5000 acres of Headwaters Old-Growth forest, agreed to set aside 7000 acres for 50 years to protect marbled Murrelets, and sold both the Owl Creek and Grizzly Creek groves to the state, the nature of PALCO's business plan from an old-growth company to a company dependent on second growth.

Conclusion: PALCO's HCP is far more restrictive than state forestry rules and is good for the environment; PALCO is now a certified sustainable second growth company; the HCP is having a positive impact on improving the environment.

V. PALCO's Refinancing of 1998 – Was a profit made?

Facts:

In 1998, PALCO was able to refinance its SCOPAC subsidiary with debt rated as “investment grade” by both Moody’s and Standard and Poor’s.

The Scotia Pacific Company LLC refinancing generated approximately \$843 million in net proceeds from the sale of three classes of investment grade debt:

- Most of the proceeds (over \$780 million) retired existing debt (no profit was made on the refinancing).
- \$25 million established a prefunding account for the express purpose of acquiring additional timberlands of which only a small portion remains.
- The bulk of the remainder paid accrued interest and required prepayment premiums on the retired debt.
- The debt was rated investment grade at the time of issue and was priced at fixed coupon rates of 6.55%, 7.11%, and 7.71% on the three classes of bonds.
- The repayment schedule was designed to amortize the first two classes in line with expected SCOPAC cash flows based on sustained yield through 2014.
- The remaining debt could be paid off in 2014 or amortized through 2028.
- \$703 million remained outstanding at December 31, 2004.

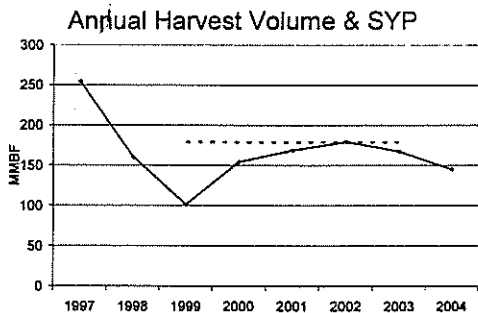
The SCOPAC public debt was downgraded by Standard and Poor’s and Moody’s in February 2005 and remains on credit watch with negative implications. The downgrade by S&P was the result of the negative impact from lower than expected harvest levels and the impact that it has had on the cash flow available for debt service. They further stated that with the recent approval of only 50% of the CDF approved acreage, the reduced logging at SCOPAC has caused a raw-material shortfall at PALCO which, in turn, has almost totally eroded the Company's liquidity and caused covenant violations under its revolving credit facility. Standard & Poor's believes the Company can avoid filing for bankruptcy protection if it is allowed to harvest at its planned levels.

Conclusion: PALCO's refinancing in 1998 was a good business decision; the refinancing provided investment grade interest only debt until 2014; none of the money went to enrich MAXXAM and no profit was made on the refinancing.

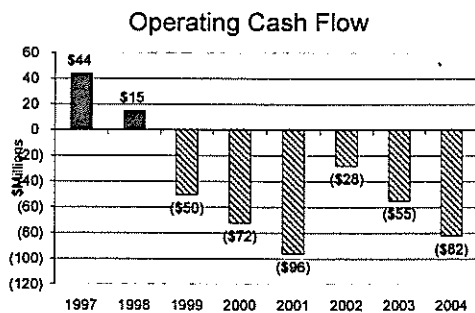
VI. PALCO's finance and scientific performance under the HCP

Facts:

Taken individually and in combination, the impacts of the legislative, regulatory, and judicial developments since the signing have denied PALCO the benefits of the Headwaters transaction.



PALCO's approved annual sustainable harvest level was 178 mmbf at the time of the signing of the HCP and SYP on March 1, 1999. Only one year (2002) have we harvested at that level. In the first six years we have operated 27mmbf below the SYP level averaging only 151mmbf per year. See the chart for yearly harvest levels. The years since signing the HCP have not been financially attractive. For instance, PALCO's logging and hauling costs have doubled (that is nearly \$25 million annually in increased costs), science and monitoring costs have increased significantly to implement our "science drives policy" commitments and to implement the HCP to its fullest. PALCO has spent over \$65 million in the past six years. PALCO's science staff has increased for 10 to over 40 full time scientists and adds an additional 15 to 20 temporary junior scientists and technicians during the summer season. Our employee base has decreased by 600 people.



This combination of increased costs and harvesting below sustainable levels, has caused the Company to be in a negative operating cash flow position for the past six years. The graph on the left reflects cash generated or used by operations, along with cash expenditures for capital investments and debt principal payments. This totals \$389 million negative cash flow over this time period. To continue operations and to offset this negative cash flow, PALCO used: 1) the Headwaters monies, 2) used approximately \$100 million from other timberland asset sales at Owl and Grizzly Creeks to the state, closed several non-profitable gravel and wood-waste operations, closed three old-growth sawmills, outsourced our logging and hauling operations, and invested substantial capital to improve efficiency of lumber operations. As an example, in late 2003, the PALCO Board of Directors approved the use of operating funds and our lines of credit to construct a state-of-the-art sawmill and planer valued at \$30 million. Over the past 19 years, our Board has authorized over \$300 million of new capital investments.

Conclusion: The HCP has increased PALCO's operating costs significantly and when combined with lower than expected harvest levels, has caused significant weakening of PALCO's financial position; PALCO is not asking for anything more than what was promised in the agreement in terms of regulatory certainty: all we want is what we agreed to. MAXXAM has invested heavily in PALCO since the acquisition in 1986.

VII. PALCO needs THPs approved in Freshwater and Elk quickly

Facts:

To understand the critical need for THPs in Freshwater and Elk in the first half 2005, you need to look at the 2004 situation. PALCO's business plan in 2004 was to harvest at 165mmbf which is below our sustainable level. The North Coast Regional Water Quality Control Board started to slow approvals of our CDF approved plans during the second half 2004. By year end, we only harvested 144mmbf and had only 16mmbf of logs in our log inventory decks (35mmbf in the decks is normal at year end). We normally have limited harvest during January through April in Freshwater and Elk.

Our plan for 2005 was to harvest 165 mmbf and purchase approximately 20 mmbf from third party landowner which has historically been our outside purchase level. The 2005 harvest plan of 165 mmbf is shown in the following table.

Net MMBF	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Harvest	13.2	14.3	12.8	9.8	8.5	12.8	16.7	20.3	19.5	20.9	10.8	5.5

PALCO was expecting to harvest approximately 37.7mmbf in the Elk and Freshwater watersheds in 2005, representing approximately 60% of volume in the first quarter as is shown below.

Net MMBF	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Elk & Fresh	5.8	10.4	10.2	6.2	2.6	0.5	0.6	0.0	1.1	0.3	0.0	0.0
% of Logs-to-Mill	37%	72%	73%	39%	17%	3%	4%	0%	6%	2%	0%	0%

In anticipation of this work, and in reliance on approval of the plans by the California Department of Forestry ("CDF"), PALCO invested \$2,000,000 in road improvements in Elk and Freshwater last summer getting the roads ready for this year's harvest.

To date, the executive director of the Water Board has permitted us to cut only half of the clear cut equivalent acre plans approved by CDF. This means our volume will be reduced by almost 30% this quarter.

And what does that mean?

- PALCO will not have enough funds to pay for operations – its workers, its scientists, its contractors.
- PALCO may be unable to borrow to make up this shortfall, because its borrowing is based on timber inventory; and with fewer THPs, there is simply less inventory – at least 30% less.
- The indebtedness secured by its timberlands is threatened with default, because PALCO will not have sufficient funds to pay interest due in July.
- Logging and hauling contractors employed by PALCO will have reduced work available for their 460 employees.

- A reduction in PALCO's ability to purchase goods and services in the community will negatively impact the business climate in Humboldt County.
- Monthly unemployment costs to the state of California will be in the \$millions.

We need all of the CDF previously approved THPs to be released up to the "clear-cut equivalent acres" level also authorized by CDF.

Conclusion: *PALCO faces bankruptcy because of the stranglehold on THPs by the NCRWQCB;*

VIII. PALCO's forest products history has not been a financial success

Facts:

During the past 19 years, PALCO has generated almost \$4 billion in revenues but has shown a cumulative pre-tax loss. PALCO's expenses and costs have increased substantially since the HCP which reduces operating margins.

Forest Products Financial Information – 1986-2004

MAXXAM INC.
FOREST PRODUCTS SEGMENT FINANCIAL INFORMATION
1986 - 2004

(\$ in millions)

	1986	1987	1988	1989	1990	1991	1992
Revenues	\$ 119.8	\$ 150.8	\$ 160.8	\$ 183.6	\$ 198.0	\$ 205.7	\$ 223.4
(Expenses)	(76.1)	(99.3)	(105.3)	(121.5)	(134.5)	(149.4)	(158.3)
Operating Income (Loss)	43.7	51.5	55.5	62.1	63.5	56.3	65.1
Gain on Sale of Headwaters, Owl Creek, & Grizzly	-	-	-	-	-	-	-
Income (Loss) Before Tax & Minority Interests	(27.9)	(19.1)	0.6	(14.9)	(11.1)	(31.8)	(28.4)
Income (Loss) Excluding Headwaters, Owl Creek, & Grizzly	(27.9)	(19.1)	0.6	(14.9)	(11.1)	(31.8)	(28.4)
Capital Expenditures	34.8	26.6	13.6	9.9	13.1	6.4	8.7

	1993	1994	1995	1996	1997	1998	1999
Revenues	\$ 233.5	\$ 249.6	\$ 242.6	\$ 264.6	\$ 287.2	\$ 233.6	\$ 187.8
(Expenses)	(179.2)	(170.5)	(168.3)	(257.3)	(202.3)	(192.7)	(191.9)
Operating Income (Loss)	54.3	79.1	74.3	7.3	84.9	40.9	(4.1)
Gain on Sale of Headwaters, Owl Creek, & Grizzly	-	-	-	-	-	-	239.8
Income (Loss) Before Tax & Minority Interests	(17.7)	(5.2)	6.4	6.3	20.9	(24.7)	196.1
Income (Loss) Excluding Headwaters, Owl Creek, & Grizzly	(17.7)	(5.2)	6.4	6.3	20.9	(24.7)	(43.7)
Capital Expenditures	11.1	11.3	9.9	15.2	22.9	22.0	23.1

	2000	2001	2002	2003	2004	Totals
Revenues	\$ 200.1	\$ 185.3	\$ 199.4	\$ 208.5	\$ 202.1	\$ 3,936.4
(Expenses)	(192.5)	(196.1)	(180.6)	(174.0)	(196.7)	(3,146.5)
Operating Income (Loss)	7.6	(10.8)	18.8	34.5	5.4	789.9
Gain on Sale of Headwaters, Owl Creek, & Grizzly	59.6	16.3	-	17.4	-	333.1
Income (Loss) Before Tax & Minority Interests	23.9	(59.6)	(33.5)	(18.1)	(49.3)	(87.1)
Income (Loss) Excluding Headwaters, Owl Creek, & Grizzly	(35.7)	(75.9)	(33.5)	(35.5)	(49.3)	(420.2)
Capital Expenditures	14.0	13.4	12.2	19.1	29.8	317.2

The above data set is prepared based on GAAP financial statements and include non-cash items. Since 1999, the Company has generated a net loss before taxes of \$274 million, excluding the land sales related to the Headwater Transaction, and spent over \$100 million in capital expenditures to invest in the future growth of the business.

Conclusion: *Combined, the operating losses and capital investments created a \$389 million negative cash flow over the last six years; MAXXAM did not enrich themselves with the on-going operations of PALCO.*