

# **Comments on the *Pacific Lumber Company Economic White Paper*<sup>1</sup>**

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## **Introduction**

This Paper is in response to the Economic White Paper produced by Pacific Lumber (PALCO) and submitted on March 15, 2005 to the North Coast Regional Water Board. I have reviewed Securities and Exchange Commission (SEC) annual company filings (10-K) for PALCO, Scotia Pacific and MAXXAM for the years 1993 to 2004 along with related financial statements and offering documents to compile the following analysis/ rebuttal to the economic assertions present in the PALCO White Paper. These documents reflect the extremely complex nature of the relationship between all the MAXXAM companies.

Pacific Lumber Company (PALCO) and its subsidiaries are a wholly owned subsidiary of MAXXAM Group Inc (MGI). MGI is a wholly owned subsidiary of MAXXAM Holdings Inc. (MGHI), which in turn is a wholly owned subsidiary of MAXXAM Inc. (MAXXAM, a publicly traded company). PALCO's principally wholly owned subsidiaries are Scotia Pacific Holding Company and Salmon Creek Company. MAXXAM purchased the old PALCO in 1986. The term PALCO usually refers both to the current PALCO, which contains the lumber milling operations of old PALCO, and PALCO's subsidiary, Scotia Pacific, which contains all the timber assets of the former company.

Mr. Charles E. Hurwitz is Chairman of the Board and Chief Executive Officer of MAXXAM. Mr. Hurwitz, members of his immediate family, and trusts they control collectively own approximately 68.8% of the aggregate voting power of MAXXAM (1998 Scotia Pacific Offering Memorandum for Timber Notes). Mr. Hurwitz is widely known for his aggressive business operations.

## **Conclusions**

MAXXAM has taken money out of PALCO in subtle and complex ways and has directed PALCO to harvest trees at rates that greatly exceeds sustainable forest practices. MAXXAM has put PALCO at risk by borrowing large sums of money, not paying down its long-term debt, and thereby keeping PALCO a highly leveraged company.

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<sup>1</sup> By Robert E. Manne, President and CEO, Gary L. Clark, Vice President of Finance, Pacific Lumber, March, 2005

PALCO and Scotia Pacific are in financial trouble. They are losing money and may have to restructure their operations. This condition is the result of the risky business model that MAXXAM has chosen to follow for these companies. MAXXAM has kept PALCO highly leveraged for its entire period of ownership, since 1986. Old PALCO ran a successful, sustainable business model. MAXXAM PALCO has tripled the old harvest rates to unsustainable levels, nearly doubled the operating income, and still lost an average of \$20 million a year since the takeover. Old PALCO averaged over \$20 million a year in net income in the four years prior to the takeover. Current losses are due to the fact that MAXXAM PALCO has been saddled with over \$800 million in long-term debt and the interest payments required on these amounts. By comparison, old PALCO had \$30 million in long-term debt at the time of the takeover. Since purchasing PALCO in 1986, MAXXAM PALCO has only made minimal principal payments. MAXXAM PALCO has refinanced its debt three times, and each time back up to previous levels above \$860 million. None of the profit from accelerated harvesting has been used to pay off this company debt. Instead, MAXXAM has removed at least \$724 million in PALCO funds for its own use<sup>2</sup>.

### **The Question of Bankruptcy**

PALCO writes in its White Paper “*If PALCO is put into bankruptcy, Humboldt County will suffer severe economic harm*”. It is much more likely that, in the threatened case of PALCO’s, or its subsidiary Scotia Pacific’s, bankruptcy, both timber harvest and milling would continue, and local workers would keep working but under the oversight of a Federal Bankruptcy judge (Gary Clark, CFO PALCO at SWRCB hearing, 4/5/05). It is true that the local economy would probably experience some slowdown, but most of the “economic harm” would be borne by the Timber Note holders. It is highly unlikely that MAXXAM would step in and keep Scotia Pacific out of bankruptcy; their own board vice-chairman and general counsel Kent Friedman has been recently quoted saying, “I can’t remember the last time I’ve seen it (MAXXAM) put money into a subsidiary.”<sup>3</sup>

Even if PALCO stays out of bankruptcy this year by convincing the Water Board to approve harvest of all the acreage it demands, it will need more acreage again next year, and the next, to keep up its payments on the Timber Notes. It will continually be at risk of default on its Timber Notes because they require such substantial interest payments (up to \$55 million a year). PALCO has over leveraged the value of their timberlands and even if they cut every tree they own, it may not be enough to pay back its current debts. PALCO’s financial difficulties are the result of deliberate business decisions, and not the result of any regulatory decisions.

### **Analysis of Pacific Lumber’s Economic White Paper**

What now follows is my analysis and rebuttal on a point-by-point basis of the items laid out in the PALCO Economic White Paper of March 2005. I have put *items in italics that are directly*

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<sup>2</sup> This is an extremely conservative estimate that I have gathered from the limited public information I have available covering mostly 1993 to 2004. I am missing almost all company information from 1986 to 1993 when very high harvesting rates probably contributed substantial profits to MAXXAM. A thorough examination of the multiple company books would be necessary to have a better estimate to the true amounts.

<sup>3</sup> April 20, 2005 Matt Wirz Debtwire.

*from the PL Economic White paper or quoted from other of its publicly available company documents.*

***I. PALCO's (sic) has a very positive "economic impact" in the county***

**PALCO White Paper Facts:** PALCO details a number of local economic benefits to its employees and to Humboldt County of their operations. I believe that the economic impacts of PALCO as stated in the White Paper are reasonably accurate. The company does have substantial positive impact on the community and jobs from its operations in Humboldt County.

**PALCO White Paper Conclusions:** *"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.*

I do not support their White Paper's conclusion to this section, which are actually unrelated to the facts offered by PALCO in this section. Old PALCO (the company MAXXAM purchased in 1986) had been around for 125 years. I do not believe that the MAXXAM owned PALCO, as currently structured, can possibly survive even the next 10 years, hardly another seven generations. This is based on the highly leveraged business model MAXXAM has imposed on PALCO and the unsustainable harvest levels PALCO has operated over the past 19 years since the MAXXAM takeover.

In addition, the potential bankruptcy of Scotia Pacific (see below) would have much less severe impacts than predicted in this document. My reasons for these beliefs are outlined below.

**Old vs New PALCO**

Old PALCO was around 125 years before MAXXAM took over. During the last four years of its independent existence it averaged \$73 million in sales, \$24 million in pre-interest operating income and \$20 million in profits before taxes each year (1981 to 1984). It had a long-term debt of \$30 million dollars and an annual interest expense of around \$1.3 million. This Company would clearly have lasted another 125 years, as this was a low risk, sustainable business approach.

New PALCO has operated for 19 years since MAXXAM has taken over. During the years of MAXXAM control, PALCO has averaged \$207 million in sales, an operating income before interest expense of \$41.57 million, but has averaged over \$22 million in LOSSES each year since the take over (data supplied from the PALCO White Paper, March 2005). In other words, it has tripled sales, nearly doubled operating income (income calculated before taxes and interest payments) and has gone from \$20 million a year in profits as old PALCO to over \$20 million a year in losses as new PALCO<sup>4</sup>. The company has averaged over \$800 million in long-term debt over the entire 19 years of MAXXAM's ownership and the interest payments on this debt has mainly caused these losses.

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<sup>4</sup> These are losses from company operations and do not count the extra profit made by PALCO in the Headwaters deal.

### **Unsustainable Harvest Levels**

PALCO's has harvested at unsustainable rates for the entire time that MAXXAM has owned PALCO. In 1987, a publicly released PALCO timber cruise gave an estimate of 6.5 billion board feet (bf) of harvestable timber available to the Company. In 1997, the next publicly released timber estimate gave 3.2 billion bf of timber remaining. This yields an average of 300 million bf/year for 10 years between 1987 and 1997 – this rate of harvest is equivalent to a 20-year harvest cycle. A 20-year harvest cycle is not sustainable. In the 1998 Headwaters deal, an “allowance” of 176 million bf/year was granted<sup>5</sup>. Dividing this into the 3.2 billion bf remaining timber gives an average 18-year harvest cycle on 1998 timber volume, or requires that future harvests naturally decrease rapidly from initial levels. The MAXXAM PALCO historical timber harvest rates have lead directly to greatly reduced harvest levels in the 20<sup>th</sup> year of MAXXAM's ownership of PALCO. This is not surprising since Redwood and Douglas Fir trees take much longer than 20 years to grow to harvestable size. MAXXAM has effectively mined beyond a renewable forest resource level. This harvesting model puts the forests of PALCO at risk from over harvesting which would create environmental harm.

### **Highly Leveraged Business Model**

As noted earlier, the current PALCO is run as highly leveraged and under an extremely risky business model. This approach is a perfectly legal business practice designed to maximize the return on equity in the firm by minimizing equity investment. This high-risk approach has produced excellent payments to the company owner (MAXXAM) over the last 19 years but has put the future of the company (PALCO/Scotia Pacific) at risk. Even the company recognizes this: ***“Due to its highly leveraged condition, the Company (Scotia) is more sensitive than less leveraged companies to factors affecting its operations, including low log prices, governmental regulation and litigation affecting timber harvesting practices on the Company Timberlands, and general economic conditions.”*** The company has stated this numerous times in Scotia Pacific's annual reports to bondholders, its SEC filings and many other documents.

An example of this high leverage is that a Debt to Equity ratio cannot even be calculated for the new PALCO<sup>6</sup>. This is because the company has NEGATIVE equity (there are more debts than assets). In quantitative terms, new PALCO has twice as much debt as assets (debts over 200% of assets). The debt level has been this high almost continuously since Old PALCO was purchased. A company is usually considered very highly leveraged when debts equal assets. Old PALCO debts were about 10% of its assets.

This high leverage is a business choice by MAXXAM. When MAXXAM first purchased Old PALCO with over \$750 million in borrowed money, MAXXAM's own Debt to Equity ratio was 5:1 (or 5 times as much debt as equity in 1986). MAXXAM transferred the debt acquired to purchase the company into PALCO and in July 1986 refinanced the purchase debt into \$879 million in long-term debt<sup>7</sup>.

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<sup>5</sup> This rate actually was determined in 1997 by PALCO, prior to the final Headwaters deal, as the fundamental harvest rate required to meet the debt obligations of its 1998 Timber Note sale. See Annex 1, Structuring Schedule Assumptions, 1998 Scotia Pacific Timber Note Offering Memorandum.

<sup>6</sup> This is a normal company metric used in the investment industry to evaluate stability of companies.

<sup>7</sup> MAXXAM itself, incorporating the debt of PALCO, currently has a negative equity of over \$600 million in its latest SEC 10-K filing for year ending 12/31/04. This is highly unusual for a company.

MAXXAM reorganized PALCO between 1986 and 1988, selling off PALCO's old office building for \$31 million, recapturing \$55 million from old PALCO's pension plan, and selling the Cutting and Welding Division of old PALCO for at least a \$125 million gain<sup>8</sup>. Little of this money went to pay off the debt of PALCO and most apparently was distributed to MAXXAM.

In 1993, MAXXAM had two separate refinancings, one into PALCO and Scotia Pacific (set up in 1993) for \$611 million and another \$226.7 million in a MAXXAM holding company, MAXXAM Group Inc (MGI); a total of \$838 million dollars. This refinancing paid off the old debt in PALCO, slightly lowered the interest rates on the long-term debt and to my best ability to determine, allowed MAXXAM to take the \$226.7 million dollars out of PALCO (the MGI Notes were secured only by its stock ownership of PALCO as its major asset). Again, total debt burden to PALCO (which had to provide dividends to MGI to pay that debt) was over \$838 million: so that after eight years of ownership, PALCO remained with over \$800 million in long-term debt.

In 1998, MAXXAM and PALCO again refinanced the company debt related to the timberlands. This time, all the new debt was placed into Scotia Pacific. As Scotia company documents state, the Timber ***"Notes are senior secured obligations of Scotia and do not constitute obligations of, and are not guaranteed by, Pacific Lumber or any other person."*** (Scotia Pacific 10-K 12/31/98: Part II, Item 5). This clearly was done to insulate PALCO from the debt payment requirements. An interesting feature of this 1998 refinancing was that most of the money from the Headwaters deal, over \$460 million, was put into a collateral account in Scotia Pacific to secure the high mortgage on the Timber Notes. Obviously there was not enough value in the timber itself to secure a mortgage over \$860 million and additional collateral was required. This is a very clear example of how highly leveraged the company actually is.

The average interest rate was lowered in the 1998 refinancing, to around 7.43%, but the total long-term debt was again increased to \$867 million dollars. PALCO asks in its White Paper ***"Was a Profit made"*** from this refinancing? Their claim is no, and in the literal sense this is true. Most of the refinancing amount was used to pay off old debt: that in Scotia Pacific, that in PALCO (all long term debt paid off) and that in MGI. Note that \$226.7 million in MGI debt was paid off in 1998, taking the 1993 MGI refinancing off the books and making that money free and clear to MAXXAM. Either you count the initial 1993 bond money as payment to MAXXAM or the retirement of the debt as a benefit to MAXXAM in 1998, either way it was a clear \$225 million that MAXXAM extracted from PALCO. In 1998 an additional \$14.7 million was paid from MGI up to MAXXAM, and this I would certainly consider a profit though hidden through multiple company dividends. Again, the PALCO companies were left with over \$868 million in long-term debt, meaning that no long-term debt was paid off in the previous 5 years and keeping the company as leveraged as ever. Meanwhile MAXXAM could be considered to have received at least \$241.4<sup>9</sup> million out of the deals.

Since, 1998 PALCO has not done another refinance and has slowly paid some of its long-term debt back. As of December 31, 2004 the balance was \$703 million. The company choice has

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<sup>8</sup> The sale price of the Cutting and Welding Division was \$325 million but MAXXAM had allocated \$200 of PALCO debt to this Division for accounting purposes, yielding the estimated net profit of \$125 million.

<sup>9</sup> Counting the 1993 MGI bond money of \$226.7 million that was paid off by assets from PALCO in 1998 and dividend payment of \$14.7 million from MGI to MGHI.

been to make all necessary interest payments and pay the minimum principal necessary. In six years, \$165 million has been paid off. At this rate it would take another 25 years to pay off all the long-term debt. I have never seen in any of the documents I have reviewed any mention anywhere that PALCO has any intention of paying off its long-term debt. The 1998 Scotia Timber Note offering document talks about refinancing the 1998 debt again after 15.5 years or in around 2013. In fact, since 1998, Scotia has delivered over \$182 million in dividends<sup>10</sup> to PALCO. This is money that could have been used to pay down much more of the debt but apparently has been used to send money through to MAXXAM<sup>11</sup>. The implication is that PALCO wishes to remain a highly leveraged company. This is the model MAXXAM has chosen and it is the model that puts PALCO at risk today.

### **Bankruptcy**

A PALCO bankruptcy itself may not happen. All long-term debt is held in Scotia Pacific, a wholly owned subsidiary of PALCO, which was set up specifically to hold the Timber Note debt. Scotia Pacific has mortgaged all the timberlands to secure that debt and they would be the most likely company to go bankrupt. PALCO's entire business strategy is to maximize harvest to make payments on the Timber Notes Scotia Pacific issued in 1998.

PALCO itself was at some risk of defaulting on its business credit lines. It had a year-to-year Bank of America line of credit that required PALCO to maintain certain financial ratios and income levels. Until this was replaced recently, PALCO was in default on this line of credit. PALCO refinanced its Revolving Credit Facility (the old \$30 million annual credit line from Bank America) with two other banks on April 19, 2005. PALCO now has two five-year credit lines for \$40 and \$35 million, with CIT Group and Credit Suisse First Boston, respectively. This greatly reduces the risk of bankruptcy in the PALCO company itself. However, this is not expected to help Scotia Pacific. MAXXAM's board vice-chairman and general counsel Kent Friedman made clear that the new liquidity would not be used to help Scotia pay \$27 million of interest due 20 July on \$751 million of asset backed bonds: he said recently "I'd be surprised if MAXXAM did that as I can't remember the last time I've seen it (MAXXAM) put money into a subsidiary."<sup>12</sup>

A Scotia bankruptcy reorganization would occur if Scotia was to default on the Timber Notes. The Notes largely require only interest payments at this time and go into technical default only if principal payments are missed. PALCO/MAXXAM could continue to maintain interest payments with small sales of assets or other financial contributions back from MAXXAM into PALCO and avoid bankruptcy altogether if it wished.

However, if Scotia goes into bankruptcy, there are two probable outcomes. The companies could be put into bankruptcy with MAXXAM continuing to operate the companies. MAXXAM would have the ability to negotiate with the bondholders and other creditors. MAXXAM could make this a long and drawn out process costing the banks and the Timber Note holders any interest and principal payments until negotiations could be finalized. There may be some

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<sup>10</sup> Data from Scotia Pacific annual 10-K reports submitted to the SEC for the years 1999 through 2004.

<sup>11</sup> Since the 1998 refinancing paid off all of PALCO's long-term debt (all long-term debt now only Scotia Pacific), PALCO itself has not been required to submit annual 10-K reports to the SEC.

<sup>12</sup> Mark Wirz Debwire dated April 20<sup>th</sup>, 2005 and SEC documents.

disruption of harvest levels and lumber production but there should be no cessation of business operations. In fact, current harvest levels would be quite economic if the debt burden from the Timber Note financing was removed. MAXXAM could potentially keep the companies in bankruptcy long enough for the timber market prices to increase and allow MAXXAM to refinance the Timber Notes again and keep control of the companies.

A second possibility is that the Timber Note holders might successfully gain control of Scotia in the bankruptcy process and come to own the property. They would have every economic interest to continue logging operations. PALCO and Scotia, as before, would be affected by the uncertainty of the bankruptcy proceedings but operations at PALCO and Scotia would probably continue at near current rates but under the direction of a federal judge, not MAXXAM. .

In either case, timber harvest and milling should continue and workers would keep working. The local economy would experience some slowdown during this period of uncertainty, but most of the economic harm would be borne by the Timber Note holders and possibly MAXXAM.

## ***II. MAXXAM's acquisition of PALCO in 1986***

***PALCO White Paper Facts:*** Most information contained in this section of the White Paper is correct. ***The acquisition of PALCO was financed by a combination of public debt, bank credit agreements, and funds made available by the acquired company***<sup>13</sup>. However, the White Paper omits the substantial and complex nature of the company structure and financings at many levels of the MAXXAM group related to the PALCO purchase. PALCO also refers to the Pacific Meridian Report of 1986. They claim its projected harvest scenarios were never used by PALCO to manage its business and cite a number of 1999 or later agreements and plans as more pertinent to current management guidance. It is interesting that PALCO only cites studies since 1999 and that while PALCO may not have used the Meridian Report for management guidance, the most aggressive the harvesting scenario proposed in the Meridian Report tracks very well with the actual harvest levels PALCO pursued up until the 1999 Headwaters agreement reduced their harvest levels.

***PALCO White Paper Conclusions:*** ***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.***

At the time of purchase, Old PALCO was a conservatively run company in business for 125 years and it would have been able to remain in business for another 125 years. MAXXAM has completely changed the management style and harvest rates (see comments under section I above).

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<sup>13</sup> From the PALCO Economic White Paper. The total purchase price was \$874 million of which \$750 million was long-term debt, the rest would have been bank credit agreements and money from old PALCO itself. One might argue that MAXXAM put no cash money into the company at all, using PALCO's money and new debts to unwillingly purchase itself.

The White Paper states that *PALCO's retirees have received all their pension payments* but MAXXAM removed \$55 million of pension assets from the company immediately after purchase. It has been in court ever since defending that action. MAXXAM insured the rest of the pension payments through the company Executive Life, which underwent one of the largest taxpayer funded bailouts in insurance industry history.

MAXXAM put very little of its own money into purchasing PALCO in 1986. It borrowed \$750 million and made up the other \$125 million with a short-term bank credit line and funds from inside of old PALCO. MAXXAM has subsequently removed at least \$724 million through sales of old PALCO assets, net proceeds of complex financing deals, and excess dividends and profits received from PALCO. This means that MAXXAM has netted at least \$600 million dollars from its operation of PALCO<sup>14</sup>. That is a 500% return on the money MAXXAM used for purchase<sup>15</sup> and is equal to a 64% internal rate of return. PALCO profits have not been used to pay off debt but to support MAXXAM. The White Paper states that "*MAXXAM has not cut and run*", but MAXXAM has used the sale of company assets, refinancing, and dividends from PALCO to take a lot of money out of the company. MAXXAM has refinanced and taken so much money out that PALCO has a negative equity position (nearly twice as much debt as assets). This is highly unusual for any company operating as an ongoing concern.

### **III The Headwaters Agreement was unprecedented in this county, Who got what?**

**PALCO White Paper Facts:** The PALCO analysis is mostly correct as far as it goes. However, it omits substantial information about what PALCO got monetarily and in kind for its Headwaters deal. One very interesting comment from the White Paper facts is that "*the agreement included the transfer of the Headwaters and Elkhead Forests to the United States and California for less than appraised value.*" I do not believe this can be true. PALCO gave up 5,600 acres in the Headwaters Forest and received in money and property an equivalent of over \$532 million dollars as shown below. PALCO got an equivalent of \$95,000 PER ACRE for its Headwaters transfer.

Additional sales by PALCO to the government of between 2000 to 3000 acres from the Grizzle Creek and Owl Creek Groves have netted PALCO another \$83.7 million. These sales, when combined with the Headwaters acreage mean that government sales have totaled \$616 million for less than 4% of PALCO's original acreage! These sales returned over 70% of the initial \$874 million cost MAXXAM paid to purchase old PALCO and its 200,000 acres in 1986.

*Another way to look at this is using PALCO's own financing where it was able to mortgage the remaining company acreage after the Headwater deals as part of the 1998 Scotia Timber Note sale for \$867 million. In that offering, 205,000 acres were mortgaged to the bond holders at a rate of only \$4300 an acre. MAXXAM was able to get over twenty times this amount per acre from the government for its prime old growth Headwaters acreage but is having trouble making the payments on 1998 Timber Notes. This indicates that the economics of the Headwaters deal was extremely favorable to PALCO.*

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<sup>14</sup> MAXXAM would have had to pay back the bank credit line and would have lost use of the original PALCO assets used to make the purchase.

<sup>15</sup> Not counting the long-term debt, which still is effectively outstanding.

**Table 1: Headwaters Deal**

<b>HEADWATERS DEAL</b>		
<b>Amounts</b>	<b>Comments</b>	<b>Source of Info</b>
<b>5600</b>	Number of Acres old growth given in Headwaters agreement	from Scotia 10K 12/31/98
<b>7700</b>	acres in Elk River received in exchange for Headwaters	from Scotia 10K 12/31/98
<b>\$ 78,000,000</b>	Estimated Value total Elk River lands	from Scotia 10K 12/31/98
<b>9,470</b>	Total Acreage of Elk River Lands valued at \$78 million	from Scotia 10K 12/31/98
<b>7,700</b>	Actual acreage given to PALCO from Elk River lands	from Scotia 10K 12/31/98
<b>\$ 63,421,331</b>	Value of Elk River lands given from State to PALCO as lands in trade for 5600 acres of HEADWATERS = 7700/9470 *\$78 million	from Scotia 10K 12/31/98
<b>\$ 299,850,000</b>	to Salmon Creek but to be placed in an Escrow account to support timber bonds (285 million)	from Scotia 10K12/31/98
<b>\$ 169,000,000</b>	Actually received for sale of Headwater to PALCO then contributed to Scotia for SAR account	from Scotia 10K 12/31/00
<b>468,850,000</b>	CASH value to PALCO et al for Headwaters Deal	
<b>\$ 532,271,331</b>	total Value to Company for Headwaters Forest deal	from Scotia 10K 12/31/00
<b>\$ 95,048</b>	<b>Dollars per Acre for the 5600 Headlands Property</b>	Divide \$532 million by 5600 acres

***PALCO White Paper Conclusions: The Headwaters Agreement was good for the environment, the public at large, the state and federal governments and PALCO. The monies for the Headwaters Agreement stayed within PALCO to fund capitol investments and cover operating losses; none of the money went to enrich MAXXAM.***

The Headwaters Agreement was good for the environment in that it greatly constrained PALCO's previous harvesting practices and policies. As to the money staying within PALCO, it is much more complicated than that as shown below in the section about the 1998 Scotia Pacific Timber Note financing (and Attachment 1). The money from Headwaters was mainly used to collateralize the Timber Note offering by Scotia Pacific in 1998. However, the money from the Timber Note sale paid off debts in Scotia Pacific, PALCO and MGI and yielded at least a \$240 million benefit to MAXXAM<sup>16</sup>. Therefore I would assert that the Headwaters deal indirectly was used to enrich MAXXAM. In addition, Charles Hurwitz received \$9 million from MAXXAM for his role in securing the Headwaters Agreement<sup>17</sup>.

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

I will leave it for others to certify how great for the environment PALCO's HCP has been. With regard to how tough the HCP appeared to PALCO at the time it was issued, I will simply quote a

<sup>16</sup> Paid off MGI debt of \$225 million and gave a \$14.7 dividend. See section V, "*PALCO's Refinancing of 1998 – Was a profit made?*"

<sup>17</sup> Numerous filings with the SEC in 2000 during a shareholder proxy fight, including Form DFAN 14A, filed 5/23/2000..

Scotia Pacific document from the time just prior to the agreement: “*Pacific Lumber and the Company have filed a sustained yield plan (SYP) and habitat conservation plan (HCP) covering multiple species found on the Company Timberlands (the Multi-Species HCP) which, if approved, could result in a number of substantial benefits, including faster reparation and approval of THPs and the ability to harvest in certain of the Company Timberlands in which it has previously been difficult to obtain such approval.*”<sup>18</sup>

## ***V. PALCO’s Refinancing of 1998 – Was a profit made?***

***PALCO White Paper Facts:*** PALCO asks in its White Paper “*Was a Profit made*” from this refinancing? Their claim is that no profit was made. In the literal sense this is true as most of the refinancing amount was used to pay off old debt (see Attachment I, Scotia Pacific 1998 Timber Note Sale). There were debts in Scotia Pacific, PALCO and in **MAXXAM Group Inc** (MGI, the MAXXAM company immediately above PALCO on the org chart) that were paid off.

***PALCO White Paper Conclusions:*** *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.*

Was the 1998 refinancing a good business decision for PALCO? To see the true benefit of the 1998 refinancing you have to link it to the 1993 refinancing. The 1993 financing involved two parts: PALCO issued \$612 million in debt and MGI issued \$226.7 in debt (See Attachment 2).

With regards to PALCO, the 1998 refinancing increased its debt to over \$867 million in order to make a \$259.9 million dividend to MGI, which paid off MGI’s debt (see Attachment 1). PALCO wasn’t legally responsible for the MGI’s debt. Only MAXXAM gained from the MGI loan originally and from having it paid off by its subsidiary PALCO. I would not consider the \$259.9 million dividend from PALCO to MGI a good business decision for PALCO, only MAXXAM.

There was a true benefit to MAXXAM for the \$225 million in MGI debt that was paid off as part of this 1998 refinancing. This removed the 1993 MGI Bond Offering, which had an original amount of \$226.7 million<sup>19</sup>. The MGI notes established in 1993 were collateralized by nothing but the stock of MGI, whose only major asset was its ownership of PALCO (see Attachment 2, 1993 Refinancing). This money in 1993 would have provided direct cash payment from the loan proceeds for MAXXAM’s use. So while this debt was paid off in 1998, it freed the debt to MGI, making the 1993 loan proceeds tax free income to MAXXAM. The 1993 loan never had to be repaid from MAXXAM coffers. This clearly did enrich MAXXAM; either in 1993 when MAXXAM got the money or in 1998 when the debt used to acquire the money was extinguished. The 1998 refinancing also paid an additional \$14.7 million dividend from MGI up to MAXXAM.

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<sup>18</sup> Scotia Pacific Company LLC, *Offering Memorandum for 1998 Timber Note Sale*, Page 7.

<sup>19</sup> See again, section I comments about the Highly Leveraged Business Model and section III, Headwaters Deal. Yes, this is truly complex and difficult to follow. It is an inherent part of the complicated company structure MAXXAM uses to control its subsidiary companies.

To summarize the benefit from these two refinancings: MGI got a \$25 million dividend from PALCO's 1993 refinancing (see Attachment 2), MAXXAM got the \$226.7 million in 1993 bond money (Attachment 2, paid off in 1998), MAXXAM also got the dividend of \$14.7 million in 1998. So in total from these two financings MAXXAM actually got  $\$25 + \$226.7 + \$14.7 = \$266.4$  million. MAXXAM had not literally enriched itself with the 1993 MGI bond money because it was still a legal debt on its books until 1998.

I would consider the \$266.4 million as an enrichment of MAXXAM, but notice that it has been structured as mostly loan proceeds that are not taxable income and can correctly be characterized as not being "profits".

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

***PALCO White Paper Facts:*** PALCO's operating costs have increased, timber harvests have been below expectations and this has led to significant "operating cash flow" losses. "Operating cash flow" losses are listed as \$389 million since 1999. "Operating cash flow" is an unusual financial term as it consists of operating income (logging and milling income minus expenses), interest and principal payments, and capital expenditures (treated as an annual expense). There are components of each of these that have caused problems for PALCO and there is certainly more to them than PALCO discloses. I will review these items below in the conclusion part of this section.

***PALCO White Paper Conclusions:*** *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.*

### **Harvesting levels**

It is true that PALCO has not been able to attain their desired harvest levels of 178 million board feet annually (mmbf). To review why, we need to look at their history just prior to the time of PALCO's current troubles.

The HCP was part of the Headwaters agreement and began to have effect on March 1, 1999. This was part of a set of agreements that were aimed at reducing and controlling PALCO timber harvests after the much higher harvesting levels prior to 1999. In the immediate three years before the agreement PALCO averaged a harvest of almost 300 mmbf per year<sup>20</sup>. Examining the longer term harvesting levels since the MAXXAM takeover of PALCO shows that this was their average harvest rate since takeover. Their first timber survey in 1987 showed PALCO lands to have over 6.5 billion board feet. Their next public release of timber estimate in 1997 showed only an equivalent of 3.2 billion board feet of timber. This translates to over 300 mmbf per year. During these 10, years PALCO harvested over half of their entire timber inventory. I would not

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<sup>20</sup> "Over the past three years, Pacific Lumber's annual lumber production has averaged 297 million board feet, with approximately 309, 291 and 290 million board feet produced in 1997, 1996, and 1995 respectively." Scotia Pacific Company LLC, Offering Memorandum for 1998 Timber Note Sale,, page 11).

consider this rate to sustainable when it takes well over 20 years for new trees to reach harvestable levels.

The “promised” 178 mmbf level that was part of the HCP and Headwaters deal was actually dictated by PALCO’s earlier 1998 refinancing (harvest numbers calculated in 1997) which locked in this amount to pay back the large debt PALCO was incurring to do its refinancing<sup>21</sup>. The 178 mmbf harvest level could never be sustained for long as it would deplete the 3.2 billion bf inventory in less than 18 years. In addition, the actual scientific basis for the 178 mmbf harvest level that was part of the HCP is presently being challenged in litigation.

### **Required scientific and environmental improvements**

With regards to PALCO’s much higher harvesting expenses after the agreement, this is a reflection of both halving its harvest rate on a base of fixed expenses and of increased expenses because of the regulatory science and harvesting controls imposed by the HCP. However, the HCP imposes these controls largely because of the environmental problems caused by the much higher previous harvest levels and methods of PALCO.

### **Increased Interest expenses**

As detailed above in section V, PALCO’s Refinancing of 1998 increased the level of debt of the PALCO companies from the \$612 million dollar level it had in 1993 to over \$867 million due to the new refinancing. Essentially they mortgaged the company for \$867 million in 1998. The interest expense on this new debt has cost the company over \$300 million since 1999. This is a huge amount of PALCO’s total losses of \$389 million since 1999.

### **Capital Investments**

In the White Paper, PALCO shows \$111.4 million of capital investments since 1999 as a major component of their \$389 million negative cash flow (this does not mention their interest expenses noted above). In their graph in section VI they are characterizing those capital investments as losses within their operating cash flow while omitting the \$333 in profits they earned from 1999 through 2004 from sale of the Headwater package. Please note that in normal financial statements, capital expenditures are not treated as expenses; as they are simply an investment in company assets that does not have a net effect on a balance sheet.

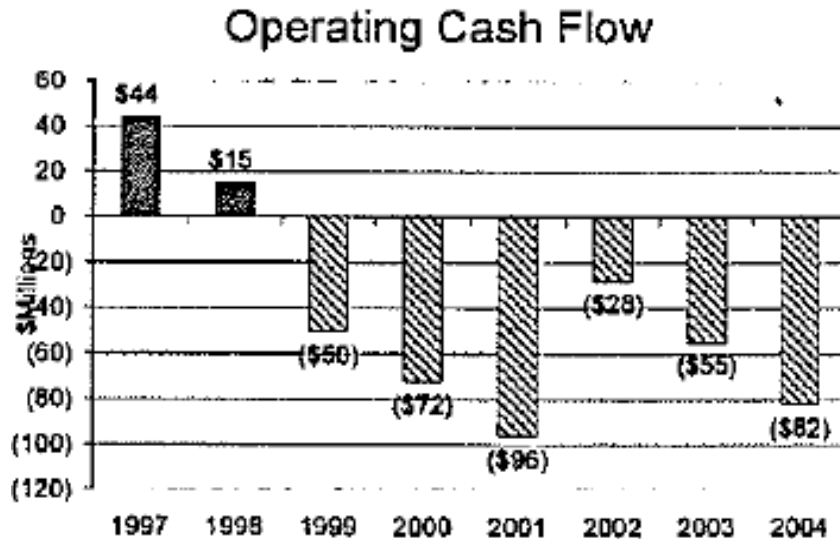
### **Conclusion**

The graph and discussion of a negative operating cash flow creates the misleading impression that over-regulation has caused PALCO to lose \$389 million since 1999 (see graph below). In fact, according to their own financial information (Attachment 3) PALCO operating income from lumber harvesting and milling was a positive \$51.4 million during that time period. The calculation of their \$389 million negative cash flow consists of approximately \$325 million in interest payments and unreported debt principal repayment amounts, \$111.6 million for capital improvements (treated as cash flow losses, not the investments that they are) minus the \$51.4 million in operating income. PALCO also omits from this calculation of operating cash flow the \$333 million profit from the Headwaters deal.

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<sup>21</sup> This rate actually was determined in 1997 by PALCO, prior to the final Headwaters deal, as the fundamental harvest rate required to meet the debt obligations of its 1998 Timber Note sale. See Annex 1, Structuring Schedule Assumptions, 1998 Scotia Pacific Timber Note Offering Memorandum

PALCO White Paper Graph (page 11) –Note total Operating Cash Flow losses since 1999 total \$389 million



In addition, the last sentence of PALCO’s conclusion in section VI states that “MAXXAM has invested heavily in PALCO since the acquisition in 1986.” My analysis shows exactly the opposite - a 500% return on their money out of PALCO<sup>22</sup>

**VII. PALCO needs THPs approved in Freshwater and Elk quickly.**

**PALCO White Paper Facts:** In this section PALCO shows the expected harvest levels for 2005 and shows the projected shortfall if the Elk and Freshwater watersheds are not harvested. They show that total projected 2005 harvest is 165 mmbf, of which 37.7 mmbf is from Elk and Freshwater.

**PALCO White Paper Conclusions:** *PALCO faces bankruptcy because of the stranglehold on THPs by the NCRWQCB.*

The economic situation of PALCO is dire. However, it is totally of its own creation. See the “Highly Leveraged Business Model” in Section I above. I find it hard to believe that the additional Elk and Freshwater acreage not yet approved by Regional Water Board is responsible for the near bankruptcy of PALCO.

The Regional Water Board has approved to date half of this Elk and Freshwater acreage to be harvested. PALCO states in their White Paper that they have averaged harvesting 151 mmbf per year since 1999. Half of the Elk and Freshwater acreages are projected to yield 19 mmbf. Subtracting the half not yet approved, from the projected total of 165 mmbf shows that even

<sup>22</sup> See my analysis in Section VIII, “PALCO’s forest product history has not been a financial success”

without any additional approvals by the Regional Water Boards this year, PALCO would harvest 146 mmbf. This is only 5 mmbf below their average. The additional acreage may be approved later this year, and even if not harvested this year, it will be there next year.

Again, the economic situation of PALCO is entirely of its own making. They have chosen a highly leveraged business model and chosen not to pay down its high long-term debts when able, leaving them very vulnerable to changes in market and regulatory conditions. PALCO claims to be having financial problems since 1999, and yet they blame it all on the THPs and the North Coast Regional Water Quality Control Board. The THPs have only been an issue for the last six months and involve only a net 5-mmbf difference from previous years' harvest levels. PALCO's current problems are certainly much bigger than a 5-mmbf harvest level.

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

**PALCO White Paper 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." PALCO provides a table showing a partial financial statement of their Forest Products division for the last 19 years. It noticeably does not disclose the annual interest payment component of these finances, which has contributed substantially to these operating losses.

**Table 2. Old vs New PALCO finances**

<b>In Millions of Dollars</b>	<b>Old PALCO (1)</b>	<b>New PALCO (2)</b>
<b>Averages</b>		
Net Sales	\$ 73.11	\$ 207.18
Depreciation, depletion and amortization	\$ 2.45	
operating income	\$ 24.49	\$ 41.57
interest expense	\$ 1.64	
income before income taxes, minority interest and extraordinary item	\$ 25.45	\$ (22.12)
Net Income	\$ 16.63	
<b>Long Term Debt (3)</b>	<b>30</b>	<b>868</b>
<i>(1) Old PALCO average from 1981 to 1985</i>		
<i>(2) New PALCO income does not include gains from sale of Headwaters Acreage. New PALCO average from 1986 to 2004 as disclosed in White Paper, blank averages not disclosed in White Paper</i>		
<i>(3) Old PALCO Long term debt at end of 1985. New PALCO debt is average of four financings: Purchase, 1986, 1993, and 1998</i>		

**PALCO White Paper Conclusions:** 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 ongoing operations of PALCO.

PALCO has not been a financial success because it has been so highly leveraged. It has averaged paying \$50 to \$60 million a year in long-term debt interest since it was taken over by MAXXAM. It is extremely hard to be profitable when your operating income has averaged \$40 million a year and you must pay \$50 to \$60 million in interest. This structure has completely been the result of MAXXAM's choices. They have refinanced four times and each time the

amount has averaged \$867 million. Money generated in the company has been used to reinvest in the company.

PALCO claims over \$300 million has been reinvested. Yet, this is less than half the amount that I calculate being withdrawn. Where has the money gone? A lot has left the company from PALCO to MAXXAM. At least \$724 million has been distributed out of PALCO since 1985. This is an extremely conservative estimate in that it does not include the yearly dividends that PALCO has sent up to MAXXAM between 1986 to 1998<sup>23</sup>. But it does represent 18% of the four billion dollars<sup>24</sup> in total revenue generated by PALCO since the takeover and is nearly equal to the average long-term debt PALCO has. Most of this money has left through difficult to follow inter-company dividends and bond financing, and much more may be further hidden. New PALCO is currently highly leveraged and in danger of bankruptcy, even with the very “profitable” sale of the Headwater’s forest, which paid MAXXAM 70% of the entire cost of purchasing old PALCO. MAXXAM has enriched itself and in the process it has put the ongoing operations of PALCO and Scotia Pacific at risk.

**Table 3. MAXXAM Money Trail.**

Date	Information	MAXXAM Money to purchase PALCO	MAXXAM Money out from Sales, Dividends, and Cash Withdrawals
Feb-86	1986 Purchase of PL	\$ 124,000,000	
10-Jul-86	Refinancing of PL debt (estimated withdrawal number)		\$ 64,000,000
14-Nov-86	Sale of old PALCO HQ building		\$ 31,200,000
1986	Removal of excess old PALCO Pension Assets		\$ 55,000,000
1988 (est)	Sale of old PALCO Cutting and Welding Unit (estimated net number after \$200 million debt repayment on \$325 million sale price)		\$ 125,000,000
23-Mar-93	PALCO Refinancing, half debt in PALCO, half in Scotia Pacific. Dividend to MAXXAM		\$ 25,000,000
4-Aug-93	MAXXAM Group Inc.(MGI) debt issuance, using PALCO equity as collateral (counted as money to MAXXAM)		\$ 226,700,000
1998	Dividend to MAXXAM Group Holding Inc. (money to MAXXAM)		\$ 14,700,000
2000	Dividend from Scotia to PALCO, after all PALCO debt paid off		\$ 73,100,000
2001	Dividend from Scotia to PALCO, after all PALCO debt paid off		\$ 79,900,000
2002	Dividend from Scotia to PALCO, after all PALCO debt paid off		\$ 29,400,000
2003	No Dividend from Scotia to PALCO		\$ -
2004	No Dividend from Scotia to PALCO		
	<b>Totals</b>	<b>\$ 124,000,000</b>	<b>\$ 724,000,000</b>

<sup>23</sup> I do not have the annual PALCO 10-Ks for this period or any MAXXAM 10-Ks prior to 1994.

<sup>24</sup> PALCO White Paper, Section 8.

**Attachment 1: 1998 Scotia Timber Note Sale.**

<b>1998 Scotia Timber Note Sale</b>			
Acres	<b>206,000</b>	substantially all of Scotia's acres serve as security for timber	from Scotia 10K12/31/98
Timber Volume	<b>3,200,000</b>	Mbfe -old growth equivalent timber by volume on 3/1/1999 sale of timber notes (about 46% old growth Redwood and Douglas Fir), <b>note only half of 1986 timber volume</b>	from Scotia 10K12/31/98
Scotia Timber Note total amount	<b>\$ 867,200,000</b>	Timber Notes issued on July 20, 1998, consummated finally 3/25/99 Included refinancing of old companies debt and a dividend of 526,100,000. Pay off old Scotia Timber Notes due July 20, 2038, carry overall effective interest rate of 7.43 per annum.	from Scotia 10K12/31/98
		<b>"Notes are senior secured obligations of Scotia and do not constitute obligations of, and are not guaranteed by, Pacific Lumber or any other person."</b>	from Scotia 10K12/31/98
Scotia Timber value	<b>\$ 249,200,000</b>	<b>Value of Timber and Timberlands in Scotia at time of Timber Note sale</b>	1998 Scotia Timber Note offering Document
<b>To Help secure notes, Palco contributed Headwaters money to Scotia to help collateralize the notes which far exceeded the timberland value.</b>			
Headwaters to Scotia	<b>\$ 285,000,000</b>	Money from Salmon Creek Headwaters deal put into Scotia Escrow used to secure timber notes issued on all of PALCO	from Scotia 10K12/31/98
Headwaters to Scotia	<b>\$ 169,000,000</b>	On Nov 18, 1999 this amount contributed to Scotia from PALCO from sale of Headwaters timberlands and set aside in the SAR account to make payments on Timber Notes.	from Scotia 10K12/31/99
Headwaters to Scotia	<b>\$ 67,000,000</b>	Actual value for company sale of Owl Creek grove, December 2000, put into SAR account to help collateralize 1998 Timber Notes	from Scotia 10K12/31/00
Total extra collateral	<b>\$ 521,000,000</b>	Total Money placed into SAR to collateralize 1998 Timber	from Scotia 10K12/31/98
Scotia debts and financing expenses paid	<b>\$ (341,100,000)</b>	Into Scotia to pay off old long term debt and pay for expenses of refinancing. "Company recognized an extraordinary loss of \$35.4 million in 1998 for the early extinguishment of the Old Timber Notes."	from Scotia 10K12/31/98
Scotia dividend to PALCO	<b>\$ 526,100,000</b>	Tax Free Cash Dividend to PALCO for year ending 12/31/1998 from net proceeds of Timber Notes Sale	from Scotia 10K12/31/98
Palco debts paid	<b>\$ (235,000,000)</b>	Retire all of Palco long-term debts	From Scotia 1998 Timber Notes Offering Memorandum
Palco other debts paid	<b>\$ (9,500,000)</b>	Pay Palco purchase money debt on timberlands transferred to Scotia	From Scotia 1998 Timber Notes Offering Memorandum
Palco dividend MGI	<b>\$ 259,900,000</b>	Dividend from Palco to MGI (MAXXAM Group Inc)	From Scotia 1998 Timber Notes Offering Memorandum
MGI Notes paid	<b>\$ (225,700,000)</b>	Pay off MGI debt (see 1993 financing of \$226,700,000 cash to MAXXAM)	From Scotia 1998 Timber Notes Offering Memorandum
MGI dividend to MGHI	<b>\$ 14,700,000</b>	Payment from MGI to pay part of MGHI (MAXXAM group Holding Inc, direct parent of MGI) debt payment	From Scotia 1998 Timber Notes Offering Memorandum

**Attachment 2. 1993 Refinance**

<b>Date</b>	<b>Company</b>	<b>Amounts</b>	<b>Comments</b>	<b>Source of Info</b>
23-Mar-93	Scotia	\$ 376,953,000	7.95% Timber collateralized notes in newly formed Scotia Pacific Holding Company, due 3/23/03	1993 10-K Palco, page 33/115
23-Mar-93	PL	\$ 235,000,000	10.5% Senior Notes due 2003 on PALCO books	1993 10-K Palco, page 33/115
23-Mar-93	PL	\$(163,784,000)	Paying off 12% Series A Senior Notes due July 1, 1996	1993 10-K Palco, page 33/115
23-Mar-93	PL	\$(304,725,000)	Paying off 12.2% Series B Senior Notes due July 1, 1996	1993 10-K Palco, page 33/115
23-Mar-93	PL	\$ (41,750,000)	Paying off 12.5% Senior Subordinated Debentures July 1, 1998	1993 10-K Palco, page 33/115
23-Mar-93	PL	\$ (28,867,000)	Paying off Bank Credit agreement	1993 10-K Palco, page 33/115
		\$ 72,827,000	Net Loan Proceeds	
23-Mar-93	PL	\$ 35,000,000	Funds liquidity account to support new loans	1993 10-K Palco, page 34/115
23-Mar-93	PL	\$ 25,000,000	Dividend to Subsidiary of MGI	1993 10-K Palco, page 34/115
4-Aug-93	MGI	100,000,000	MGI stock pledged for 11.25% ten year notes on Aug 4, 1993, Note Palco "represents the substantial portion of MGI's assets and operations."	1993 10-K Palco, page 41/115
4-Aug-93	MGI	126,700,000	MGI stock pledged for 12.25% ten year notes on Aug 4, 1993	1993 10-K Palco, page 41/115
<b>1993</b>	<b>Scotia</b>	<b>\$ 376,953,000</b>	<b>New debt in Scotia Pacific</b>	
<b>1993</b>	<b>PL</b>	<b>\$ 235,000,000</b>	<b>New debt in PALCO itself</b>	
	<b>PALCO</b>	<b>\$ 611,953,000</b>	<b>Total new debt in PALCO companies, PL and Scotia</b>	
<b>1993</b>	<b>MGI</b>	<b>\$ 226,700,000</b>	<b>New debt in MGI, MAXXAM Group Inc.</b>	
<b>1993</b>	<b>MAXXAM</b>	<b>\$ 838,653,000</b>	<b>New debt in MAXXAM companies, PL, Scotia, and MGI</b>	

**Attachment 3: Last six years of PALCO finances (from PALCO White Paper)**

	1999	2000	2001	2002	2003	2004	Totals
1 Revenue	\$ 187.8	\$ 200.1	\$ 185.3	\$ 199.4	\$ 208.5	\$ 202.1	\$ 1,183.2
2 (Expenses)	\$ (191.9)	\$ (192.5)	\$ (196.1)	\$ (180.6)	\$ (174.0)	\$ (196.7)	\$ (1,131.8)
3 Operating income (loss)	\$ (4.1)	\$ 7.6	\$ (10.8)	\$ 18.8	\$ 34.5	\$ 5.4	\$ 51.4
4 Gain on sale of Headwaters, etc	\$ 239.8	\$ 59.6	\$ 16.3		\$ 17.4		\$ 333.1
5 Imputed interest, depreciation, extrodinary losses (= 3 + 4 - 6)	(39.60)	(43.30)	(65.10)	(52.30)	(70.00)	(54.70)	\$ (325.0)
6 Income (loss) before tax and minority interest	\$ 196.1	\$ 23.9	\$ (59.6)	\$ (33.5)	\$ (18.1)	\$ (49.3)	\$ 59.5
7 Income (loss) Excluding Headwaters, etc.	\$ (43.7)	\$ (35.7)	\$ (75.9)	\$ (33.5)	\$ (35.5)	\$ (49.3)	\$ (273.6)
8 Capital Expenditures (these are not annual expenses)	\$ 23.1	\$ 14.0	\$ 13.4	\$ 12.2	\$ 19.1	\$ 29.8	\$ 111.6
"Operating Cash Flow" w/o headwaters (= 7 - 8 )	(66.80)	(49.70)	(89.30)	(45.70)	(54.60)	(79.10)	\$ (385.2)
"Operating Cash Flow" w headwaters (= 6 - 8 )	173.0	9.9	(73.0)	(45.7)	(37.2)	(79.1)	\$ (52.1)