

POTLATCH CORP  
Form 10-Q  
November 07, 2006  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**Form 10-Q**

(Mark One)

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the quarterly period ended September 30, 2006

Or

**Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-32729

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**POTLATCH CORPORATION**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**82-0156045**  
(I.R.S. Employer  
Identification No.)

601 West Riverside Ave., Suite 1100

**Spokane, Washington**  
(Address of principal executive offices)

**99201**  
(Zip Code)

(509) 835-1500

Registrant's telephone number, including area code

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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. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

The number of shares of common stock of the registrant outstanding as of September 30, 2006 was 38,747,457.

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POTLATCH CORPORATION AND CONSOLIDATED SUBSIDIARIES

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**Table of Contents****PART I****ITEM 1. Financial Statements**

Potlatch Corporation and Consolidated Subsidiaries

Statements of Operations

Unaudited (Dollars in thousands - except per-share amounts)

	Quarter Ended September 30		Nine Months Ended September 30	
	2006	2005	2006	2005
Revenues	\$ 398,108	\$ 405,540	\$ 1,215,212	\$ 1,110,923
Costs and expenses:				
Depreciation, depletion and amortization	22,989	21,729	67,995	60,404
Materials, labor and other operating expenses	334,625	340,359	1,028,248	932,169
Selling, general and administrative expenses	23,206	18,999	68,946	61,284
	380,820	381,087	1,165,189	1,053,857
Earnings from operations	17,288	24,453	50,023	57,066
Interest expense	(7,229)	(7,236)	(21,911)	(21,722)
Debt retirement costs	53		53	
Interest income	355	514	1,452	1,827
Earnings before taxes	10,467	17,731	29,617	37,171
Provision (benefit) for taxes (Note 4)	(13,765)	6,641	(65,386)	14,125
Net earnings	\$ 24,232	\$ 11,090	\$ 95,003	\$ 23,046
Net earnings per common share (Note 5):				
Basic	\$ .63	\$ .38	\$ 2.66	\$ .79
Diluted	.62	.38	2.65	.79
Distributions per common share (annual rate) <sup>(1)</sup>	1.96	.60	1.96	.60
Average shares outstanding (in thousands):				
Basic	38,724	29,179	35,688	29,055
Diluted	38,858	29,401	35,870	29,238

(1) Distributions for 2006 reflect the annualized rate, after adjustment for a special earnings and profit distribution of \$15.15 per common share paid in the first quarter.

Certain 2005 amounts have been reclassified to conform to the 2006 presentation.

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

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Potlatch Corporation and Consolidated Subsidiaries

Condensed Balance Sheets

Unaudited (Dollars in thousands - except per-share amounts)

	September 30, 2006	December 31, 2005
<b>Assets</b>		
Current assets:		
Cash	\$ 7,315	\$ 6,133
Short-term investments	9,437	57,700
Receivables, net	117,191	114,641
Inventories (Note 7)	160,192	209,696
Prepaid expenses	17,077	15,006
Total current assets	311,212	403,176
Land, other than timberlands	8,556	8,507
Plant and equipment, at cost less accumulated depreciation	566,261	589,161
Timber, timberlands and related logging facilities	393,781	400,595
Other assets	253,664	227,358
	\$ 1,533,474	\$ 1,628,797
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities:		
Current installments on long-term debt	\$ 3,157	\$ 2,357
Accounts payable and accrued liabilities	163,856	144,943
Total current liabilities	167,013	147,300
Long-term debt	324,464	333,097
Other long-term obligations	252,392	245,867
Deferred taxes	124,610	197,385
Stockholders' equity	664,995	705,148
	\$ 1,533,474	\$ 1,628,797
Stockholders' equity per common share	\$ 17.16	\$ 24.01
Working capital	\$ 144,199	\$ 255,876
Current ratio	1.9:1	2.7:1

Certain 2005 amounts have been reclassified to conform to the 2006 presentation.

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

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Potlatch Corporation and Consolidated Subsidiaries

Condensed Statements of Cash Flows

Unaudited (Dollars in thousands)

	<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
<b>Cash Flows From Operations</b>		
Net earnings	\$ 95,003	\$ 23,046
Adjustments to reconcile net earnings to net operating cash flows:		
Depreciation, depletion and amortization	67,995	60,404
Deferred taxes	(72,775)	
Cost of permit timber harvested	3,229	3,747
Equity-based compensation expense	2,970	1,628
Employee benefit plans	(981)	(2,907)
Working capital changes	60,569	(42,040)
Funding of qualified pension plans	(18,092)	
<b>Net cash provided by operating activities</b>	<b>137,918</b>	<b>43,878</b>
<b>Cash Flows From Investing</b>		
Decrease in short-term investments	48,263	60,917
Additions to plant and properties	(37,243)	(91,162)
Other, net	(4,514)	(6,430)
<b>Net cash provided by (used for) investing activities</b>	<b>6,506</b>	<b>(36,675)</b>
<b>Cash Flows From Financing</b>		
Change in book overdrafts	3,228	837
Issuance of common stock	6,261	
Repayment of long-term debt	(7,833)	(1,078)
Issuance of treasury stock	513	10,880
Purchase of treasury stock		(1,868)
Distributions to common stockholders	(146,112)	(13,103)
Income tax benefit resulting from the exercise of employee stock options	1,233	
Other, net	(532)	491
<b>Net cash used for financing activities</b>	<b>(143,242)</b>	<b>(3,841)</b>
Increase in cash	1,182	3,362
Cash at beginning of period	6,133	8,646
<b>Cash at end of period</b>	<b>\$ 7,315</b>	<b>\$ 12,008</b>

Net interest payments (net of amounts capitalized) for the nine months ended September 30, 2006 and 2005 were \$15.3 million and \$15.1 million, respectively. Net income tax payments (refunds) for the nine months ended September 30, 2006 and 2005 were (\$1.5) million and \$15.9 million, respectively.

Certain 2005 amounts have been reclassified to conform to the 2006 presentation.

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

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Potlatch Corporation and Consolidated Subsidiaries

Notes to Consolidated Financial Statements

Unaudited (Dollars in thousands)

**NOTE 1. GENERAL** - The accompanying Condensed Balance Sheets at September 30, 2006 and December 31, 2005, the Statements of Operations for the quarters and nine months ended September 30, 2006 and 2005, and the Condensed Statements of Cash Flows for the nine months ended September 30, 2006 and 2005 have been prepared in conformity with accounting principles generally accepted in the United States of America. We believe that all adjustments necessary for a fair statement of the results of such interim periods have been included. All adjustments were of a normal recurring nature; there were no material nonrecurring adjustments.

This Form 10-Q should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2005, as filed with the Securities and Exchange Commission.

For purposes of this report, any reference to Potlatch, the company, we, us, and our means Potlatch Corporation and all of its wholly owned subsidiaries, except where the context indicates otherwise.

**NOTE 2. RECENT ACCOUNTING PRONOUNCEMENTS** - In February 2006, the Financial Accounting Standards Board, or FASB, issued Statement of Financial Accounting Standards (SFAS) No. 155, Accounting for Certain Hybrid Financial Instruments. Under this Statement, companies may elect to measure at fair value entire financial instruments containing embedded derivatives that would otherwise have to be accounted for separately. The Statement also requires companies to identify interests in securitized financial assets that are freestanding derivatives or contain embedded derivatives that would have to be accounted for separately, clarifies which interest- and principal-only strips are not subject to SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, and amends SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, to revise the conditions of a qualifying special purpose entity due to the new requirement to identify whether interests in securitized financial assets are freestanding derivatives or contain embedded derivatives. SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. We currently do not have any of the financial instruments that would fall under the provisions of this Statement and therefore believe that adoption of the Statement on its effective date will not have a material effect on our financial condition or results of operations.

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are currently reviewing the Interpretation to determine the effect it will have on our financial condition, results of operations and disclosure requirements.

In June 2006, the FASB Emerging Issues Task Force (EITF) ratified issue No. 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation). The scope of EITF 06-3 includes any tax assessed by a governmental authority that is directly imposed on a revenue-producing transaction between a seller and a customer. This issue provides that a company may adopt a policy of presenting taxes either gross within revenue or on a net basis. If taxes subject to this issue are significant, a company is required to disclose its accounting policy for presenting taxes and the amount of such taxes



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that are recognized on a gross basis. We do not believe the adoption of EITF 06-3 will have a material effect on our financial condition and results of operations.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the FASB board having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We are currently reviewing this Statement to determine what effect, if any, it will have on our financial condition and results of operations.

In September 2006, the FASB also issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R). This Statement requires a company to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity. This Statement also requires a company to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions.

SFAS No. 158 requires a company that is a business entity and sponsors one or more single-employer defined benefit plans to:

Recognize the funded status of a benefit plan measured as the difference between plan assets at fair value (with limited exceptions) and the benefit obligation in its statement of financial position. For a pension plan, the benefit obligation is the projected benefit obligation; for any other postretirement benefit plan, such as a retiree health care plan, the benefit obligation is the accumulated postretirement benefit obligation.

Recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost pursuant to SFAS No. 87, Employers Accounting for Pensions, or SFAS No. 106, Employers Accounting for Postretirement Benefits Other Than Pensions. Amounts recognized in accumulated other comprehensive income, including the gains or losses, prior service costs or credits, and the transition asset or obligation remaining from the initial application of Statements 87 and 106, are adjusted as they are subsequently recognized as components of net periodic benefit cost pursuant to the recognition and amortization provisions of those Statements.

Measure defined benefit plan assets and obligations as of the date of the employer's fiscal year-end statement of financial position (with limited exceptions).

Disclose in the notes to financial statements additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation.

This Statement amends SFAS No. 87, SFAS No. 88, Employers Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits, SFAS No. 106, SFAS No. 132 (revised 2003), Employers Disclosures about Pensions and Other Postretirement Benefits, and other accounting literature. Upon initial application of this Statement and thereafter, a company should continue to apply the provisions in Statements 87, 88 and 106 in measuring plan assets and benefit obligations as of the date of its statement of financial position and in determining the amount of net periodic benefit cost.

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For a company with publicly traded equity securities, SFAS No. 158 is effective for fiscal years ending after December 15, 2006. We are currently assessing the effect of the Statement on our Consolidated Financial Statements. However, based on the funded status of the company's defined benefit pension and postretirement benefit plans as of December 31, 2005 (our most recent measurement date), it is expected that the adoption of SFAS No. 158 will have a material impact on our Consolidated Balance Sheet and Consolidated Statement of Stockholders' Equity. The ultimate amounts to be recorded are highly dependent on a number of actuarial assumptions, most significantly the discount rates in effect at December 31, 2006 and the actual rate of return on our pension assets for 2006 as well as the tax effects of the adjustment. Changes in assumptions and actual asset performance from expectations as of the last measurement date could impact the effect of implementing SFAS No. 158 in our Consolidated Financial Statements at December 31, 2006.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin (SAB) No. 108 (Topic 1N), "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements." SAB 108 addresses how the effects of prior year uncorrected misstatements should be considered when quantifying misstatements in current year financial statements. It requires registrants to quantify errors using both the balance sheet and income statement approaches and to evaluate whether either approach results in quantifying a misstatement as material in light of relevant quantitative and qualitative factors. When the effect of initial adoption is determined to be material, SAB 108 allows registrants to record that effect as a cumulative effect adjustment to beginning-of-year retained earnings. SAB 108 is effective for annual financial statements covering the first fiscal year ending after November 15, 2006. We have not yet determined the effect, if any, the adoption of this SAB will have on our financial condition and results of operations.

In September 2006, the FASB issued FASB Staff Position (FSP) No. AUG AIR-1, "Accounting for Planned Major Maintenance Activities." This FSP prohibits companies from recognizing planned major maintenance costs under the accrue-in-advance method, which allowed the accrual of a liability over several reporting periods before the maintenance is performed. FSP AUG AIR-1 is applicable to entities in all industries for fiscal years beginning after December 15, 2006, and must be retroactively applied. We are in the process of determining the effect this FSP will have on our financial condition and results of operations.

**NOTE 3. REIT CONVERSION** - Effective January 1, 2006, we restructured our operations to qualify for treatment as a real estate investment trust, or REIT, for federal income tax purposes. The REIT tax rules require that we derive most of our income, other than income generated by a taxable REIT subsidiary, from investments in real estate, which for us primarily includes income from the sale of standing timber. Accordingly, prior to our REIT conversion, we transferred to our wholly owned taxable REIT subsidiary, Potlatch Forest Products Corporation, which we refer to in this report as Potlatch TRS, substantially all of our non-timberland assets, consisting primarily of Potlatch's manufacturing facilities engaged in the manufacturing of wood products, pulp and paperboard and tissue products, assets previously used by Potlatch for the harvesting of timber and the sale of logs, and selected land parcels that Potlatch expects will be sold or developed for higher and better use purposes. Our use of Potlatch TRS, which is taxed as a C corporation, enables us to continue to engage in these non-REIT qualifying businesses without violating the REIT requirements. In connection with this restructuring, our subsidiary that holds our timberlands has agreed to sell standing timber to Potlatch TRS at fair market prices.

As a consequence of our conversion to a REIT, we were not permitted to retain earnings and profits accumulated during years when we were taxed as a C corporation. Therefore, in order to remain qualified as a REIT, we distributed these earnings and profits by making a one-time special distribution to stockholders, which we refer to as the special E&P distribution, on March 31, 2006. The special E&P distribution, with an aggregate value of \$445 million, consisted of \$89 million in cash and approximately 9.1 million shares of Potlatch common stock valued at \$356 million.

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**NOTE 4. INCOME TAXES** - As a REIT, generally we will not be subject to federal corporate income taxes on ordinary taxable income and capital gains income from real estate investments that we distribute to our stockholders. If certain requirements are met, only our taxable REIT subsidiaries are subject to corporate-level income taxes. We will, however, be subject to corporate taxes on built-in gains (the excess of fair market value over tax basis at January 1, 2006) on sales of real property (other than timber) held by the REIT during the first ten years following the REIT conversion. We will continue to be required to pay federal corporate income taxes on earnings from our non-real estate investments, principally our manufacturing operations, which are now held by Potlatch TRS.

For the quarter ended September 30, 2006, an income tax benefit of \$13.8 million was recorded, compared to an income tax provision of \$6.6 million recorded in the third quarter of 2005. The third quarter of 2006 included a net tax benefit of \$9.2 million primarily related to an agreement reached with the Internal Revenue Service regarding tax issues pertaining to open tax years. Excluding this net tax benefit, the company recorded an income tax benefit of \$4.6 million, which was due to a pre-tax loss for Potlatch TRS. The income tax provision for the third quarter of 2005 reflected the adjustment of the estimated tax rate to 38.0% from 38.5% used for the first half of 2005. The estimated effective tax rate was reduced in the third quarter of 2005 to incorporate the anticipated effect of the Qualified Domestic Production Activity deduction and the estimated effect of changes to state tax apportionments.

For the nine months ended September 30, 2006, we recorded an income tax benefit of \$65.4 million. The tax benefit was largely due to the reversal of \$51.2 million in timber-related deferred tax liabilities that were no longer necessary as a result of the company's REIT conversion, as well as the \$9.2 million net tax benefit discussed above. Excluding these net tax benefits, the company recorded an income tax benefit of \$5.0 million. During the first nine months of 2005, an estimated tax rate of 38.0% was used to derive an income tax provision of \$14.1 million, calculated on our income from operations, before taxes, of \$37.2 million.

**NOTE 5. EARNINGS PER COMMON SHARE** Earnings per common share are computed by dividing net earnings by the weighted average number of common shares outstanding in accordance with SFAS No. 128, Earnings Per Share. The following table reconciles the number of common shares used in the basic and diluted earnings per share calculations:

(Dollars in thousands - except per-share amounts)	Quarter Ended		Nine Months Ended	
	September 30		September 30	
	2006	2005	2006	2005
Net earnings	\$ 24,232	\$ 11,090	\$ 95,003	\$ 23,046
Basic average common shares outstanding	38,723,804	29,179,174	35,688,377	29,055,127
Incremental shares due to:				
Common stock options	55,971	209,720	74,922	174,758
Performance shares	78,456		105,955	
Restricted stock units			580	
Accelerated stock repurchase program		12,456		7,920
Diluted average common shares outstanding	38,858,231	29,401,350	35,869,834	29,237,805
Basic earnings per common share	\$ .63	\$ .38	\$ 2.66	\$ .79
Diluted earnings per common share	\$ .62	\$ .38	\$ 2.65	\$ .79

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On March 31, 2006, the company paid a special E&P distribution, consisting of approximately 9.1 million shares of common stock and \$89 million in cash, in association with the REIT conversion. Reflected below are pro forma results giving effect to the common stock distribution for diluted earnings per common share for the quarter and nine months ended September 30, 2006 and 2005, as if the common stock distribution had occurred at the beginning of each period:

(Dollars in thousands - except per-share amounts)	Quarter Ended		Nine Months Ended	
	September 30 2006	2005	September 30 2006	2005
Net earnings	\$ 24,232	\$ 11,090	\$ 95,003	\$ 23,046
Diluted earnings per share				
As reported	\$ .62	\$ .38	\$ 2.65	\$ .79
Pro forma	\$ .62	\$ .29	\$ 2.45	\$ .60

For the quarter ended September 30, 2006, 40,728 performance shares, 28,401 restricted stock units and options to purchase 604,893 shares of common stock were excluded in the computation of diluted earnings per share because their effect was anti-dilutive. For the nine months ended September 30, 2006, 40,728 performance shares, 28,401 restricted stock units and options to purchase 307,177 shares of common stock were excluded in the computation of diluted earnings per share because their effect was anti-dilutive. Options to purchase 116,850 shares of common stock for the nine months ended September 30, 2005, were not included in the computation of diluted earnings per share because the exercise prices of the options were greater than the average market price of the common shares.

The computation of diluted average common shares outstanding for 2005 was affected by our accelerated stock repurchase program, which was completed during the third quarter of 2005, to the extent that the volume weighted average price of the shares purchased by the counterparty under the program exceeded the price per share initially paid at the program's inception. Throughout the repurchase program, it was assumed that any additional amounts payable to the counterparty would be settled by shares of the company's stock, and thus any such differential that existed at the end of each reporting period was included in the computation of diluted average common shares outstanding. The reverse treasury stock method was used to calculate the additional number of shares to be included in the diluted share total. At the completion of the repurchase program, we elected to settle the differential due to the counterparty with a \$1.9 million cash payment rather than with shares of the company's stock.

**NOTE 6. EQUITY-BASED COMPENSATION** In December 2004, the FASB issued SFAS No. 123 (revised 2004), Share-Based Payment (SFAS No. 123R). We adopted the provisions of SFAS No. 123R on its effective date of January 1, 2006, using the modified prospective method.

At September 30, 2006, we had four stock incentive plans, the 1989, 1995, 2000 and 2005 plans, under which stock option, performance share or restricted stock unit grants were outstanding. All of these plans have received stockholder approval. We were originally authorized to issue up to 1.5 million shares, 1.7 million shares, 1.4 million shares and 1.6 million shares under our 1989 Stock Incentive Plan, 1995 Stock Incentive Plan, 2000 Stock Incentive Plan and 2005 Stock Incentive Plan, respectively. At September 30, 2006, no shares were available for future use under the 1989 and 1995 Stock Incentive Plans, while approximately 1.3 million shares were authorized for future use under the 2000 and 2005 Stock Incentive Plans. All exercises of stock options or distributions of performance shares or restricted stock will be made through issuance of new shares after January 31, 2006. Prior to that date, treasury shares were utilized.

During the quarter and nine months ended September 30, 2006, we recorded equity-based compensation expense of \$1.0 million and \$3.0 million, respectively, of which \$0.9 million during the quarter related to performance shares and \$0.1 million related to restricted stock units. For the nine

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months ended September 30, 2006, compensation expense of \$2.7 million and \$0.3 million related to performance shares and restricted stock units, respectively. All outstanding stock options were fully vested prior to January 1, 2006. The net income tax benefit recognized in the Statements of Operations for equity-based compensation totaled \$0.4 million and \$1.2 million for the quarter and nine months ended September 30, 2006, respectively.

Prior to 2006, we applied the intrinsic value method under APB No. 25 and related Interpretations in accounting for our equity-based compensation. As a result, no compensation cost was recognized for stock options granted under the plans because the exercise price was equal to market value at the grant date. For performance share awards, which were first granted in December 2003, compensation expense was recorded ratably over the performance period based upon the market value of our stock and the likelihood that performance measurements would be met. No restricted stock units were outstanding prior to 2006.

Our pre-tax income for the three and nine months ended September 30, 2006 was \$0.9 million and \$3.8 million higher than what would have been reported under APB No. 25, respectively. The following table illustrates the impact SFAS No. 123R has had on our net earnings and net earnings per share:

<b>(Dollars in thousands - except per-share amounts)</b>	<b>Quarter Ended September 30, 2006</b>	<b>Nine Months Ended September 30, 2006</b>
Net earnings, as reported	\$ 24,232	\$ 95,003
Add: equity-based compensation expense recorded under SFAS No. 123R, net of tax	627	1,812
Deduct: equity-based compensation expense determined under APB No. 25, net of tax	(1,168)	(4,110)
Pro forma net earnings	\$ 23,691	\$ 92,705
Basic net earnings per share, as reported	\$ .63	\$ 2.66
Diluted net earnings per share, as reported	.62	2.65
Pro forma basic net earnings per share	.61	2.60
Pro forma diluted net earnings per share	.61	2.58

Prior to the adoption of SFAS No. 123R, we presented all tax benefits of deductions resulting from the exercise of stock options as operating cash flows in the Condensed Statement of Cash Flows. SFAS No. 123R requires the \$1.2 million of cash flow as of September 30, 2006, representing the income tax benefit resulting from the exercise of employee stock options, to be classified as a financing cash flow.

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Had we adopted SFAS No. 123R in the prior year period, the effect of adoption would have approximated the pro forma disclosures made under SFAS No. 123 as of September 30, 2005, as follows:

(Dollars in thousands - except per-share amounts)	Quarter Ended September 30, 2005	Nine Months Ended September 30, 2005
Net earnings, as reported	\$ 11,090	\$ 23,046
Add: equity-based compensation expense recorded under APB No. 25, net of tax	316	1,009
Deduct: equity-based compensation expense determined under SFAS No. 123, net of tax	(454)	(1,379)
Pro forma net earnings	\$ 10,952	\$ 22,676
Basic net earnings per share, as reported	\$ .38	\$ .79
Diluted net earnings per share, as reported	.38	.79
Pro forma basic net earnings per share	.38	.78
Pro forma diluted net earnings per share	.37	.78

The net income tax benefit recognized in the Statements of Operations for equity-based compensation for the quarter and nine months ended September 30, 2005, totaled \$0.2 million and \$0.6 million, respectively.

**Stock Options**

All outstanding stock options were granted with an exercise price equal to the market price on the date of grant, are fully exercisable after two years and expire not later than 10 years from the date of grant. In December 2005, the executive compensation and personnel policies committee of the board of directors, which we refer to as the committee, decided that no new stock options would be granted in 2005, and thus granted performance shares only. The committee believes that performance shares provide a superior incentive to stock options for employees in a REIT. Additionally, the committee approved the accelerated vesting of all outstanding, unvested, stock options effective December 31, 2005. As a result, 58,275 options vested on that date instead of the normal vesting date of December 4, 2006.

The special E&P distribution of \$15.15 per common share paid in the first quarter of 2006 qualified as an equity restructuring event under our stock incentive plans. In order to maintain the same intrinsic value to option holders immediately before and after the special distribution was paid, the number of options granted and exercise prices of all outstanding stock options were adjusted after the record date for the special E&P distribution payment. The adjustment is reflected in the activity for 2006 presented in the table below.

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A summary of outstanding stock options and changes during the nine month period ended September 30, 2006 is presented below:

	Shares	Weighted Avg. Exercise Price	Intrinsic Value (in thousands)
Outstanding at January 1	849,960	\$ 37.76	
Granted			
Adjustment as a result of special E&P distribution	360,435	26.40	
Shares exercised	(251,770)	26.90	\$ 3,166
Canceled or expired	(516)	35.44	
Outstanding at September 30	958,109	26.42	10,235
Exercisable	958,109	26.42	10,235

There were no unvested stock options outstanding during the nine months ended September 30, 2006. The total intrinsic value of stock options exercised for the nine month period ended September 30, 2005 was \$3.8 million.

The following table summarizes information about stock options outstanding at September 30, 2006:

Range of Exercise Prices	Options Outstanding and Exercisable		
	Number Outstanding at September 30, 2006	Weighted Avg. Remaining Contractual Life	Weighted Avg. Exercise Price
\$15.8849 to \$19.0779	135,539	5.81 years	\$ 17.42
\$21.3279 to \$29.5181	546,972	3.92 years	24.85
\$32.0957 to \$35.4393	275,598	5.06 years	33.95
\$15.8849 to \$35.4393	958,109	4.52 years	26.42

Cash received from stock option exercises for the nine months ended September 30, 2006 and 2005 was \$6.8 million and \$10.9 million, respectively. The actual tax benefit realized for the tax deductions from option exercises totaled \$0.2 million, \$0.8 million, \$1.2 million and \$1.5 million for the quarters ended September 30, 2006 and 2005, and the nine months ended September 30, 2006 and 2005, respectively.

**Performance Shares**

Performance share awards granted under the plans have a three year performance period, and shares will be issued at the end of the period if the performance measure is met. The performance measure is a comparison of the percentile ranking of our total shareholder return compared to the total shareholder return performance of a selected peer group of forest products companies. The number of performance shares actually issued, as a percentage of the amounts initially granted, could range from 0% - 150% for the 2003 grant and 0% - 200% for the 2004, 2005 and 2006 grants. Performance shares granted under the program may not be voted until issued. A dividend equivalent will be calculated based upon performance shares earned and issued and will be paid out as additional shares.

Under APB No. 25, compensation cost related to performance shares for the company was expensed using the market price of the company's common stock at the close of each reporting date, adjusted for the estimated number of shares to be ultimately issued. Upon adoption of SFAS No. 123R, the fair value of all performance share awards after January 1, 2006, is estimated by an independent third party using a Monte Carlo simulation model. Performance share awards granted prior to the adoption of SFAS No. 123R are valued at the market value of the company's stock at the date of grant.

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A summary of outstanding performance share awards and changes during the nine month period ended September 30, 2006 is presented below:

	Shares	Weighted Avg. Grant Date Fair Value	Intrinsic Value (in thousands)
Unvested shares outstanding at January 1	228,599	\$ 47.38	
Granted	40,728	64.99	
Forfeited	(27,533)	49.77	
Unvested shares outstanding at September 30	241,794	50.07	\$ 8,446

As of September 30, 2006, there was \$6.5 million of total unrecognized compensation cost related to non-vested performance share awards. The cost is expected to be recognized over a weighted average period of 1.5 years.

**Restricted Stock Units**

Our 2005 Stock Incentive Plan also allows for awards to be issued in the form of restricted stock units. During 2006, certain officers of the company were granted awards of restricted stock units (RSUs), which will be increased by the amount of distributions paid during the vesting period. The terms of the awards state that 20% of the RSUs will vest on each of the first and second anniversaries of the awards, with the remaining 60% vesting on the third anniversary. Thus, no RSUs had vested as of September 30, 2006.

A summary of outstanding RSU awards and changes during the nine month period ended September 30, 2006, is presented below:

	Shares	Weighted Avg. Grant Date Fair Value	Intrinsic Value (in thousands)
Unvested shares outstanding at January 1			
Granted	31,051	\$ 49.30	
Forfeited	(2,650)	38.30	
Unvested shares outstanding at September 30	28,401	50.32	\$ 1,054

For restricted stock awards granted during the period, the fair value of each share was estimated on the date of grant using the grant date market price.

As of September 30, 2006, there was \$1.1 million of total unrecognized compensation cost related to non-vested RSU awards. The cost is expected to be recognized over a weighted average period of 2.4 years.

**NOTE 7. INVENTORIES** - Inventories at the balance sheet dates consist of:

(Dollars in thousands)	September 30, 2006	December 31, 2005
Raw materials	\$ 73,244	\$ 101,984
Finished goods	86,948	107,712
	\$ 160,192	\$ 209,696



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**NOTE 8. PENSION AND OTHER POSTRETIREMENT BENEFIT PLANS** - The table below details the components of net periodic costs (benefit):

Quarters ended September 30:

(Dollars in thousands)	Pension Benefit Plans		Other Postretirement Benefit Plans	
	2006	2005	2006	2005
Service cost	\$ 3,137	\$ 2,573	\$ 696	\$ 386
Interest cost	8,476	8,171	4,019	4,086
Expected return on plan assets	(15,614)	(15,075)		
Amortization of prior service cost	531	513	(642)	(650)
Recognized actuarial loss	1,448	331	1,979	2,470
Net periodic cost (benefit)	\$ (2,022)	\$ (3,487)	\$ 6,052	\$ 6,292

Nine months ended September 30:

(Dollars in thousands)	Pension Benefit Plans		Other Postretirement Benefit Plans	
	2006	2005	2006	2005
Service cost	\$ 9,162	\$ 7,847	\$ 2,088	\$ 2,195
Interest cost	25,050	24,914	12,057	14,340
Expected return on plan assets	(46,145)	(45,967)		
Amortization of prior service cost	1,556	1,563	(1,925)	(2,032)
Recognized actuarial loss	4,273	1,010	5,938	8,851
Net periodic cost (benefit)	\$ (6,104)	\$ (10,633)	\$ 18,158	\$ 23,354

Due to the funded status of our qualified pension plans at December 31, 2005, no minimum pension contributions are required for 2006. As discussed in the notes to our financial statements for the year ended December 31, 2005, we expect to make contributions totaling \$19.5 million to our defined benefit pension plans in 2006, consisting of a \$1.4 million contribution to our non-qualified plan and a voluntary \$18.1 million contribution to our qualified plans. As of September 30, 2006, \$19.1 million of contributions had been made. No change to the original estimate is anticipated.

**NOTE 9. SEGMENT INFORMATION** Prior to our REIT conversion, our businesses were organized into four reportable operating segments, as defined by SFAS No. 131, Disclosures About Segments of an Enterprise and Related Information: Resource; Wood Products; Pulp and Paperboard; and Consumer Products. Beginning in 2006, the REIT conversion, discussed in Note 3 on page 7, resulted in the separation of the Resource segment into two reportable business segments. The new Resource segment consists of the following activities: managing our timberlands to optimize stumpage sales, the harvesting of our timber, the procurement of other wood fiber, log buying and selling, and entering into recreational and hunting leases. The new Land Sales and Development segment consists of the development and sale of selected non-strategic land parcels, including sales for higher and better use purposes. Results for this segment depend on the timing of closing of transactions resulting from our efforts to identify, develop and market property with higher and better use values. Amounts for 2005 for these segments have been reclassified to conform to the 2006 presentation.

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The Wood Products segment produces lumber, plywood and particleboard. The Pulp and Paperboard segment produces paperboard and pulp. The Consumer Products segment produces consumer tissue products.

(Dollars in thousands)	Quarter Ended		Nine Months Ended	
	September 30 2006	September 30 2005	September 30 2006	September 30 2005
<b>Segment Revenues</b>				
Resource	\$ 84,710	\$ 90,794	\$ 218,689	\$ 209,195
Land sales and development	1,139	6,938	3,810	9,502
Wood products				
Lumber	89,703	103,795	302,771	289,602
Plywood	12,657	12,943	42,452	40,197
Particleboard	5,928	4,036	15,138	13,286
Other	9,209	10,183	30,053	26,925
	117,497	130,957	390,414	370,010
Pulp and paperboard				
Paperboard	131,080	133,178	395,743	372,682
Pulp	23,004	18,099	53,811	45,317
Other	302	206	915	681
	154,386	151,483	450,469	418,680
Consumer products	113,232	95,541	329,909	281,203
	470,964	475,713	1,393,291	1,288,590
Elimination of intersegment revenues	(72,856)	(70,173)	(178,079)	(177,667)
Total consolidated revenues	\$ 398,108	\$ 405,540	\$ 1,215,212	\$ 1,110,923
Intersegment revenues or transfers				
Resource	\$ 54,130	\$ 56,350	\$ 130,779	\$ 133,673
Wood products	3,956	3,712	11,143	11,189
Pulp and paperboard	14,742	10,084	36,077	32,735
Consumer products	28	27	80	70
Total	\$ 72,856	\$ 70,173	\$ 178,079	\$ 177,667
Operating Income (Loss)				
Resource	\$ 19,262	\$ 19,957	\$ 43,408	\$ 42,954
Land sales and development	788	6,043	2,768	7,496
Wood products	(5,161)	5,943	5,581	28,212
Pulp and paperboard	14,302	402	16,560	2,695
Consumer products	6,186	2,379	20,059	3,230
Eliminations	(6,578)	(1,506)	(4,859)	625
	28,799	33,218	83,517	85,212
Corporate	(18,332)	(15,487)	(53,900)	(48,041)

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Consolidated earnings before taxes	\$ 10,467	\$ 17,731	\$ 29,617	\$ 37,171
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Certain 2005 amounts have been reclassified to conform to the 2006 presentation.

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**ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**  
**Cautionary Statement Regarding Forward-Looking Information**

This report contains, in addition to historical information, certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, including without limitation, statements regarding future revenues, cash flows, distributions, compliance with REIT tax rules, costs, manufacturing output, capital expenditures, timber harvest levels and other timber supply issues. Words such as anticipate, expect, will, intend, plan, target, project, believe, seek, schedule, estimate, and similar expressions are intended to identify such statements. These forward-looking statements reflect management's current views regarding future events based on estimates and assumptions, and are therefore subject to known and unknown risks and uncertainties and are not guarantees of future performance. Our actual results of operations could differ materially from those expressed or implied by forward-looking statements contained in this report. Important factors that could cause or contribute to such differences include, but are not limited to, changes in the United States and international economies; changes in exchange rates between the U.S. dollar and other currencies; changes in the level of construction activity; changes in worldwide demand for our products; changes in worldwide production and production capacity in the forest products industry; competitive pricing pressures for our products; unanticipated manufacturing disruptions; changes in general and industry-specific environmental laws and regulations; unforeseen environmental liabilities or expenditures; weather conditions; changes in raw material, energy, and other costs; implementation or revision of governmental policies and regulations affecting import and export controls or taxes; the ability to satisfy complex rules in order to remain qualified as a REIT; and changes in tax laws that could reduce the benefits associated with REIT status. Forward-looking statements contained in this report present management's views only as of the date of this report. Except as required under applicable law, we do not intend to issue updates concerning any future revisions of management's views to reflect events or circumstances occurring after the date of this report.

**Overview**

Potlatch is a real estate investment trust, or REIT, with 1.5 million acres of forestland in Arkansas, Idaho, Minnesota and Oregon. Through a taxable subsidiary, the company also operates 13 manufacturing facilities that produce lumber and panel products and bleached pulp products, including paperboard and tissue products. We completed our conversion to a REIT effective January 1, 2006. By converting to a REIT, we expect to be better able to compete for timberland acquisitions against other tax-advantaged entities, and we believe that our stockholders will benefit from the increased distributions we expect to make as a REIT. Our regular annual distribution is expected to be approximately \$76 million in 2006, compared to \$17.5 million in 2005.

Beginning in 2006, the REIT conversion, discussed in Note 3 on page 7, resulted in the separation of the Resource segment into two reportable business segments. The new Resource segment consists of the following activities: managing our timberlands to optimize stumpage sales, the harvesting of our timber, the procurement of other wood fiber, log buying and selling, and entering into recreational and hunting leases. For the first nine months of 2006, Resource segment revenues were \$218.7 million, representing approximately 16% of our total revenue, before elimination of intersegment revenues. Intersegment revenues were \$130.8 million for the period.

The new Land Sales and Development segment consists of the development and sale of selected non-strategic land parcels, including sales for higher and better use purposes. Results for this segment depend on the timing of closing of transactions resulting from our efforts to identify, develop and market property with higher and better use values. For the first nine months of 2006, revenues for the Land Sales and Development segment were \$3.8 million. The segment did not have any intersegment revenues during the period.

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The remaining three segments of our business consist of the following:

The Wood Products segment manufactures lumber, plywood, and particleboard at eight mills located in Arkansas, Idaho, Michigan and Minnesota. The segment's products are largely commodity products, which are sold to wholesalers primarily for use in home building and other construction activity. Wood Products segment revenues were \$390.4 million for the first nine months of 2006, representing approximately 28% of our total revenues, before elimination of intersegment revenues. Intersegment revenues were \$11.1 million for the period.

The Pulp and Paperboard segment manufactures bleached paperboard used in packaging and bleached softwood market pulp. The Pulp and Paperboard segment operates two pulp and paperboard mills located in Arkansas and Idaho. Pulp and Paperboard segment revenues were \$450.5 million for the first nine months of 2006, representing approximately 32% of the company's total revenues, before elimination of intersegment revenues. Intersegment revenues were \$36.1 million for the period.

The Consumer Products segment manufactures tissue products primarily sold on a private label basis to major grocery store chains. The segment operates two tissue mills with related converting facilities in Idaho and Nevada, and an additional tissue converting facility located in Illinois. Consumer Products segment revenues were \$329.9 million for the first nine months of 2006, representing approximately 24% of our total revenues, before elimination of intersegment revenues. The segment did not have significant intersegment revenues during the period.

**Factors Influencing Our Results of Operations and Cash Flows**

The operating results of our timberlands and manufacturing businesses have been and will continue to be influenced by a variety of factors, including the cyclical nature of the forest products industry, changes in timber prices and in harvest levels from our timberlands, competition, international trade agreements or disputes, the efficiency and level of capacity utilization of our manufacturing operations, changes in our principal expenses such as wood fiber and energy costs, and changes in the production capacity of our manufacturing operations as a result of major capital spending projects, asset dispositions or acquisitions and other factors.

Our results of operations and cash flow are affected by the fluctuating nature of timber prices. The demand for and supply of standing timber have been and are expected to be subject to cyclical and other fluctuations, which often result in variations in timber prices. The demand for softwood sawtimber is primarily affected by the level of new residential construction activity and, to a lesser extent, home repair and remodeling activity and other industrial uses of wood fiber, which are subject to fluctuations due to changes in economic conditions, interest rates, population growth, weather conditions and other factors. The demand for pulpwood is also cyclical, and tends to fluctuate based on changes in the demand for paper, tissue and similar products, as well as conversion capacity in the relevant region. Reductions in residential construction activity and other events reducing the demand for standing timber could have a material adverse effect on our results of operations and cash flow.

Our results of operations and cash flow are also affected by changes in timber availability at the local and national level. Increases in timber supply could adversely affect the prices that we receive for timber. Our timberland ownership is currently concentrated in Idaho, Arkansas and Minnesota. In Arkansas and Minnesota, most timberlands are privately owned. Historically, increases in timber prices have often resulted in substantial increases in harvesting on private timberlands, including lands not previously made available for commercial timber operations, causing a short-term increase in supply that has tended to moderate price increases. In Idaho, where a greater proportion of timberland is publicly owned, any substantial increase in timber harvesting from these lands could significantly reduce timber prices, which could harm our results of operations. In the last twenty years, environmental concerns and other factors have limited timber sales by government agencies, which historically had been major suppliers of timber to the United States forest products industry, particularly in the West. Any reversal of

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policy that substantially increases public timber sales could materially adversely affect our results of operations and cash flow. On a local level, timber supplies can fluctuate depending upon factors such as changes in weather conditions and harvest strategies of local forest products industry participants, as well as occasionally high timber salvage efforts due to unusual pest infestations or fires.

Changes in harvest levels on our timberlands also may have a significant impact on our results of operations, due in part to the low cost basis of our timber from timberlands we acquired many years ago. Over the long term, we manage our timberlands on a sustainable yield basis to achieve a balance between timber growth and timber harvests. From time to time, however, we may choose, consistent with our environmental commitments, to harvest timber at levels above or below our estimate of sustainability for various reasons. For example, for several years prior to 2005, we had been harvesting timber in Idaho at a level below the estimated long-term sustainable harvest level. Due to a current imbalance in timber ages on our Idaho timberlands, beginning in 2005 and for a period of approximately 5-10 years, we expect to significantly increase the timber harvest level on our Idaho timberlands in order to improve the long-term productivity and sustainability of these timberlands. We also anticipate that, as a result of this period of increased timber harvest activity, the annual harvest levels on our existing Idaho timberlands will subsequently decrease to a level below the sustainable harvest level for a period of time, before increasing again to achieve the optimal long-term sustainable harvest level. On a short-term basis, our timber harvest levels may be impacted by factors such as demand for timber and harvesting capacity. We also experience seasonally lower harvest activity during the winter and early spring due to weather conditions. Longer term, our timber harvest levels may also be affected by purchases of additional timberlands, sales of existing timberlands and changes in estimates of long-term sustainable yield because of genetic improvements and other silvicultural advances, as well as by natural disasters, regulatory constraints and other factors beyond our control.

Beginning in the fourth quarter of 2005, our 17,000 acre hybrid poplar plantation in Boardman, Oregon, transitioned from a development stage to an operating stage. As a result, we expect to increase our harvest and sale of wood fiber over the next three to five years to a sustainable annual harvest level of approximately 340,000 tons and thereby increase our cash flow from the plantation operations. The increased harvests will also increase the amount of depletion and depreciation expense that we expect to incur as we amortize our approximate \$100 million investment in the plantation over an eleven-year harvest cycle. This plantation was originally established to provide an alternative source of wood chips for pulp making. In 2001, due to declining wood chip prices, we altered our strategy for the plantation toward the production of high quality logs for conversion into higher value, non-structural lumber products, such as furniture and moldings. It is our belief that hybrid poplar lumber will serve as a cost-competitive alternative to other regional hardwood species, mainly red alder, which are in tight supply. However, because there are no other producers of hybrid poplar sawlogs in the United States, it is uncertain whether we will be successful in developing an adequate market for hybrid poplar lumber. The cash flow that we will generate from our Boardman operation will depend primarily on the development of new markets for products manufactured from hybrid poplar sawlogs and on the prices we are able to obtain for hybrid poplar sawlogs converted into these products.

The operating results of our manufacturing operations generally reflect the cyclical pattern of the forest products industry. Historical prices for our manufactured products have been volatile, and we, like other manufacturers in the forest products industry, have very limited influence over the timing and extent of price changes for our products. Product pricing is significantly affected by the relationship between supply and demand. Product supply is influenced primarily by fluctuations in available manufacturing capacity. Demand is affected by the state of the economy in general and a variety of other factors. The demand for our wood products is affected by the level of new residential construction activity and, to a lesser extent, home repair and remodeling activity, which are subject to fluctuations due to changes in economic conditions, interest rates, population growth, weather conditions and other factors. The demand for most of our pulp and paperboard products is primarily affected by the general state of the global economy, and the economies in North America and East Asia in particular. The demand for our tissue products is primarily affected by the state of the United States economy.

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The markets for our products are highly competitive and companies that have substantially greater financial resources than we do compete with us in each of our lines of business. Logs and other fiber from our timberlands, as well as our wood products, are subject to competition from timberland owners and wood products manufacturers in North America and to a lesser extent in South America, Europe, Australia and New Zealand. Our pulp-based products, other than tissue products, are globally traded commodity products. Because our competitors in these segments are located throughout the world, variations in exchange rates between the U.S. dollar and other currencies can significantly affect our competitive position compared to our international competitors. As it is generally not profitable to sell tissue products overseas due to high transportation costs, currency exchange rates do not have a major effect on our ability to compete in our tissue business.

Tariffs, quotas or trade agreements can also affect the markets for our products, particularly our wood products. For example, in 2002, the United States imposed duties on imported lumber from Canada in response to a dispute over the stumpage pricing policies of some provincial governments. On April 27, 2006, the United States and Canada announced a negotiated agreement to end the trade dispute. The final agreement was implemented on October 13, 2006, at which time the United States ceased collecting duties on Canadian softwood lumber imports, and Canada initiated the imposition of taxes or quotas on Canadian softwood exports in accordance with the terms of the settlement agreement. The agreement also requires the United States to return to Canada approximately U.S. \$5 billion of duties the United States had collected on Canadian softwood lumber imports. Canada, in turn, is required to pay approximately U.S. \$1 billion to the United States, of which approximately U.S. \$500 million will be distributed to members of the Coalition for Fair Lumber Imports, of which Potlatch is a member. We expect to receive about \$40 million of the \$500 million as our pro rata share of the funds to be returned to the coalition. The settlement agreement requires Canada to return all money due to US interests within six months. We expect to receive 50% or more of our share of the amount to be returned in the fourth quarter of 2006. The seven year agreement, with a renewal clause, brings to close over 20 years of litigation and is expected to have a stabilizing effect on the North American softwood lumber marketplace while relieving the political tension that has accompanied the longstanding dispute.

Our manufacturing businesses are capital intensive, which leads to high fixed costs and generally results in continued production as long as prices are sufficient to cover variable costs. These conditions have contributed to substantial price competition, particularly during periods of reduced demand. Some of our competitors may currently be lower-cost producers in some of the businesses in which we operate, and accordingly these competitors may be less adversely affected than we are by price decreases. For the periods presented in this Form 10-Q, temporary downtime was taken at two of our facilities due to an inability to cover variable costs. Our Prescott and Warren, Arkansas, lumber mills took approximately four weeks and three weeks of downtime, respectively. The profitability of our manufacturing segments depends largely on our ability to operate our manufacturing facilities efficiently and at or near full capacity. Our operating results can be adversely affected if market demand does not justify operating at these levels or if our operations are inefficient or suffer significant interruption for any reason.

Energy costs, which have become one of our most volatile operating expenses over the past several years, impact almost every aspect of our operations, from natural gas used at our manufacturing facilities to in-bound and out-bound transportation surcharges. In periods of high energy prices, market conditions may prevent us from passing higher energy costs on to our customers through price increases, and therefore such increased costs could adversely affect our operating results. We have taken steps through conservation and electrical production to reduce our exposure to both the volatile spot market for energy and to rate increases by regulated utilities. Our energy costs in future periods will depend principally on our ability to continue to produce a substantial portion of our electricity needs internally, on changes in market prices for natural gas and on reducing energy usage.

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Another significant expense is the cost of wood fiber needed to supply our manufacturing facilities. The cost of various types of wood fiber that we purchase in the market has at times fluctuated greatly because of economic or industry conditions. Selling prices of our products have not always increased in response to wood fiber price increases, nor have wood fiber prices always decreased in conjunction with declining product prices. On occasion, our results of operations have been and may in the future be adversely affected if we are unable to pass cost increases through to our customers.

The disparity between the cost of wood fiber harvested from our timberlands and the cost of wood fiber purchased on the open market is due to the fact that the capitalized costs to establish our fee timber were expended many years ago. Our initial stand establishment costs remain as a capitalized asset until the timber reaches maturity, which typically ranges from 30 to 60 years. Ongoing forest management costs, which include recurring items necessary to the ownership and administration of timber producing property, are expensed as incurred. The cost of purchased wood fiber is significantly higher due to the fact that the wood fiber being purchased from third parties is mature and is purchased at the current market price.

Changes in our manufacturing capacity, primarily as a result of capital spending programs or asset purchases and dispositions, have affected our results of operations in recent periods. In May 2005, we purchased a lumber mill in Gwinn, Michigan. This change has affected or will affect our levels of net revenues and expenses, as well as the comparability of our operating results from period to period.

It is our practice to periodically review strategic and operational alternatives to improve our operating results and financial position. In this regard, we will continue to consider, among other things, adjustments to our capital expenditures and overall spending, the expanding or restructuring of our operations to achieve efficiencies, and the disposition of assets that may have greater value to others. There can be no assurance that we will be successful in implementing any new strategic or operational initiatives or, if implemented, that they will have the effect of improving our operating results and financial position.

As a REIT, we expect to be better able to compete for acquisitions of timberlands against other entities that use tax-efficient structures. It is uncertain whether any material timberland acquisitions will occur and, if an acquisition is consummated, whether it will perform in accordance with our expectations. In addition, we anticipate financing acquisitions through cash from operations, borrowings under our credit facility or proceeds from equity or debt offerings. Our inability to finance future acquisitions on favorable terms or the failure of any acquisition to perform as we expect could harm our results of operations.

## Critical Accounting Policies

Our principal accounting policies are discussed on pages 51-55 of our Annual Report on Form 10-K for the year ended December 31, 2005. The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported financial position and operating results of the company. Management believes the critical accounting policies discussed below represent the most complex, difficult and subjective judgments it makes in this regard.

Long-lived assets. Due to the capital-intensive nature of our industry, a significant portion of our total assets are invested in our manufacturing facilities. Also, the cyclical patterns of our businesses cause cash flows to fluctuate by varying degrees from period to period. As a result, long-lived assets are a material component of our financial position with the potential for material change in valuation if assets are determined to be impaired. We account for impairment of long-lived assets in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. SFAS No. 144 requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable, as measured by its undiscounted estimated future cash flows. We use our operational budgets to estimate future cash



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flows. Budgets are inherently uncertain estimates of future performance due to the fact that all inputs (revenues, costs, capital spending) are subject to frequent change for many different reasons, as previously described in Factors Affecting Our Results of Operations and Cash Flows. Because of the number of variables involved, the interrelationship between the variables and the long-term nature of the impairment measurement, sensitivity analysis of individual variables is not practical. Budget estimates are adjusted periodically to reflect changing business conditions and operations are reviewed, as appropriate, for impairment using the most current data available. To date, this process has not resulted in an impairment charge for any of our assets.

**Timber and timberlands.** Timber and timberlands are recorded at cost, net of depletion. Expenditures for reforestation, including all costs related to stand establishment, such as site preparation, costs of seeds or seedlings and tree planting, are capitalized. Expenditures for forest management, consisting of regularly recurring items necessary to the ownership and administration of our timber and timberlands, are accounted for as current operating expense. Our cost of timber harvested is determined based on costs capitalized and the related current estimated recoverable timber volume. Recoverable volume does not include anticipated future growth, nor are anticipated future costs considered.

There are currently no authoritative accounting rules relating to costs to be capitalized in the timber and timberlands category. We have used relevant portions of current accounting rules, industry practices and our judgment in determining costs to be capitalized or expensed. Alternate interpretations and judgments could significantly affect the amounts capitalized. Additionally, models and observations used to estimate the current recoverable timber volume on our lands are subject to judgments that could significantly affect volume estimates. Following are examples of factors that add to the complexity of the assumptions we make regarding capitalized or expensed costs:

harvest cycles can vary by geographic region and by species of timber;

weather patterns can affect annual harvest levels;

environmental regulations and restrictions may limit the company's ability to harvest certain timberlands;

changes in harvest plans may occur;

scientific advancement in seedlings and timber growing technology may affect future harvests; and

land sales and acquisitions affect volumes available for harvest.

Different assumptions for either the cost or volume estimates, or both, could have a significant effect upon amounts reported in our statements of operations and financial condition. Because of the number of variables involved and the interrelationship between the variables, sensitivity analysis of individual variables is not practical.

**Environmental liabilities.** We record accruals for estimated environmental liabilities in accordance with SFAS No. 5, Accounting for Commitments and Contingencies. These estimates reflect assumptions and judgments as to the probable nature, magnitude and timing of required investigation, remediation and monitoring activities. In making these estimates, we consider, among other things, the activities we have conducted at any particular site, information obtained through consultation with applicable regulatory authorities and third-parties, and our historical experience at other sites that are judged to be comparable. We must also consider the likelihood of changes in governmental regulations, advancements in environmental technologies, and changing legal standards regarding liability. Due to the numerous uncertainties and variables associated with these assumptions and judgments, and changes in governmental regulations and environmental technologies, our accruals are subject to substantial uncertainties and our actual costs could be materially more or less than the estimated amounts.

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**Pension and postretirement benefits.** The determination of pension plan expense and the requirements for funding our pension plans are based on a number of actuarial assumptions. Two critical assumptions are the discount rate applied to pension plan obligations and the rate of return on plan assets. For other postretirement employee benefit (OPEB) plans, which provide certain health care and life insurance benefits to qualified retired employees, critical assumptions in determining OPEB expense are the discount rate applied to benefit obligations and the assumed health care cost trend rates used in the calculation of benefit obligations.

Note 12 to our 2005 Form 10-K consolidated financial statements included information for the three years ended December 31, 2005, on the components of pension and OPEB expense and the underlying actuarial assumptions used to calculate periodic expense, as well as the funded status for our pension and OPEB plans as of December 31, 2005 and 2004. Note 8, Pension and Other Postretirement Benefit Plans, on page 14 of this Form 10-Q, includes information on the components of pension and OPEB expense for the quarters and nine months ended September 30, 2006 and 2005.

The discount rate used in the determination of pension benefit obligations and pension expense is based on high-quality fixed income investment interest rates. At December 31, 2005, we calculated obligations using a 5.60% discount rate. The discount rates used at December 31, 2004 and 2003 were 5.90% and 6.25%, respectively. To determine the expected long-term rate of return on pension assets, we employ a process that analyzes historical long-term returns for various investment categories, as measured by appropriate indices. These indices are weighted based upon the extent to which plan assets are invested in the particular categories in arriving at our determination of a composite expected return. The assumed long-term rate of return on pension plan assets used for the three-year period ended December 31, 2005, was 9.5%. Over the past 28 years, the period we have actively managed pension assets, our actual average annual return on pension plan assets has been approximately 11.5%.

Total periodic pension plan income in 2005 was \$14.1 million. An increase in the discount rate or the expected return on plan assets, all other assumptions remaining the same, would increase pension plan income, and conversely, a decrease in either of these measures would decrease plan income. As an indication of the sensitivity that pension income has to the discount rate assumption, a 25 basis point change in the discount rate would affect annual plan income by approximately \$1.4 million. A 25 basis point change in the assumption for expected return on plan assets would affect annual plan income by approximately \$1.6 million. The actual rates on plan assets may vary significantly from the assumption used because of unanticipated changes in financial markets.

No minimum pension contributions to our qualified plans are required for 2006 due to the funded status of those pension plans at December 31, 2005. However, we expect to make contributions to our pension plans totaling approximately \$19.5 million in 2006, consisting of a \$1.4 million contribution to our non-qualified plan and a voluntary \$18.1 million contribution to our qualified plans.

For our OPEB plans, expense for 2005 was \$29.6 million. The discount rate used to calculate OPEB obligations was 5.60% at December 31, 2005, and 5.90% and 6.25% at December 31, 2004 and 2003, respectively. The assumed health care cost trend rate used to calculate OPEB obligations and expense for 2005 was a 12% increase over the previous year, with the rate of increase scheduled to decline one percent annually to a long-term ultimate rate increase assumption of 6% for 2011 and thereafter.

As an indication of the sensitivity that OPEB expense has to the discount rate assumption, a 25 basis point change in the discount rate would affect annual plan expense by approximately \$1.2 million. A 1% change in the assumption for health care cost trend rates would have affected 2005 plan expense by approximately \$2.0 - \$2.4 million and the total postretirement obligation by approximately \$29.5 - \$34.8 million. The actual rates of health care cost increases may vary significantly from the assumption used because of unanticipated changes in health care costs.

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Periodic pension and OPEB expense are included in Materials, labor and other operating expenses and Selling, general and administrative expenses in the Statements of Operations. The expense is allocated to all business segments. Depending upon the funded status of the different plans, either a long-term asset or long-term liability is recorded for plans with overfunding or underfunding, respectively. Any unfunded accumulated pension benefit obligation in excess of recorded liabilities is accounted for in stockholders' equity in accumulated other comprehensive income. See Note 12 to our 2005 Form 10-K financial statements for related balance sheet effects at December 31, 2005 and 2004.

**Results of Operations**

As noted above, our business is organized into five reporting segments: Resource; Land Sales and Development; Wood Products; Pulp and Paperboard; and Consumer Products. Sales or transfers between segments are recorded as intersegment revenues based on prevailing market prices. Because of the role of the Resource segment in supplying our manufacturing segments with wood fiber, intersegment revenues represent a significant portion of the Resource segment's total net revenues. Intersegment revenues represent a substantially smaller percentage of revenues for our other segments.

The following table sets forth period-to-period changes in items included in our Statements of Operations for the quarters and nine months ended September 30, 2006 and 2005.

	Quarter Ended September 30			Nine Months Ended September 30		
	2006	2005	Increase (Decrease)	2006	2005	Increase (Decrease)
	(Dollars in thousands)					
Revenues	\$ 398,108	\$ 405,540	(2%)	\$ 1,215,212	\$ 1,110,923	9%
Costs and expenses:						
Depreciation, depletion and amortization	22,989	21,729	6%	67,995	60,404	13%
Materials, labor and other operating expenses	334,625	340,359	(2%)	1,028,248	932,169	10%
Selling, general and administrative expenses	23,206	18,999	22%	68,946	61,284	13%
Earnings from operations	17,288	24,453	(29%)	50,023	57,066	(12%)
Interest expense	(7,229)	(7,236)	%	(21,911)	(21,722)	1%
Debt retirement costs	53		*	53		*
Interest income	355	514	(31%)	1,452	1,827	(21%)
Provision (benefit) for taxes	(13,765)	6,641	*	(65,386)	14,125	*
Net earnings	\$ 24,232	\$ 11,090	119%	\$ 95,003	\$ 23,046	312%

\* Not a meaningful figure.

Certain 2005 amounts have been reclassified to conform to the 2006 presentation.

In the period-to-period discussion of our results of operations below, when we discuss our consolidated revenues, contributions by each of the segments to our revenues are reported after elimination of intersegment revenues. In the Discussion of Business Segments section below, each segment's revenues are set forth before elimination of intersegment revenues.

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*Quarter Ended September 30, 2006, Compared to Quarter Ended September 30, 2005*

**Revenues** Total revenues decreased 2% to \$398.1 million for the quarter ended September 30, 2006, from \$405.5 million for the same period in 2005. Resource segment revenues decreased \$3.9 million to \$30.6 million for the third quarter of 2006, primarily due to decreased sales of logs to external customers in Arkansas. Land Sales and Development revenues were \$1.1 million for the third quarter of 2006, compared to \$6.9 million for the third quarter of 2005. The decrease was due to fewer strategic land sales in the third quarter of 2006. Wood Products revenues were \$113.5 million for the third quarter of 2006, a \$13.7 million decrease from \$127.2 million in the third quarter of 2005, primarily as a result of decreased shipments and lower sales prices for lumber. Revenues for the Pulp and Paperboard segment decreased to \$139.6 million for the third quarter of 2006, compared to \$141.4 million for the third quarter of 2005, primarily due to decreased shipments of paperboard and pulp to external customers. Consumer Products revenues were \$113.2 million for the third quarter of 2006, \$17.7 million more than in the same 2005 period due to increased shipments and higher selling prices for consumer tissue products.

**Depreciation, depletion and amortization** For the quarter ended September 30, 2006, depreciation, depletion and amortization totaled \$23.0 million, compared to \$21.7 million for the same period in 2005. The increase was primarily due to depreciation and higher depletion expense related to our Boardman, Oregon, hybrid poplar operation.

**Materials, labor and other operating expenses** Materials, labor and other operating expenses decreased from \$340.4 million for the third quarter of 2005 to \$334.6 million for the quarter ended September 30, 2006. The lower costs were due primarily to decreased lumber, paperboard and pulp shipments, partially offset by higher wood fiber and maintenance costs for the Pulp and Paperboard segment and higher pulp costs for the Consumer Products segment.

**Selling, general and administrative expenses** For the third quarter of 2006, selling, general and administrative expenses were \$23.2 million, compared to \$19.0 million incurred for the same period in 2005. The increase was due to higher compensation, consulting and bad debt expenses in 2006.

**Interest expense** Interest expense totaled \$7.2 million for both the quarter ended September 30, 2006, and the quarter ended September 30, 2005.

**Debt retirement costs** During the third quarter of 2006, the remaining \$5.5 million balance of our 10% Senior Subordinated Notes was redeemed. In association with the redemption, we incurred pre-tax expenses of \$0.3 million for premium-related costs and \$0.1 million for deferred debt issuance costs. These expenses were more than offset by interest rate swap income associated with the notes.

**Interest income** For the quarter ended September 30, 2006, interest income was \$0.4 million, compared to \$0.5 million for the same period in 2005.

**Provision (benefit) for taxes** For the quarter ended September 30, 2006, an income tax benefit of \$13.8 million was recorded, compared to an income tax provision of \$6.6 million recorded in the third quarter of 2005. The third quarter of 2006 included a net tax benefit of \$9.2 million primarily related to an agreement reached with the Internal Revenue Service (IRS) regarding tax issues pertaining to open tax years. Excluding this net tax benefit, the company recorded an income tax benefit of \$4.6 million, which was due to a pre-tax loss for Potlatch's taxable REIT subsidiary, or Potlatch TRS. The income tax provision for the third quarter of 2005 reflected the adjustment of the estimated tax rate to 38.0% from 38.5% used for the first half of 2005. The estimated effective tax rate was reduced in the third quarter of 2005 to incorporate the anticipated effect of the Qualified Domestic Production Activity deduction and the estimated effect of changes to state tax apportionments.

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**Net Earnings** For the quarter ended September 30, 2006, we recorded net earnings of \$24.2 million, compared to net earnings of \$11.1 million for the same period in 2005. The benefit for taxes discussed above and better results for the Pulp and Paperboard and Consumer Products segments were responsible for the higher earnings.

**Discussion of business segments**

The Resource segment reported operating income of \$19.3 million for the three months ended September 30, 2006, down from \$20.0 million earned in the third quarter of 2005. Revenues for the segment were \$84.7 million for the third quarter of 2006, compared to \$90.8 million for the same period in 2005. The decrease in revenues was attributable to a decreased harvest of fee timber and lower selling prices for logs in Arkansas. Resource segment expenses were \$65.4 million in the third quarter of 2006, compared to \$70.8 million in the third quarter of 2005. The lower expenses were due primarily to the decreased harvest of fee timber in Arkansas, partially offset by higher costs for our Boardman, Oregon, hybrid poplar operation. The Boardman operation was in a development stage in the third quarter of 2005, and most of the expenses were capitalized in that quarter. Following the start of harvesting operations in late 2005, most operating costs are now expensed against income.

The Land Sales and Development segment reported operating income of \$0.8 million for the third quarter of 2006, compared to \$6.0 million for the third quarter of 2005. Results for this segment depend on the timing of closing of transactions resulting from our efforts to identify, develop and market property with higher and better use values. Revenues for the segment were \$1.1 million for the 2006 quarter, versus \$6.9 million for the same period of 2005. The decreased revenues for the segment were due to fewer strategic land sales in the third quarter of 2006. Most of our land sales activity was on hold during the third quarter of 2006 pending our assessment of all our lands for alternative values, which is expected to be completed in late 2006. Expenses for the segment were \$0.4 million for the third quarter of 2006, compared to \$0.9 million for the same period in 2005.

The Wood Products segment reported an operating loss of \$5.2 million for the quarter ended September 30, 2006, compared to income of \$5.9 million recorded in the third quarter of 2005. Segment revenues were \$117.5 million for the third quarter of 2006, compared to \$131.0 million for the same period in 2005. Lumber revenues were \$89.7 million, down from \$103.8 million in 2005. The lower lumber revenues were due to an 11% decrease in shipments and lower selling prices. Lumber shipments for the third quarter of 2006 were negatively affected by temporary downtime taken at our Arkansas lumber mills due to poor market conditions. Our Prescott and Warren, Arkansas, lumber mills took four and three weeks of downtime, respectively, during the third quarter of 2006. Plywood revenues were \$12.7 million for the third quarter of 2006, slightly lower than \$12.9 million reported in the third quarter of 2005. Particleboard revenues were \$5.9 million for the third quarter of 2006, compared to \$4.0 million for the same period of 2005, due primarily to a 30% increase in selling prices and increased shipments. Other sales for the segment, which consist primarily of by-products such as chips, were \$9.2 million for the quarter ended September 30, 2006, compared to \$10.2 million for the third quarter of 2005. Segment expenses were lower for the third quarter of 2006, totaling \$122.7 million versus \$125.0 million for the third quarter of 2005. Decreased lumber shipments were primarily responsible for the lower segment expenses.

The Pulp and Paperboard segment reported operating income for the third quarter of 2006 of \$14.3 million, compared to \$0.4 million for the third quarter of 2005. Segment revenues were \$154.4 million for the third quarter of 2006, \$2.9 million higher than the \$151.5 million recorded in the same period of 2005. Paperboard revenues decreased to \$131.1 million, compared to \$133.2 million reported for the third quarter of 2005. The unfavorable comparison was primarily due to decreased shipments, partially offset by higher selling prices. Pulp revenues (including intersegment revenues) were \$23.0 million for the three months ended September 30, 2006, \$4.9 million higher than the \$18.1 million recorded in the third quarter of 2005. The increase in pulp revenues was due to significantly higher selling prices, partially offset by decreased shipments to external customers. Expenses for the segment were \$140.1 million for the third quarter of 2006, compared to \$151.1 million for the same period in 2005. The lower expenses

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were due to the decreased shipments of paperboard and pulp and lower energy costs, partially offset by higher wood fiber and maintenance costs.

The Consumer Products segment reported operating income of \$6.2 million for the three months ended September 30, 2006, compared to \$2.4 million for the third quarter of 2005. Revenues for the segment were \$113.2 million for the third quarter of 2006, a 19% increase from \$95.5 million recorded in the same period of 2005. The significant increase in revenues was due to a 12% increase in shipments and higher net selling prices. The increased shipments were primarily the result of our plan to reduce inventories. The higher net selling prices were due to a combination of price increases and sheet count reductions. Segment expenses were \$107.0 million for the third quarter of 2006, compared to \$93.2 million for the third quarter of 2005. The higher expenses were largely attributable to the increased shipments of consumer tissue products and higher pulp costs.

*Nine Months Ended September 30, 2006, Compared to Nine Months Ended September 30, 2005*

**Revenues** For the nine months ended September 30, 2006, revenues increased 9%, to \$1.22 billion, from \$1.11 billion for the same period in 2005. Resource revenues increased to \$87.9 million, compared to \$75.5 million for the first nine months of 2005. The increased revenues were due primarily to increased sales of Idaho logs to external customers. Land Sales and Development revenues were \$3.8 million for the first nine months of 2006, \$5.7 million less than for the same period in 2005 due to fewer strategic land sales. Wood Products revenues increased to \$379.3 million, from \$358.8 million for the first nine months of 2005, due primarily to increased lumber and plywood shipments. Pulp and Paperboard segment revenues were \$414.4 million for the nine months ended September 30, 2006, \$28.5 million more than in the same period in 2005 due to increased shipments and higher selling prices for paperboard and pulp to external customers. Consumer Products segment revenues increased to \$329.8 million from \$281.1 million due to higher selling prices and increased shipments of consumer tissue products.

**Depreciation, depletion and amortization** - For the nine months ended September 30, 2006, depreciation, depletion and amortization totaled \$68.0 million, compared to \$60.4 million recorded in the first nine months of 2005. The increase was primarily due to depreciation and higher depletion expense related to our Boardman, Oregon, hybrid poplar operation, combined with higher depreciation related to the Gwinn, Michigan, lumber mill acquired in May 2005.

**Materials, labor and other operating expenses** - Materials, labor and other operating expenses increased to \$1.03 billion for the nine months ended September 30, 2006, from \$932.2 million for the nine months ended September 30, 2005. The higher costs were due primarily to increased lumber, plywood, pulp, paperboard and consumer tissue shipments, higher log and freight costs for the Wood Products segment, higher maintenance and freight costs for the Pulp and Paperboard segment, and higher pulp and packaging costs for the Consumer Products segment.

**Selling, general and administrative expenses** - Selling, general and administrative expenses were \$68.9 million for the first nine months of 2006, compared to \$61.3 million incurred for the same period of 2005. The increase was primarily due to higher compensation, bad debt and consulting expenses in 2006.

**Interest expense** - Interest expense totaled \$21.9 million for the nine months ended September 30, 2006, compared to \$21.7 million in the prior year period.

**Debt retirement costs** During the first nine months of 2006, the remaining \$5.5 million balance of our 10% Senior Subordinated Notes was redeemed. In association with the redemption, we incurred pre-tax expenses of \$0.3 million for premium-related costs and \$0.1 million for deferred debt issuance costs. These expenses were more than offset by interest rate swap income associated with the notes.

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**Interest income** For the nine months ended September 30, 2006, interest income was \$1.5 million, compared to \$1.8 million for the same period in 2005.

**Provision (benefit) for taxes** - For the nine months ended September 30, 2006, we recorded an income tax benefit of \$65.4 million. The tax benefit was largely due to the reversal of \$51.2 million in timber-related deferred tax liabilities that were no longer necessary as a result of our REIT conversion, as well as a net tax benefit of \$9.2 million primarily related to an agreement reached with the IRS during the third quarter of 2006 regarding tax issues pertaining to open tax years. Excluding these tax benefits, we recorded an income tax benefit of \$5.0 million, which was due to a pre-tax loss for Potlatch TRS. For the first nine months of 2005, an estimated tax rate of 38.0% was used to derive an income tax provision of \$14.1 million, calculated on our income from operations, before taxes, of \$37.2 million.

**Net earnings** - We recorded net earnings of \$95.0 million for the nine months ended September 30, 2006, compared to net earnings of \$23.0 million for the same period in 2005. The tax benefit discussed above and better results for the Consumer Products and Pulp and Paperboard segments were primarily responsible for the higher earnings.

**Discussion of business segments**

The Resource segment reported operating income of \$43.4 million for the first nine months of 2006, compared to \$43.0 million for the same period of 2005. Segment revenues were \$218.7 million for the first nine months of 2006, compared to \$209.2 million recorded for the same period in 2005. The higher revenues for 2006 were due to an increased harvest of fee timber and higher selling prices for logs in Idaho, partially offset by a decreased harvest of fee timber and lower selling prices in Arkansas. Resource segment expenses were \$175.3 million in the first nine months of 2006, compared to \$166.2 million in the first nine months of 2005. The increased expenses reflected the higher costs associated with the increased harvest of fee timber in Idaho and higher costs at our Boardman operation. The Boardman operation was in a development stage in the first nine months of 2005, and most of the expenses were capitalized. Following the start of harvesting operations in late 2005, most operating costs are now expensed against income.

The Land Sales and Development segment reported operating income of \$2.8 million for the first nine months of 2006, compared to \$7.5 million for the first nine months of 2005. Revenues for the segment were \$3.8 million for the first nine months of 2006, versus \$9.5 million for the same period of 2005. The lower revenues for the segment were due to fewer strategic land sales in the first nine months of 2006. Most of our land sales activity has been on hold during 2006 pending the assessment of all our lands for alternative values, which is expected to be completed in late 2006. Expenses for the segment were \$1.0 million for the first nine months of 2006, compared to \$2.0 million for the same period of 2005.

The Wood Products segment reported operating income of \$5.6 million for the first nine months of 2006, compared to income of \$28.2 million recorded in the first nine months of 2005. Revenues for the segment rose to \$390.4 million for the first nine months of 2006, 6% higher than the \$370.0 million recorded for the same period in 2005. Lumber revenues were \$302.8 million, up from \$289.6 million in the same period in 2005. The favorable comparison was primarily due to increased lumber shipments from our Gwinn, Michigan, lumber mill, which we acquired in May 2005, and our Lewiston, Idaho, lumber mill. Lower selling prices for lumber and temporary downtime taken in 2006 at our Prescott and Warren, Arkansas, lumber mills, due to poor market conditions, partially offset the increased shipments at Gwinn and Lewiston. Plywood revenues increased to \$42.5 million for the first nine months of 2006, compared to \$40.2 million for the first nine months of 2005. The increased plywood revenues were due to a 6% increase in shipments. Particleboard revenues were \$15.1 million for the first nine months of 2006, \$1.8 million higher than the \$13.3 million recorded for the first nine months of 2005 due to higher selling prices and increased shipments. Other sales for the segment were \$30.1 million for the first nine months of 2006, 12% higher than the \$26.9 million recorded for the first nine months of 2005, due largely to chip sales at our Gwinn lumber mill. Segment expenses were higher for the first nine months

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of 2006, totaling \$384.8 million, versus \$341.8 million for the first nine months of 2005. Increased lumber and plywood shipments and higher log costs largely accounted for the increase over 2005.

The Pulp and Paperboard segment reported operating income of \$16.6 million for the first nine months of 2006, compared with \$2.7 million for the first nine months of 2005. Segment revenues were \$450.5 million for the first nine months of 2006, up from \$418.7 million for the same period in 2005. Paperboard revenues increased to \$395.7 million for the first nine months of 2006, compared to \$372.7 million in the first nine months of 2005. Higher selling prices and increased shipments were primarily responsible for the increased revenues. Pulp revenues (including intersegment revenues) were higher for the first nine months of 2006, totaling \$53.8 million, compared to \$45.3 million for the same period in 2005. The increase in pulp revenues for the 2006 period was due to higher selling prices and increased shipments to external customers. Segment expenses were higher for the first nine months of 2006, totaling \$433.9 million, compared to \$416.0 million in the first nine months of 2005. The increase reflected the higher volumes of pulp and paperboard shipments for the first nine months of 2006 compared to 2005, combined with higher maintenance and freight costs.

The Consumer Products segment reported operating income of \$20.1 million for the first nine months of 2006, compared to \$3.2 million for the first nine months of 2005. Segment revenues were \$329.9 million for the first nine months of 2006, \$48.7 million higher than the \$281.2 million recorded for the same period in 2005. The increase in revenues was due to higher selling prices and increased shipments compared to the prior year period. The higher selling prices in 2006 were attributable to a combination of price increases and sheet count reductions, and the increased shipments were primarily the result of our plan to reduce inventories. Segment expenses were higher for the first nine months of 2006, totaling \$309.9 million, versus \$278.0 million in the first nine months of 2005. Increased shipments and higher pulp and packaging costs were primarily responsible for the higher segment expenses.

## Funds from Operations

Funds from Operations, or FFO, is a non-GAAP measure that is commonly used by REITs in the real estate industry. The most directly comparable GAAP measure to FFO is net earnings. Although the National Association of Real Estate Investment Trusts<sup>®</sup>, or NAREIT, has published a definition of FFO, modifications to the NAREIT definition of FFO are common among REITs, as companies seek to provide financial measures that meaningfully reflect their businesses. FFO as we define it is presented as a supplemental financial measure. We do not use FFO as, nor should it be considered to be, an alternative to net earnings computed under GAAP as an indicator of our operating performance or as an alternative to cash from operating activities computed under GAAP as an indicator of our ability to fund our cash needs. FFO, as we define it, may not be comparable with measures of similar titles reported by other companies.

We define FFO as net earnings, less the benefit from taxes resulting from the reversal of timber-related deferred tax liabilities that are no longer necessary as a result of our REIT conversion, plus depreciation, depletion and amortization. For the third quarter of 2006, FFO also excludes the benefit from taxes related to the agreement reached with the IRS regarding tax issues pertaining to open tax years. Management believes that FFO is a meaningful supplemental measure of our operating performance because historical cost accounting for assets such as our manufacturing facilities and timberlands assumes that the value of such assets diminishes predictably over time. However, the values of our manufacturing facilities and timberlands have historically risen and fallen based on market conditions for the products we manufacture and for timber and timberlands. Management also considers the FFO measure in determining, among other things, quarterly and annual distribution rates to recommend to our board of directors, future levels of capital spending and debt repayment. We disclose this supplemental financial measure to enable investors to align their analysis and evaluation of our operating results along the same lines as management uses in planning and executing our business strategy.



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For the quarter and nine months ended September 30, 2006, FFO was \$38.0 million and \$102.6 million, respectively, compared to \$32.8 million and \$83.5 million for the quarter and nine months ended September 30, 2005, respectively.

Below is a reconciliation of Net Earnings to FFO for the quarters and nine months ended September 30, 2006 and 2005:

(Dollars in thousands)	Quarter Ended September 30		Nine Months Ended September 30	
	2006	2005	2006	2005
Net earnings	\$ 24,232	\$ 11,090	\$ 95,003	\$ 23,046
Benefit from taxes related to REIT conversion and deferred tax adjustment	(9,216)		(60,398)	
Depreciation, depletion and amortization	22,989	21,729	67,995	60,404
Funds from Operations	\$ 38,005	\$ 32,819	\$ 102,600	\$ 83,450

**Liquidity and Capital Resources**

At September 30, 2006, our financial position included long-term debt of \$327.6 million, including current installments on long-term debt of \$3.2 million. Long-term debt at September 30, 2006 (including current installments) decreased from the balance at December 31, 2005 of \$335.5 million due to the redemption of the remaining \$5.5 million of our 10% Senior Subordinated Notes and normal repayments on maturing debt of \$2.4 million. The Senior Subordinated Notes, which had a maturity of 2011, were redeemed on July 15, 2006. Stockholders' equity for the first nine months of 2006 decreased by \$40.2 million due to distributions to common stockholders totaling \$146.1 million, which were partially offset by net earnings of \$95.0 million. The distributions to common stockholders consisted of the cash portion of the special E&P distribution, which totaled \$89.0 million, and regular quarterly distributions of \$57.1 million. The ratio of long-term debt (including current installments) to stockholders' equity was .49 to 1 at September 30, 2006, compared to .48 to 1 at December 31, 2005.

Scheduled payments due on long-term debt during each of the five years subsequent to December 31, 2006, are as follows:

(Dollars in thousands)	
2007	\$ 6,159
2008	209
2009	100,410
2010	11
2011	5,011

Working capital totaled \$144.2 million at September 30, 2006, a decrease of \$111.7 million from the December 31, 2005 balance of \$255.9 million. The significant changes in the components of working capital are as follows:

Short-term investments decreased by \$48.3 million. The decrease was due to the use of short-term investments to fund a portion of the cash distributions to common stockholders.

Inventories decreased by \$49.5 million, primarily due to decreases in tissue, log and lumber inventories. The lower tissue inventories were largely the result of our plan to reduce inventories for the Consumer Products segment. Unfavorable lumber market conditions, especially in Arkansas where temporary downtime was taken at our Prescott and Warren lumber mills, were primarily responsible for the lower log and lumber inventories.

Accounts payable and accrued liabilities increased \$18.9 million due primarily to increased accrual balances for interest, property taxes and employee benefits.



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Net cash provided by operating activities for the first nine months of 2006 totaled \$137.9 million, compared with \$43.9 million for the same period in 2005. Cash provided by working capital changes in the first nine months of 2006 of \$60.6 million, versus cash used for working capital changes of \$42.0 million in the first nine months of 2005, was largely responsible for the favorable comparison.

For the nine months ended September 30, 2006, net cash provided by investing activities was \$6.5 million, compared to net cash used for investing activities of \$36.7 million for the first nine months of 2005. In the first nine months of 2006, a decrease in our short-term investments provided \$48.3 million in cash, as discussed above, and we used \$37.2 million for capital spending. Capital spending in the first nine months of 2006 included \$3.7 million for a new bathroom tissue line at our tissue converting facility in Elwood, Illinois, and \$4.8 million toward the installation of coating equipment at our paperboard facility in Lewiston, Idaho. The balance of capital spending in the first nine months of 2006 focused on forest resources and various smaller projects designed to improve product quality and manufacturing efficiency. Cash was used in the first nine months of 2005 primarily for capital spending projects, partially offset by cash provided by a decrease in our short-term investments.

Net cash used for financing activities totaled \$143.2 million for the nine months ended September 30, 2006, compared with \$3.8 million during the same period in 2005. The cash used for financing in the first nine months of 2006 consisted of distributions to common stockholders of \$146.1 million and the repayment of \$7.8 million in long-term debt, which were slightly offset by the issuance of \$6.3 million of common stock related to the exercise of stock options and a \$3.2 million increase in book overdrafts. The majority of the cash used for financing activities in the first nine months of 2005 was for distributions to common stockholders, partially offset by the issuance of treasury stock related to the exercise of stock options.

In connection with our REIT conversion, we expect to increase our regular annual distribution rate from an aggregate amount of \$17.5 million in 2005 to approximately \$76 million in 2006. Based on historical operating results and taking into account planned increases in harvest activities on our Idaho timberlands, we expect to fund a substantial majority of these annual distributions using the cash flows from our REIT-qualifying timberland operations. Any shortfall between cash available for distribution from REIT operations and the anticipated initial annual distribution to stockholders of approximately \$76 million is expected to be funded through cash on hand, bank borrowings, dividends from Potlatch TRS, or a combination thereof. Our ability to fund distributions through bank borrowings is subject to our continued compliance with debt covenants, as well as the availability of borrowing capacity under our lending arrangements. If our operations do not generate sufficient cash flows and we are unable to borrow, we may be required to reduce our quarterly distributions. In addition, even if cash available for distribution from our REIT operations is sufficient on an annual basis to fund the entire distribution to stockholders, we anticipate that it will be necessary to utilize some short-term borrowing to fully fund distributions in the first half of each year as a result of the lower harvest activity during winter and early spring. Significant decreases in timber prices or other factors that materially adversely affect the cash flows from our REIT operations could result in our inability to maintain the expected distribution rate.

In addition, the rules with which we must comply to maintain our status as a REIT limit our ability to use dividends from our manufacturing businesses for the payment of stockholder distributions. In particular, at least 75% of our gross income for each taxable year as a REIT must be derived from sales of our standing timber and other types of real estate income. No more than 25% of our gross income may consist of dividends from Potlatch TRS and other non-qualifying types of income. This requirement may limit our ability to receive dividends from Potlatch TRS and may impact our ability to fund distributions to stockholders using cash flows from Potlatch TRS. Our board of directors, in its sole discretion, will determine the actual amount of distributions to be made to stockholders based on consideration of a number of factors, including, but not limited to, our results of operations, cash flow and capital requirements, economic conditions, tax considerations and borrowing capacity.

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Our current unsecured bank credit facility, which expires on December 22, 2008, provides for a revolving line of credit of up to \$175 million, including a \$35 million subfacility for letters of credit and a \$10 million subfacility for swing line loans. Usage under either or both subfacilities reduces availability under the revolving line of credit. As of September 30, 2006, there were no borrowings outstanding under the revolving line of credit; however, approximately \$14.4 million of the letter of credit subfacility was being used to support several outstanding letters of credit. Loans under the credit facility bear interest at LIBOR plus between 0.625% and 1.625% for LIBOR loans, and a base rate effectively equal to the bank's prime rate plus up to 0.625% for other loans. Currently, we are eligible to borrow under the credit facility at LIBOR plus 0.875%.

The agreement governing our credit facility contains covenants that, among other things, limit to a certain degree the ability of Potlatch and its subsidiaries to create liens, merge or consolidate, dispose of assets, incur indebtedness and guarantees, repurchase or redeem capital stock and indebtedness, make certain investments or acquisitions, enter into certain transactions with affiliates or change the nature of our business. The credit facility also contains financial maintenance covenants establishing a maximum funded indebtedness to capitalization ratio, a minimum consolidated net worth requirement, and a minimum interest coverage ratio. We will be permitted to pay dividends under the terms of the credit facility so long as we remain in pro forma compliance with the financial covenants.

The table below sets forth the most restrictive covenants in the credit facility and our status with respect to these covenants as of September 30, 2006.

	<b>Covenant Requirement</b>	<b>Actual Ratio at September 30, 2006</b>
Maximum Funded Indebtedness To Capitalization Ratio	55%	33.9%
Minimum Net Worth	80% of consolidated net worth at March 31, 2006 (1)	123.8%
Minimum Interest Coverage Ratio	2.75 to 1.00	5.56 to 1.00

- (1) The minimum requirement is 80% of consolidated net worth as of March 31, 2006, with an adjustment to the minimum requirement for the net cash proceeds, on a cumulative basis, of all equity issuances.

Events of default under the credit facility include, but are not limited to, payment defaults, covenant defaults, breaches of representations and warranties, cross defaults to certain other material agreements and indebtedness, bankruptcy and other insolvency events, material adverse judgments, actual or asserted invalidity of security interests or loan documentation, and certain change of control events involving our company.

Potlatch and several of its subsidiaries are parties to the credit agreement and eligible to borrow thereunder, subject to the \$175 million aggregate credit limit and continued compliance with debt covenants. Any borrowings by one of these entities under the credit facility reduces the credit available for all the entities. As a result, borrowings by Potlatch TRS under the credit facility would, until repaid, reduce the amount of borrowings otherwise available to Potlatch for purposes such as the funding of quarterly distributions.

We believe that our cash, cash flows from operations and available borrowings under our credit facility will be sufficient to fund our operations, stockholder distributions, capital expenditures and debt service obligations for the next twelve months. We cannot assure, however, that our business will generate sufficient cash flow from operations or that we will be in compliance with the financial covenants in our credit facility so that future borrowings thereunder will be available to us. Thus, our ability to fund our operations and stockholder distributions will be dependent upon our future financial

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performance, which will be affected by general economic, competitive and other factors, including those discussed above under the heading Factors Influencing our Results of Operations and Cash Flows, many of which are beyond our control.

In October 2005, Standard & Poor's Ratings Services (S&P) downgraded our senior unsecured debt from BB+ to BB. Since the first quarter of 2003, Fitch, Inc. has rated our senior unsecured debt at BB+. Moody's Investors Service Inc. has rated our senior unsecured debt at Ba1 and our senior secured subordinated debt at Ba2 since October 2004. Both Fitch and Moody's affirmed their ratings, with stable outlooks, in October 2005. The interest rate we pay on some of our debt is influenced by our credit ratings. See Item 3, Quantitative and Qualitative Disclosures About Market Risk below for additional information.

**ITEM 3. Quantitative and Qualitative Disclosures About Market Risk**

Our exposure to market risks on financial instruments includes interest rate risk on our short-term investments and unsecured bank credit facility, and credit rate risk on our credit sensitive debentures.

Our short-term investments are invested in time or demand deposits, certificates of deposit and U.S. Treasury and U.S. government agency obligations, all of which have very short maturity periods, and they therefore earn an interest rate commensurate with low-risk instruments. We do not attempt to hedge our exposure to interest rate risk for our short-term investments. All short-term investments are made in compliance with the requirements of the Internal Revenue Code with respect to qualifying REIT investments.

As of September 30, 2006, we had no borrowings outstanding under our unsecured bank credit facility. The interest rates applied to borrowings under the credit facility are adjusted often and therefore react quickly to any movement in the general trend of market interest rates. We do not attempt to mitigate the effects of short-term interest rate fluctuations on our credit facility borrowings through the use of derivative financial instruments.

All of our long-term debt is fixed rate and therefore changes in market interest rates do not expose us to interest rate risk for these financial instruments.

We currently have \$100 million of credit sensitive debentures outstanding that pay interest to the debt holder based upon our credit ratings as established by S&P or Moody's. The following table denotes the interest rate applicable based on various credit ratings:

Ratings		Applicable Rate(%)
Moody's	S&P	
Aaa	AAA	8.825
Aa1 Aa3	AA+ - AA-	8.925
A1 Baa2	A+ - BBB	9.125
Baa3	BBB-	9.425
Ba1	BB+	12.500
Ba2	BB	13.000
Ba3	BB-	13.500
B1 or lower	B+ or lower	14.000

On October 27, 2005, S&P announced that it had lowered our senior unsecured debt rating to BB from BB+. The rating downgrade caused the interest rate on our credit sensitive debentures to increase from 12.5% to 13.0%, effective October 27, 2005. Since October 2004, Moody's has rated our senior unsecured debt at Ba1. Moody's affirmed this rating, with a stable outlook, in October 2005.

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## QUANTITATIVE INFORMATION ABOUT MARKET RISKS

(Dollars in thousands)

	Expected Maturity Date (as of September 30, 2006)						Total
	2006	2007	2008	2009	2010	Thereafter	
Long-term debt:							
Fixed rate	\$	\$ 6,159	\$ 209	\$ 100,410	\$ 11	\$ 220,832	\$ 327,621
Average interest rate	%	6.1%	6.9%	13.0%	6.5%	6.9%	8.8%
Fair value at 9/30/06							\$ 350,722

**ITEM 4. Controls and Procedures**

We maintain disclosure controls and procedures, as such term is defined in Rule 13a-15(e) under the Securities and Exchange Act of 1934 (the Exchange Act), which are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer (CEO) and Chief Financial Officer (CFO), as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, we recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

Subject to the limitations noted above, our management, with the participation of our CEO and CFO, has evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the fiscal quarter covered by this Quarterly Report on Form 10-Q. Based on that evaluation, the CEO and CFO have concluded that, as of such date, our disclosure controls and procedures are effective to meet the objective for which they were designed and operate at the reasonable assurance level.

There were no changes in our internal control over financial reporting that occurred during the last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**PART II****ITEM 1. Legal Proceedings**

In March, April and May 2006, a series of private antitrust lawsuits were filed against Potlatch and seven other manufacturers of oriented strand board (OSB) by plaintiffs who claim they purchased OSB at artificially high prices. The cases purport to be class actions brought on behalf of direct and indirect purchaser classes. The complaints allege that the defendant OSB manufacturers violated federal and state antitrust laws by purportedly conspiring from mid-2002 to the present to drive up the price of OSB. The indirect purchaser complaints also allege that defendants violated various states' unfair competition laws and common law. The cases generally have been consolidated into two Consolidated Amended Class Action Complaints in the United States District Court for the Eastern District of Pennsylvania under the caption In Re OSB Antitrust Litigation. Each consolidated complaint seeks an unspecified amount of monetary damages to be trebled as provided under the antitrust laws and other relief. We believe the claims are without merit, and we will defend ourselves accordingly. We sold our OSB manufacturing facilities to Ainsworth Lumber Co. Ltd. in September 2004.

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On September 28, 2005, Ainsworth notified us by letter of its claims under the indemnification provisions of the asset purchase agreement between us and Ainsworth whereby Ainsworth purchased our OSB facilities. The claims involve alleged breaches of representations and warranties regarding the condition of certain of the assets sold to Ainsworth. On July 27, 2006, Ainsworth filed a complaint for breach of contract in the United States District Court for the Southern District of New York seeking an unspecified amount of monetary damages. The federal court case was subsequently dismissed voluntarily, and Ainsworth refiled its complaint in the Supreme Court of the State of New York for the County of New York on September 21, 2006. We believe the claim is without merit, and we will defend ourselves accordingly.

We believe there is no pending or threatened litigation that would have a material adverse effect on our financial position, operations or liquidity.

**ITEM 1A. Risk Factors**

There are no material changes from the risk factors previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2005. See Part I, Item 1A, Risk Factors.

**ITEM 6. Exhibits**

The exhibit index is located on page 36 of this Form 10-Q.

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SIGNATURES

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.

POTLATCH CORPORATION  
(Registrant)

By /S/ Gerald L. Zuehlke  
Gerald L. Zuehlke  
Vice President and Chief Financial Officer  
(Duly Authorized; Principal Financial Officer)

By /S/ Terry L. Carter  
Terry L. Carter  
Controller  
(Duly Authorized; Principal Accounting Officer)

Date: November 7, 2006



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POTLATCH CORPORATION AND CONSOLIDATED SUBSIDIARIES

Exhibit Index

<b>Exhibit Number</b>	<b>Description</b>
(4)	Registrant undertakes to furnish to the Commission, upon request, any instrument defining the rights of holders of long-term debt.
(10)(b) <sup>1*</sup>	Potlatch Forest Products Corporation Severance Program for Executive Employees, amended September 15, 2006, filed as Exhibit (10)(b) to the Current Report on Form 8-K filed on September 21, 2006.
(10)(c) <sup>1*</sup>	Potlatch Corporation 2000 Stock Incentive Plan, amended September 16, 2006, filed as Exhibit (10)(c) to the Current Report on Form 8-K filed on September 21, 2006.
(10)(e) <sup>1*</sup>	Potlatch Corporation 2005 Stock Incentive Plan, amended September 16, 2006, filed as Exhibit (10)(e) to the Current Report on Form 8-K filed on September 21, 2006.
(10)(h) <sup>1</sup>	Potlatch Corporation Benefits Protection Trust Agreement, amended September 16, 2006.
(10)(r) <sup>1*</sup>	Potlatch Corporation Management Performance Award Plan II, adopted September 16, 2006, filed as Exhibit (10)(r) to the Current Report on Form 8-K filed on September 21, 2006.
(10)(s) <sup>1*</sup>	Potlatch Corporation Deferred Compensation Plan for Directors II, adopted September 16, 2006, filed as Exhibit (10)(s) to the Current Report on Form 8-K filed on September 21, 2006.
(10)(t) <sup>1*</sup>	Potlatch Forest Products Corporation Salaried Employees Supplemental Benefits Plan II, adopted September 15, 2006, filed as Exhibit (10)(t) to the Current Report on Form 8-K filed on September 21, 2006.
(31)	Rule 13a-14(a)/15d-14(a) Certifications.
(32)	Furnished statements of the Chief Executive Officer and Chief Financial Officer under 18 U.S.C. Section 1350.

\* Incorporated by reference.

<sup>1</sup> Management contract or compensatory plan, contract or arrangement.