

Court File No. 07-CL-7245

POPE & TALBOT LTD. et al

MONITOR'S FIRST REPORT TO THE COURT
November 9, 2007

**ONTARIO SUPERIOR COURT OF JUSTICE
(COMMERCIAL LIST)**

IN THE MATTER OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT*,
R.S.C. 1985, c. C-36, AS AMENDED

AND IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT OF

POPE & TALBOT LTD.
POPE & TALBOT, INC.
MACKENZIE PULP LAND LTD., P&T FUNDING LTD.
PENN TIMBER, INC., POPE & TALBOT LUMBER SALES, INC.
POPE & TALBOT PULP SALES U.S., INC.
POPE & TALBOT RELOCATION SERVICES, INC.
P&T POWER COMPANY, P&T FINANCE THREE LLC

**FIRST REPORT TO THE COURT SUBMITTED BY
PRICEWATERHOUSECOOPERS INC.
IN ITS CAPACITY AS MONITOR**

INTRODUCTION

1. On October 29, 2007, Pope & Talbot Ltd. ("Ltd") and its affiliates, Pope & Talbot, Inc. ("Inc"), Mackenzie Pulp Land Ltd., P&T Funding Ltd., Penn Timber, Inc., Pope & Talbot Lumber Sales, Inc., Pope & Talbot Pulp Sales U.S., Inc., Pope & Talbot Relocation Services, Inc., P&T Power Company, P&T Finance Three Llc (Ltd, Inc and the other affiliates being referred to collectively herein as "P&T" or the "Applicants") made an application under the *Companies' Creditors Arrangement Act* (the "CCAA") and an initial order (the "Initial Order") was granted by the Honourable Mr. Justice Morawetz of the Ontario Superior Court of Justice (Commercial List) (the "Court") granting, *inter alia*, a stay of proceedings against the Applicants until November 23, 2007 (the "Stay Period") and appointing PricewaterhouseCoopers Inc. as monitor (the "Monitor"). The proceedings commenced by the Applicants under the CCAA will be referred to herein as the "CCAA Proceedings".

2. The purpose of this, the Monitor's first report (the "First Report"), is to inform the Court of the following:
 - (i) The Applicants' operations during the period October 29 to November 2, 2007, (the "Period");
 - (ii) The Applicants' receipts and disbursements for the period October 29 to November 2, 2007;
 - (iii) The Applicants' estimated accrued liabilities, incurred and unpaid, since the date of the Initial Order;
 - (iv) The Applicants' progress with respect to arranging debtor-in-possession financing ("DIP Finance");
 - (v) Cash management matters relating to Halsey CLO2 ("CLO2"), as required pursuant to paragraph 6 (c) of the Initial Order;
 - (vi) The ability of the Applicants and the Partnerships to allocate receipts and disbursements from accounts within the Cash Management System among each other in a timely fashion, as required pursuant to paragraph 6 (d) of the Initial Order; and
 - (vii) The Applicants' notification to creditors of the CCAA Proceedings, in accordance with paragraph 39 of the Initial Order.

3. Unless otherwise stated, all monetary amounts contained herein are expressed in United States Dollars, the Applicants' reporting currency. Capitalized terms used herein not otherwise defined are as defined in the Initial Order.

OPERATIONS IN THE PERIOD

4. During the Period, the Applicants contacted key customers and suppliers to advise them of the Applicants filing under the CCAA. Management has advised the Monitor that the Applicants' key customers have expressed a desire to continue to purchase goods from the Applicants and have been generally supportive of the Applicants thus far.
5. As a result of the filing, the Applicants had to expend significant time and resources in order to negotiate revised payment terms that were demanded by a number of key vendors. Although this process is ongoing, the Applicants have successfully renegotiated revised payment terms with a number of key vendors.
6. Prior to the date of the Initial Order, the Applicants had shut-down four of five sawmills in order to conserve cash. As of the date of this First Report, three of the Applicants' sawmills are now running. The mill located in Fort St. James, British Columbia is expected to re-commence operations on November 13, 2007. The Applicants' mill in Midway, British Columbia remains closed and there are currently no plans to re-start operations at this site.
7. On October 31, 2007, the Applicants' terminated the employment of 11 staff located at the Applicants' Castlegar, British Columbia and Grand Forks, British Columbia sawmills.

RECEIPTS & DISBURSEMENTS FOR THE PERIOD TO NOVEMBER 2, 2007

8. The Applicants' actual net cash flow for the week ended November 2, 2007, was approximately \$9.9 million better than its forecast cash flows set out in Exhibit G (the "Initial Forecast") of the affidavit of Neil Stuart sworn October 28, 2007, and filed in support of the Applicants CCAA application (the "Stuart Affidavit"), summarized as follows:

	Actual	Forecast	Variance
	\$000	\$000	\$000
Total Receipts ¹	13,514	10,800	2,714
Disbursements:			
Payroll and related	(1,003)	(1,718)	715
Raw materials	(1,169)	(4,201)	3,032
Freight	(1,874)	(1,759)	(115)
Pension Contribution	0	0	0
Capital Expenditures	0	(300)	300
Other	(1,197)	(4,462)	3,265
Total Disbursements	(5,243)	(12,440)	7,197
Surplus/(deficiency)	8,271	(1,640)	9,911

¹ Deposits of cheques made to the Applicants' TD Bank lockboxes are subject to a five day hold for cleaning purposes (the "Hold"). At the end of the period, \$1,731,080.29 was subject to Hold.

9. Comments on the variances between the Initial Forecast and actual receipts and disbursements are provided in Appendix A hereto.

ESTIMATED ACCRUED POST-FILING LIABILITIES AT NOVEMBER 2, 2007

10. It is estimated that the Applicants have unpaid post-filing liabilities in the range \$5.6 million to \$7.1 million as at November 2, 2007, summarized as follows:

	Low	High
	\$000	\$000
Payroll, Payroll Taxes & Benefits	(2,400)	(3,000)
Raw Materials	(500)	(600)
Freight	(200)	(300)
Capital Expenditures	(200)	(300)
Other	(2,300)	(2,900)
Total	(5,600)	(7,100)

ACTIVITIES OF THE MONITOR

11. Since the commencement of the CCAA Proceedings, the Monitor has been assisting the Applicants in its handling of matters arising as a result of the filing and has been in discussions with various stakeholders including representatives of the Agents, suppliers, customers, unions and the Province of British Columbia.

THE APPLICANTS' PROGRESS TOWARDS ARRANGING DIP FINANCE

12. As previously disclosed to the Court by the Applicants, DIP Finance is required by the Applicants in order to provide stability to operations and cash flow. The Applicants have also informed this Honourable Court that it is in negotiations with the Agents in respect of DIP Finance to be provided by the Applicants existing secured lenders (the "Lenders") and that it was expected that an agreement would be signed in that regard on or around November 9, 2007, subject to Court approval.
13. As at the time of the preparation of this report, negotiations had not been finalized. The Monitor has expressed its concerns to the Agents and the Applicants that unless DIP Finance arrangements are in place in the very near future, it would be necessary for the Applicants to consider other steps to reduce cash needs or to obtain alternative sources of DIP Finance.

TRANSACTIONS BETWEEN CLO2 AND THE APPLICANTS

14. Paragraph 6 (c) of the Initial Order states:

"all deposits made to the Cash Management System by "Halsey CL02" shall be deemed to be kept separate and apart from the funds of the Applicants and the Partnership and the Monitor shall advise the Applicants, the Partnerships and this Court of an expedient means of

segregating the funds of Halsey CI02 until such time as separate banking arrangements can be made”

15. Attached hereto, as Appendix B, is a summary setting out the background in respect of the establishment of the CLO2 partnership as well as a summary of the nature of the transactions that occur between CLO2 and the Applicants.
16. Based upon the Monitor’s review, CLO2 maintains its own bank accounts through which minimal, intermittent transactions occur related to the payment of monthly bank charges and the payment of certain amounts to CLO2’s limited partner, pursuant to CLO2 partnership agreement. As a result, it appears that cash flows related to CLO2 are segregated in its own bank account.

**ALLOCATION OF FUNDS WITHIN THE CASH MANAGEMENT SYSTEM
AMONG THE APPLICANTS AND THE PARTNERSHIPS**

17. Paragraph 6 (d) of the Initial Order states:

“the Monitor shall advise the Court within fourteen (14) days regarding the ability of the Applicants and the Partnerships to allocate receipts and disbursements from the accounts within the Cash Management System among each other in a timely fashion”
18. The Cash Management System was described in the Stuart Affidavit. The Monitor has reviewed the Cash Management System in order to obtain an understanding of the flow of cash in to, out of and between the various bank accounts within the Cash Management System.

19. As a result of its review, the Monitor has determined that the Applicants and the Partnerships do not directly allocate cash receipts and disbursements from the accounts within the Cash Management System among each other. However, the Applicants do use journal entries to book inter-company receivables and payables arising from cash receipts and disbursements. The Monitor has not yet had sufficient time to complete a review of the Applicants' processes and controls for recording and reconciling inter-company transactions and balances.


NOTIFICATION OF CREDITORS


20. In accordance with paragraph 39 of the Initial Order, the Applicants caused to be sent, by registered mail, a notice of these proceedings to all known creditors, other than employees, on Friday November 2, 2007. A copy of the notice is available on the Monitor's website at www.pwc.com/car-poptal.

The Monitor respectfully submits to the Court this, its First Report.

Dated this 9th day of November 2007.

PricewaterhouseCoopers Inc.
in its capacity as Monitor of
Pope & Talbot Ltd. and its affiliates


for
Greg Watson
President


Nigel D. Meakin
Senior Vice President

Appendix A

Variations between the Initial Forecast and the Actual Receipts and Disbursements

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Variations between the Initial Forecast and the Actual Receipts and Disbursements

1. The favourable variance of \$2.71 million in Total Receipts arose primarily due to collections of trade accounts receivables in excess of the Forecast. The Applicants are of the view that this variance is temporary in nature and is likely to reverse in future periods.
2. The favourable variance of \$715,000 in Payroll and Related costs is a result of timing differences and is anticipated to reverse in future periods.
3. For the first three days of the Period, the Applicants were not able to fully utilize the Cash Management System, which also delayed the Applicants' ability to process payments. This issue has now been rectified and payments and the Applicants are making disbursements on daily basis. The delay in the Applicants' inability to utilize its Cash Management System in the first three days of the Period led to the deferral of several forecast disbursements, as described below.
4. The favourable variance of \$3.03 million in Raw Materials disbursements is primarily the result of the Applicants deferring forecast purchases during the week, summarized as follows:
 - (i) Fibre purchases for the Applicants' pulp mills, and the associated cash disbursements, did not commence until November 1, 2007. The Applicants did not purchase any log inventory for its Canadian sawmill operations (the "Canadian Sawmills") during the week ended November 2, 2007 as the Canadian Sawmills remained shut-down during the Period. The impact of these issues was a \$1.9 million favourable variance during the Period; and

- (ii) The Applicants undertook a process to segregate invoices due prior to and after the date of the Initial Order in order to ensure compliance with the restrictions of the Initial Order. This ongoing process has consumed significant internal resources and has somewhat slowed the Applicants' ability to process payments during the Period.

- 5. The unfavourable variance of \$115,000 in Freight relates primarily to:
 - (i) An unfavourable variance of \$475,000 resulting from deposits made to various railways in respect of services to be provided subsequent to the date of the Initial Order. During the course of renegotiating payment terms, certain vendors required a deposit be provided, against which the Applicants' could draw, when services were rendered. These payment of deposits in advance of the provision of services was not included in the Forecast; and
 - (ii) An unfavourable variance of \$260,000 in payments primarily to railway and cartage Applicants for goods that had been expected to be received before the CCAA filing but that were in transit on the date of the Initial Order and delivered post-filing.
 - (iii) A favourable variance of \$620,000 resulting from significantly reduced shipping volumes during the week ended November 2, 2007 while the Applicants negotiated terms of trade for services with shipping and railcar service providers.

- 6. The favourable variance of \$3.27 million in Other costs is comprised of the following:
 - (i) A \$1.3 million timing variance in Lumber duty payments initially forecast to be paid during the Period but actually paid on November 8, 2007;

- (ii) Maintenance materials and contract services costs had a favourable variance of \$1 million during the Period. In order to properly account for pre and post-filing costs, the Applicants were not able process a number of cash disbursements that were initially forecast during the Period. Management is of the view that this variance is temporary in nature, which will reverse in future periods;
- (iii) Lease payments of \$130,000, initially forecast to be paid during the Period are now forecast to be paid over the following two weeks resulting in a timing difference which is expected to reverse. Payments were deferred while the Applicants' reviewed all leases to ensure amounts to be paid related to the Period subsequent to the Initial Order;
- (iv) Insurance payments of \$225,000, included in the Initial Forecast during the Period, were actually made during the week ended October 26, 2007, prior to the date of the Initial Order. Accordingly, this represents a permanent favourable variance; and
- (v) Other disbursements, not specifically described above, generated a temporary difference of approximately \$600,000, which are expected to reverse in future periods.

Appendix B

Establishment of the CLO2 partnership and Summary of transactions between CLO2 and the Applicants

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Background:

CLO2 is a limited partnership owned 99% by Goldenrod Asset Management (“Goldenrod”), the limited partner, and 1% by Inc., as general partner. CLO2 was established in December 2001 and became the lessee in respect of a chlorine dioxide bleaching system facility that was originally built by Inc., as a certified pollution control facility (the “CLO2 Facility”), under Oregon law. The CLO2 Facility, completed in 2000, reduces emissions from the Applicants’ Halsey, Oregon pulp mill.

As a result of the CLO2 Facility’s qualification as a pollution control facility, tax credits of approximately \$16.9 million were available for application against Oregon state income taxes over a 10-year period (to 2010).

Inc. management at the time were of the view that the tax credits would have little to no value to Inc., as Inc. was incurring net operating losses. Accordingly, Inc. identified Goldenrod as a party who was interested in the Oregon tax credits. Goldenrod and Inc. established CLO2, in partnership, to enable Goldenrod to take advantage of the Oregon tax credits. However, Goldenrod did not wish to own the CLO2 Facility. As a result a sale and leaseback transaction was arranged whereby Inc. sold the CLO2 Facility to a third party and CLO2 leased it back.

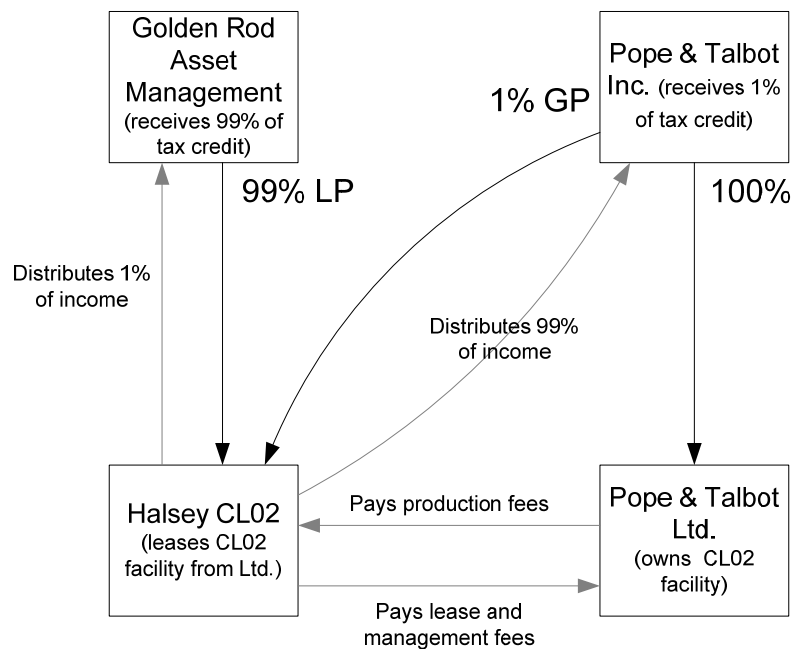
In exchange for the ability to utilize the Oregon tax credits, it appears that Goldenrod provided a significant (\$10.6 million) cash contribution to the partnership, which was used to prepay rent under the lease. The Monitor is advised that the partnership agreement indicates that Goldenrod is to realize 99% of the annual Oregon state income tax credits and Inc. is to realize 99% of the net cash profits actually generated by CLO2, on an annual basis.

In 2006, Inc. assigned its right to repurchase the CLO2 Facility to Ltd., which exercised those rights in June 2006. Accordingly, the Halsey pulp mill and the CLO2 Facility are now owned by Ltd.

Transactions between CLO2 and the Applicants and review of Bank Accounts:

As a result of the change in ownership, CLO2 now leases the facility from Ltd., and incurs both lease and management fee costs due to Ltd. for the use of the CLO2 Facility and various overheads paid for by Ltd. on CLO2's behalf. CLO2 charges Ltd. for the use of the treatment processes.

A schematic diagram of the partnership structure and flow of transactions between CLO2, Ltd. and Inc. is set forth as follows:



In fiscal 2006, CLO2 incurred approximately \$4.7 million in total lease and management fee costs due to Ltd. Ltd. incurred approximately \$5.8 million in charges due to CLO2 for the use of treatment processes. CLO2 does not provide services other than to Ltd. nor does it incur any expenses, other than to Ltd. and in respect of any statutory or tax related items. The parties do not exchange cash in respect of the charges made as between each other, except as described below.

The Monitor is advised by management that twice annually, a distribution of profits is made by CLO2 to its partners. As CLO2 does not generate any cash flow, Inc., its general partner, funds its bank account in order to enable CLO2 to pay monthly bank charges and service fees. Twice annually, a calculation of CLO2's "profits" is made and Inc. advances 1% of that amount to CLO2, to enable CLO2 to make its cash distribution to Goldenrod. Inc.'s 99% share of the bi-annual profits is not transacted in cash as Inc. would simply be funding CLO2 and receiving the same amount of cash back, in return. Therefore, this transaction is journalized in CLO2's and Inc.'s books only.

The Applicants provided the Monitor copies of bank statements in the name of CLO2 for the period from January 2007 to August 2007, during which period the total debits and credits to and from the CLO2 bank account totalled \$2,521 and \$2,798, respectively.