

# **CANFOR PULP INCOME FUND**

# **CANFOR PULP LIMITED PARTNERSHIP**

## Management's Discussion and Analysis

For the periods ended December 31, 2006

## **Canfor Pulp Income Fund and Canfor Pulp Limited Partnership 2006 Report to Unitholders Management's Discussion and Analysis**

*Canfor Pulp Income Fund (the Fund) earns income from its 49.8% indirect interest in Canfor Pulp Limited Partnership (the Partnership). The Fund accounts for its investment in the Partnership on the equity basis and does not consolidate the operations of the Partnership. In order for the Fund's unitholders to understand the results of operations, the financial statements with accompanying notes are presented for both the Fund and the Partnership. The Partnership did not have an operating business prior to July 1, 2006, and the comparative results prior to this date represent the northern bleached softwood kraft (NBSK) business of Canadian Forest Products Ltd., a subsidiary of Canfor Corporation (collectively Canfor), which the Partnership acquired on July 1, 2006. This Management's Discussion and Analysis (MD&A) provides a review of the significant developments that have impacted the Partnership's performance during 2006 relative to 2005. This MD&A should be read in conjunction with the audited consolidated financial statements and accompanying notes.*

*Factors that could impact future operations are also discussed. These factors may be influenced by known and unknown risks and uncertainties that could cause the actual results to be materially different from those stated in this discussion. Factors that could have a material impact on any future oriented statements made herein include, but are not limited to: general economic, market and business conditions; product selling prices; raw material and operating costs; exchange rates; changes in law and public policy; and opportunities available to or pursued by the Partnership.*

*In this document, references are made to EBITDA (Earnings before Interest, Taxes, Depreciation and Amortization or operating income before amortization) and distributable cash. The Partnership considers EBITDA to be an important indicator for identifying trends in the Partnership's performance and of the Partnership's ability to generate funds to meet its debt service, capital expenditure requirements and to make cash distributions to its partners. Distributable cash is a measure of cash flow used by management to determine level of cash distributions. EBITDA and distributable cash should not be considered as alternatives to net income or cash flow from operations as determined in accordance with Canadian generally accepted accounting principles. As there is no standardized method of calculating these measures, the Partnership's use of these terms may not be directly comparable with similarly titled measures used by other companies or income funds.*

*Calculations of EBITDA and distributable cash are provided in a schedule at the end of this MD&A.*

*In this MD&A, for all periods ending prior to July 1, 2006, and for all annual periods, the financial information presented for the Partnership represents its business on a carve out basis (continuity of interests) from Canfor, as if operated as a stand-alone partnership entity for the full periods. The financial information presented includes allocations of certain of Canfor's assets, liabilities and costs. The financial condition, results of operations and cash flows for these periods are not necessarily indicative of the financial condition, results of operations or cash flows that would have been incurred if the business was a separate legal entity.*

*The information in this report is as at February 16, 2007.*

*All financial references are in millions of Canadian dollars unless otherwise noted.*

### **CANFOR PULP INCOME FUND**

The Fund is an unincorporated open-ended trust established under the laws of Ontario on April 21, 2006, pursuant to the Fund Declaration. The principal head office of the Fund is located at 1700 West 75<sup>th</sup> Avenue, Vancouver, BC, Canada. The Fund has been established to acquire and hold, through a wholly owned trust, the Canfor Pulp Trust (the Trust), investments in Limited Partnership Units of the Partnership, and such other investments as the Trustees of the Fund may determine. The general partner of the Partnership is Canfor Pulp Holding Inc. (the General Partner) and each limited partner holds an ownership interest in the General Partner equal to its proportionate interest in the Partnership.

On July 1, 2006, the Fund completed the indirect acquisition of 20% of the Prince George, BC based NBSK pulp and paper business of Canfor. Canfor exchanged 14,254,005 Class A Limited Partnership Units for an equal number of Fund units and these units were then distributed by Canfor to its shareholders. As a result of these transactions, on July 1, 2006, Canfor shareholders owned all of the issued and outstanding Fund units, and the Fund held all issued and outstanding Class A Limited Partnership Units representing a 20% indirect interest in the Partnership. Canfor, through its ownership of Class B Exchangeable Limited Partnership Units, which are indirectly exchangeable for Fund units, owned the remaining 80% interest in the Partnership.

On November 30, 2006, Canfor exchanged 21,239,537 Class B Exchangeable Limited Partnership Units of the Partnership for the same number of newly issued Fund units and immediately distributed these Fund units to its shareholders as an in-kind taxable dividend of 1.49 units for every 10 Canfor shares held. Following completion of this exchange, there are a total of 35,493,542 Fund units issued and outstanding, and the Fund indirectly holds a total of 35,493,542 units of the Partnership, representing 49.8% of the Partnership and Canfor holds 35,776,483 Class B Exchangeable Limited Partnership Units, representing 50.2% of the Partnership.

Each unitholder participates pro rata in any distributions from the Fund. Income tax obligations related to the distributions of the Fund are the obligations of the unitholders and the Fund is only taxable on any amount not allocated to the unitholders.

## **EQUITY INVESTMENT IN CANFOR PULP LIMITED PARTENRSHIP**

The Fund's equity investment in the Partnership is as follows:

(thousands of dollars, unaudited)

Initial investment in the Partnership on July 1, 2006 – 14,254,005 Fund units	\$ 116,560
Issuance of Fund units for exchangeable Partnership units (November 30, 2006) – 21,239,537 Fund units	182,792
Cumulative equity in income of the Partnership	20,558
Cumulative distributions received and receivable	(30,419)
Equity investment in the Partnership as at December 31, 2006	\$ 289,491

The Fund's investment in the Partnership units is recorded using the equity method. The Fund's initial investment in the Partnership on July 1, 2006 represented the Fund's 20% ownership in the transfer of the Pulp and Paper business from Canfor to the Partnership. On November 30, 2006 Canfor exchanged 21,239,537 Class B Exchangeable Limited Partnership Units for the same number of newly issued Fund Units for a total value of \$182.8 million (\$8.61 per unit), representing the Fund's pro rata share of the carrying value of the Partnership units received on the date of the exchange.

## **OPERATING RESULTS AND LIQUIDITY**

For the six-month period ended December 31, 2006, the Fund had earnings of \$20.6 million, or \$1.15 per unit, representing its share of earnings of the Partnership for the period. Distributions declared by the Partnership and accruing to the Fund were \$30.6 million of which \$12.9 million was receivable at year-end. Cash distributions received from the Partnership are the only source of liquidity for the Fund. The Fund's requirements of administrative services are minimal and are funded through an expense distribution from the Partnership.

## **FUND DISTRIBUTIONS**

The Fund is entirely dependent on distributions from the Partnership to make its own distributions and declares distributions on a monthly basis with the record date on the last day of each month and payable within the 15 days following. Distributions from the Fund's investment in the units of the Partnership and distributions payable by the Fund to its unitholders are recorded when declared. During 2006, the Fund declared distributions of \$1.24 per unit or a total of \$30.4 million.

Monthly cash distributions from the Partnership are not directly equal to the Fund's pro rata share of the Partnership's income under the equity method.

## **FUND UNITS**

At December 31, 2006, the Fund had 35,493,542 units outstanding compared to 14,254,005 units outstanding at September 30, 2006.

## **RISKS AND UNCERTAINTIES RELATED TO THE STRUCTURE OF THE FUND**

### **Control of the Partnership**

Pursuant to a shareholders' agreement, Canfor is entitled to appoint four of the seven directors to the board of the General Partner for so long as it owns not less than 30% of the outstanding Limited Partnership Units. For so long as Canfor holds not less than a 20% indirect economic interest in the Partnership, Canfor's consent will be required in

order to approve certain significant transactions of the Partnership. In addition, under the Exchange Agreement, the Fund and the Trust will agree not to take certain actions without the prior approval of Canfor. As a result of these rights, Canfor will exercise significant influence or control over transactions submitted to the board of the General Partner and to the Fund trustees. Canfor may have sufficient voting power to prevent a change of control of the Partnership. The Fund has an indirect minority interest in the Partnership and minority representation on the board of the General Partner and therefore has limited influence over transactions of the Partnership.

The interests of Canfor may conflict with those of Fund unitholders.

### **Dependence on the Partnership**

The Fund is entirely dependent on the operations and assets of the Partnership. Cash distributions to unitholders will be dependent on, among other things, the ability of the Partnership making cash distributions. The ability of the Fund and its subsidiaries to make cash distributions or other payments or advances is subject to applicable laws and regulations and contractual restrictions contained in the instruments governing any indebtedness of those entities.

### **Cash Distributions Are Not Guaranteed and Will Fluctuate with the Business Performance**

Although the Fund intends to distribute the cash distributions received through the Canfor Pulp Trust from the Partnership, less expenses and amounts, if any, paid by the Fund in connection with the redemption of Fund units, there can be no assurance regarding the amount of income to be generated by the Partnership's business or ultimately distributed to the Fund. The ability of the Fund to make cash distributions, and the actual amount distributed, will be entirely dependent on the operations and assets of the Partnership, and will be subject to various factors including its financial performance, its obligations under applicable credit facilities, fluctuations in its working capital, the sustainability of its margin and its capital expenditure requirements. The market value of the Fund units may deteriorate if the Fund is unable to meet its distribution targets in the future.

### **Taxation of Publicly Traded Income Trusts**

On October 31, 2006, the Canadian Federal Government announced proposed plans to apply a tax on distributions from publicly traded income trusts, such as the Fund. For existing income trusts the government is proposing a four-year transition period until their 2011 taxation year before the tax would be applicable. The impact to the Fund is unknown at this time and may be significant. In addition, the proposed plans include a limitation on growth of entities such as the Fund during the transition period, which may limit the amount of new units that can be issued by the Fund, which in turn can limit investment opportunities for the Fund.

### **RELATED PARTY TRANSACTIONS**

All accounting, treasury, legal and administrative functions for the Fund are performed on its behalf by the Partnership pursuant to a support agreement. For the six months ended December 31, 2006, the Fund had incurred operating expenses with third parties of \$142,000. During the fourth quarter, the Partnership declared an expense distribution to cover the operating expenses of the Fund as provided for in the Partnership agreement. The expense distribution is accounted for by the Fund as a recovery of operating expenses and presented on a net basis in the consolidated statement of income and accumulated distributions and earnings.

### **SUBSEQUENT EVENTS**

On January 24, 2007 the Fund declared a distribution of \$0.14 per unit or \$5.0 million, payable on February 15, 2007 to unitholders of record on January 31, 2007. On February 16, 2007, the Fund declared a distribution of \$0.14 per unit or \$5.0 million, payable on March 15, 2007 to unit holders of record on February 28, 2007.

## CANFOR PULP LIMITED PARTNERSHIP

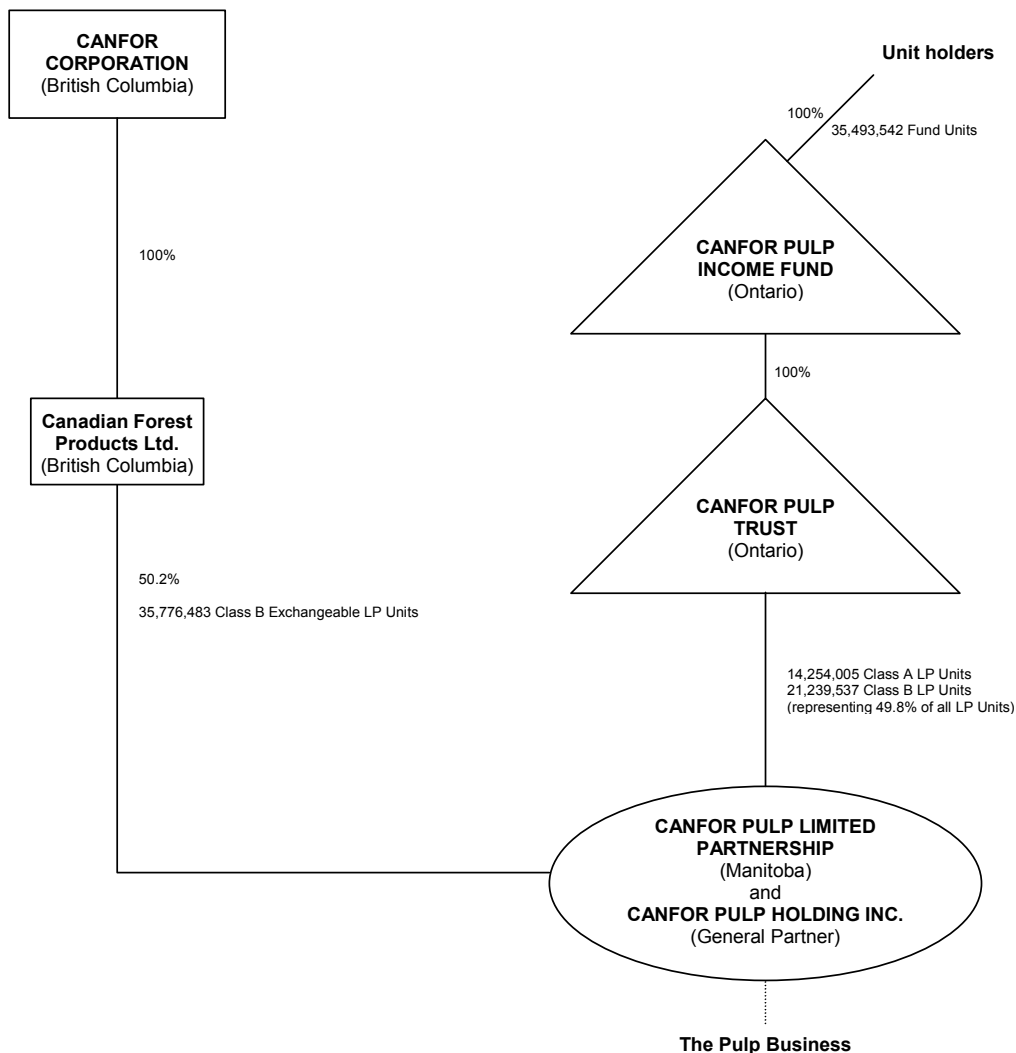
### Structure

The Partnership was formed on April 21, 2006, under the laws of Manitoba to acquire and carry on the NBSK pulp and paper business of Canfor. The business consists of two NBSK pulp mills and one NBSK pulp and paper mill located in Prince George, BC and a marketing group based in Vancouver, BC (the Pulp Business).

On July 1, 2006, Canfor transferred the Pulp Business to the Partnership in exchange for a \$125 million promissory note, 14,254,005 Class A Limited Partnership Units and 57,016,020 Class B Exchangeable Limited Partnership Units (the Spinout). Canfor then exchanged its Class A Limited Partnership Units for an equal number of Units of Canfor Pulp Income Fund (the Fund). Upon the completion of the Spinout, Canfor shareholders were entitled to receive one New Common Share of Canfor and 0.1 of a Unit of the Fund (Fund Unit), with the distribution of the Fund Units being structured as a return of capital on the Canfor Shares.

On November 30, 2006, Canfor transferred 21,239,537 Class B Limited Partnership Units of the Partnership to the Fund in exchange for the same number of Fund Units. Following completion of this exchange, the Fund indirectly holds a total of 14,254,005 Class A Limited Partnership Units and 21,239,537 Class B Limited Partnership Units, representing 49.8% of the Partnership and Canfor owns the remaining 50.2%. The Partnership is managed, on behalf of the limited partners, by Canfor Pulp Holding Inc., the General Partner. Below is a simplified schematic of the ownership structure.

### Partnership Structure



## **Business**

The Partnership is a leading global supplier of pulp and paper products with operations based in the central interior of British Columbia. The Partnership's strategy is to maximize cash flows and enhance the value of its assets by: (i) preserving its low-cost operating position, (ii) maintaining the premium quality of its products and (iii) opportunistically acquiring high quality assets.

The Partnership owns and operates three mills with annual capacity to produce over one million tonnes of northern softwood market kraft pulp, 90% of which is bleached to become NBSK pulp, for sale to the market and approximately 135,000 tonnes of kraft paper. The mills are among the lowest cost producers in Canada with a first quartile ranking based on average cost of production of NBSK pulp in the most recent PricewaterhouseCoopers LLP Market Pulp study (2005) of competitive costs of Canadian pulp mills.

## **Highlights**

- The Pulp Business of Canfor was spun out into the Canfor Pulp Limited Partnership on July 1, 2006
- November 30, 2006 Canfor dividdened out an additional 30% of the Partnership to shareholders of record on November 15, 2006
- Annual production record of 1,015,400 tonnes of market NBSK set in 2006
- Total EBITDA of the pulp and paper business for 2006 of \$184.1 million
- Total distributions in the first six months of existence for the Partnership of \$88.5 million to its limited partners.

## Selected Annual Information

(millions of dollars except volumes and per unit amounts, unaudited)	2006	2005	2004
<b>Sales volume - major products</b>			
Pulp - thousands of metric tonnes	1,001.5	982.1	974.4
Paper - thousands of metric tonnes	124.6	127.2	139.8
<b>Sales by segment</b>			
Pulp	720.9	653.8	704.0
Paper	113.5	117.4	126.3
Total sales	834.4	771.2	830.3
<b>Operating income (loss)</b>			
Pulp	146.3	26.7	58.8
Paper	3.2	3.6	(5.5)
Unallocated costs	(14.4)	(13.6)	(18.2)
Total operating income	135.1	16.7	35.1
<b>Non-operating income (expense)</b>			
Business Acquisition Costs	(5.9)	-	-
Interest expense, net	(3.8)	-	-
Foreign exchange loss on long-term debt	(2.5)	-	-
Other income (expense)	0.1	(0.2)	0.1
Total non-operating income (expense)	(12.1)	(0.2)	0.1
<b>Net income</b>	<b>123.0</b>	<b>16.5</b>	<b>35.2</b>
<b>Total assets</b>	<b>893.4</b>	<b>878.4</b>	<b>894.2</b>
<b>Total long-term debt</b>	<b>128.2</b>	<b>-</b>	<b>-</b>
<b>Net income per Partnership unit</b>			
Basic and diluted	1.73	0.23	0.49
<b>Cash distributions declared (paid and payable)</b>	<b>88.5</b>	<b>-</b>	<b>-</b>
<b>Average Canadian/US exchange rate <sup>1</sup></b>	<b>0.882</b>	<b>0.825</b>	<b>0.768</b>

### 2006 compared to 2005

The 2006 year was highlighted with the successful spinout of the Pulp Business into the Partnership, a record year for operational performance, strong markets and a good cost structure. Net income for 2006 increased by \$106.5 million and EBITDA by \$120.2 million over 2005. This significant improvement was due to increased sales prices and significantly lower fibre costs. NBSK pulp prices in US dollars increased, but combined with the effect of the strengthening Canadian currency, the net realized prices in Canadian dollar terms increased by only 4% over 2005. Increased sales and production volumes and lower fibre and conversion costs all contributed to the improved results.

<sup>1</sup> Source – Bank of Canada (average noon rate for the period)

## SELECTED QUARTERLY FINANCIAL INFORMATION

	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
(unaudited)	2006	2006	2006	2006	2005	2005	2005	2005
<b>Sales and Income</b> (millions of dollars)								
Sales	229.0	214.3	194.9	196.2	195.9	193.1	198.9	183.3
Operating income (loss)	49.3	49.7	15.7	20.4	16.7	(3.1)	(5.2)	8.3
EBITDA	61.9	62.5	26.8	32.9	29.0	9.1	5.9	19.9
Net income (loss)	44.8	41.9	15.9	20.4	16.6	(3.1)	(5.2)	8.2
<b>Per Partnership unit</b> (dollars) <sup>2</sup>								
Net income (loss), basic and diluted	0.63	0.59	0.22	0.29	0.23	(0.04)	(0.07)	0.12
<b>Statistics</b>								
Pulp shipments (000 mt)	249.8	251.4	244.6	255.7	260.7	257.9	246.8	216.7
Paper shipments (000 mt)	32.8	29.5	31.3	31.0	30.6	31.1	33.0	32.5
Average exchange rate (Cdn\$/US\$)	0.878	0.892	0.891	0.866	0.852	0.832	0.804	0.815
Average NBSK pulp list price delivered to Northern Europe (US \$)	730	711	670	622	600	588	613	642

Sales are primarily influenced by changes in market pulp prices and fluctuations in Canadian/US dollar exchange rates. Operating income, net income and EBITDA are primarily impacted by sales and price fluctuations in raw material inputs, energy prices and maintenance costs.

### Fourth Quarter 2006 Results

The Partnership had net sales of \$229.0 million, net income of \$44.8 million, or \$0.63 per unit, and EBITDA of \$61.9 million, or \$0.87 per unit, for the quarter ended December 31, 2006. These results, which are similar to the third quarter, reflect improvements in NBSK pulp pricing in all markets, the benefits of a weaker Canadian dollar and improved results from the kraft paper business, all of which were offset by higher costs. The increased costs in the fourth quarter, when compared to the prior quarter, were primarily related to fibre costs, and in addition, seasonally normal increase in the use of energy, increased costs for maintenance due to timing of several routine projects and higher administration costs. When compared to the fourth quarter of 2005, costs were lower with the exception of fibre.

Fibre costs increased during the quarter, driven by a rise in pulp mill sales returns, and in addition, market conditions brought about by reduction of sawmill residual chip volumes due to the slowing lumber markets. A small component of the cost increase was also due to the production of roundwood chips. This program was initiated in the fourth quarter of 2006 to replace sawmill residual reductions and will continue for the next few months. The Partnership may continue the roundwood chipping program in the second half of the year depending on the sawmill operating environment.

The Partnership's mills ran well with no significant maintenance downtime in the third or fourth quarters, except for the cogeneration system where power production was curtailed for the installation of modifications to the ash handling system

- The Pulp segment earned operating income of \$50.6 million in the fourth quarter of 2006, compared with operating income of \$18.5 million in the same quarter in 2005. When compared to the prior year the benefit of an 18% increase in Canadian net realized price was partially reduced by lower sales volumes and higher fibre costs.
- The Paper segment earned operating income of \$2.6 million in the fourth quarter of 2006, compared with operating income of \$1.7 million in the same quarter in 2005. Net realized price in US dollars increased by

<sup>2</sup> Based on Partnership Units outstanding at December 31, 2006 (71,270,025) for all periods

11% over the same period a year ago. Price increases and higher sales volumes were partially offset by higher costs for slush pulp, which is transferred at market price.

- Unallocated costs, comprised principally of general and administrative expenses, totalled \$3.9 million in the fourth quarter compared to \$3.5 million in the same period last year. Unallocated costs were higher as a result of higher administrative costs including audit fees, salaried employees incentive plan and legal fees. The administrative costs in prior year comparative periods primarily represent allocations of Canfor's corporate administration, legal services, human resources, treasury services and incentive plan amounts. These were based on estimates of the pulp business' share of Canfor's corporate costs. A refund of provincial sales tax of \$1.1 million reduced unallocated costs in 2005.

More detailed analysis of the fourth quarter 2006 results is found in the Fourth Quarter 2006 press release dated February 16, 2007.

## OPERATING RESULTS BY BUSINESS SEGMENT

### Pulp

(millions of dollars unless otherwise noted, unaudited)	2006	2005
Sales	720.9	653.8
EBITDA	191.3	70.1
EBITDA margin	27%	11%
Operating income	146.3	26.7
Average pulp list price – US \$ <sup>3</sup>	683	611
Average pulp list price in Cdn \$	774	741
Production – pulp (000 mt)	1,015.4	983.2
Shipments – Partnership-produced pulp (000 mt)	1,001.5	982.1
Marketed on behalf of HSLP & Canfor (000 mt)	570.6	579.9

Operating income of the pulp segment increased by \$119.6 million when compared to 2005 results. Strong performance at all mills, including an annual record for total tonnes produced, combined with improved markets and lower costs were partially offset by the strengthening Canadian dollar. Net sales increased by \$67.1 million over 2005 as a result of a 12% increase in the average pulp list price offset by the strengthening Canadian dollar which averaged Cdn\$/US\$0.882 in 2006 compared to 0.825 in 2005. Also positively impacting net sales was the shift of a higher volume of sales to North American markets, primarily at the expense of Europe, which resulted in higher revenues as the North American market list prices averaged US\$34 per tonne higher than those in Europe. Overall costs were lower in 2006 primarily due to the beneficial impact of lower chip prices, lower overall maintenance expense and lower energy costs due to full year of operation of the cogeneration project at Prince George Pulp mill.

### Operations

An annual production record for total tonnes highlighted 2006, surpassing the previous record by 20,000 tonnes. NBSK production during the year was higher by 32,200 tonnes over 2005. The increase was due to improved performance and reliability at all facilities and the Prince George Pulp mill ramped up to full rate from its curtailed production in 2005 due to precipitator installation. Total maintenance downtime for all three mills was 39 days in 2006, the same as 2005. The Partnership has moved to an 18-month cycle for its major maintenance outages and staggers these between the three pulp mills.

The cogeneration facility at the Prince George Pulp mill operated for the full year in 2006 averaging 919-megawatt hours per day compared to 788 in 2005. The cogeneration project was commissioned in 2005 and commenced electrical power generation in May 2005. A 4 day outage, taken in December 2006, for the installation of

<sup>3</sup> Per tonne, delivered to Northern Europe

improvements to the ash handling system, contributed to reduced power generation during the fourth quarter of 2006. Additional modifications to the cogeneration system are expected during 2007 to further improve its performance.

### *Markets*

The Partnership experienced strong and improved demand during 2006 compared to 2005. This was partly driven by increased consumption from Europe and Asia but mostly due to the large reduction in Canadian NBSK production capacity (approximately 1 million tonnes or 16% of Canadian capacity was shut in 2006). The capacity reduction was primarily the result of mill closures in Eastern Canada due to high fibre and energy costs and the strengthening Canadian dollar.

List prices increased in all markets during 2006, with the benchmark price for NBSK pulp delivered into Northern Europe averaging US\$683 per tonne in 2006 compared to US\$611 in 2005. Inventory levels for NBSK pulp declined to 24 days of supply, with 30 days of supply generally considered to be a balanced market.

### *Outlook – Pulp Markets*

In January 2007, list price increases were announced in all markets. For Northern Europe a US\$30 to US\$40 increase was announced, which will take prices to US\$760 to US\$770 per tonne. In the United States, a US\$20 increase will bring prices to US\$790. The Asian markets also saw a US\$20 list price increase announcements, which would take prices to US\$730 to US\$760 depending on the country of delivery.

Looking ahead into 2007, we believe that demand and pricing will hold up well through the first half of the year. While global economies are projected to slow somewhat, the year is beginning with very low global inventories and the NBSK market is expected to continue to be in short supply. Some moderation in prices in the second half of 2007 may occur.

### **Paper**

(millions of dollars unless otherwise noted, unaudited)	<b>2006</b>	2005
Sales	<b>113.5</b>	117.4
EBITDA	<b>7.0</b>	7.4
EBITDA margin	<b>6%</b>	6%
Operating income	<b>3.2</b>	3.6
<hr/>		
Production – paper (000 mt)	<b>129.1</b>	127.4
Shipments – paper (000 mt)	<b>124.6</b>	127.2

Operating income of the paper segment decreased by \$0.4 million from 2005. Net realized price in US dollars increased by 6% over the prior year but this was more than offset by the impacts of the stronger Canadian dollar and slightly lower sales volume in 2006. Higher costs for slush pulp, which is transferred to the paper mill at market price, were offset by overall lower conversion costs and improved productivity.

### *Operations*

The paper machine had a very strong year producing 1,700 tonnes above 2005. A key performance indicator for the paper machine is tonnes produced to customer orders which set an annual best in 2006 averaging 352 tonnes per day compared to 332 in 2005 and the previous best of 349 in 2004. Operations continue to focus on higher margin bleached paper production, which averaged 70% in 2006 compared to 68% in 2005.

### *Markets*

Demand remained steady in 2006 with sales matching production. We continue to grow our shipments into the North American market, specifically in the higher margin bleached products. Tight supply was the main driver of the strong kraft paper market throughout 2006.

### *Outlook – Kraft Paper Markets*

Kraft paper markets are expected to remain strong throughout 2007, as the demand supply balance is still tight on the supply side. A further price increase for bleached kraft paper is expected in the second quarter of 2007.

### **Non-Segmented Items**

(millions of dollars, unaudited)	<b>2006</b>	2005
Unallocated costs	<b>14.4</b>	13.6
Business acquisition costs	<b>5.9</b>	-
Net interest expense	<b>3.8</b>	-
Foreign exchange loss on long term debt	<b>2.5</b>	-
	<b>26.6</b>	13.6

### *Unallocated Costs*

Unallocated costs, comprised principally of general and administrative expenses, totalled \$14.4 million in 2006 compared to \$13.6 million in the prior year. Unallocated costs were higher as a result of additional administrative costs including audit fees, salaries and legal fees. The administrative costs in prior year comparative periods primarily represent allocations of Canfor's corporate administration, legal services, human resources, treasury services and incentive plan amounts. These were based on estimates of the Pulp Business' share of Canfor's corporate costs. A refund of provincial sales tax of \$1.1 million reduced unallocated costs in 2005.

### *Business Acquisition Costs*

The Partnership incurred costs related to its initial organization and the acquisition of the Pulp Business from Canfor, fully described in Note 1 to the financial statements of the Partnership, principally comprised of legal, accounting, audit and consulting fees.

### *Interest Expense*

Net interest expense of \$3.8 million represents July to November interest at prime plus 0.5% paid to Canfor for borrowing under the \$125 million promissory note and interest at rate of 6.41% paid to the holders of the US\$110 million (Cdn \$125.7 million) notes issued on November 30, 2006. Proceeds of the issuance of the US\$110 million notes were used to retire the \$125 million Canfor promissory note. The interest expense is net of interest earned on cash and cash equivalent investments. No interest expense is shown for periods prior to July 1, 2006, since the Pulp Business was an integral part of Canfor and interest was not allocated to it.

## SUMMARY OF FINANCIAL POSITION

The following table summarizes the Partnership's financial position as at December 31 of each year:

(millions of dollars, except for ratios, unaudited)	2006	2005
Ratio of current assets to current liabilities	1.92	2.02
Ratio of net debt to partners' equity <sup>4</sup>	0.17	-
Increase (decrease) in cash and cash equivalents	27.8	(0.8)
– comprised of cash flow from (used in):		
Operating activities	168.2	70.0
Financing activities	(58.1)	(27.8)
Investing activities	(82.3)	(43.0)

### Changes in Financial Position

Operating activities generated \$168.2 million in cash in 2006, which was a \$98.2 million improvement over same period last year, principally due to significantly higher NBSK pulp prices, higher sales volumes and lower fibre costs.

Cash flows from financing activities represent net cash transactions with Canfor prior to the spinout. Prior to the spinout the Pulp Business operating transactions such as sales of products, and purchases of products and services, were settled in the divisional equity account as they occurred. The excess cash flows of the Pulp Business were transferred to the central cash management system of Canfor.

The \$82.3 million of cash used in investing activities in the year represents \$62.7 million of distributions paid to Canfor and the Fund, with the balance relating to net capital expenditures.

### TRANSACTIONS WITH RELATED PARTIES

The Partnership's transactions with related parties are based on agreed upon amounts, unless otherwise noted below.

The Partnership purchased wood chips and hog fuel from Canfor sawmills in the amount of \$83.3 million in 2006 (2005 — \$106.2 million). The Partnership also purchased wood chips from Lakeland Mills Ltd. and Winton Global Lumber Ltd., in which Canfor owns a one-third interest. Purchases from these entities in 2006 were \$8.6 million (2005 — \$11.1 million).

Effective July 1, 2006, the Partnership entered into a services agreement under which Canfor provides certain business and administrative services to the Partnership. Total value of the services provided in 2006 was \$8.5 million (2005— \$11.6 million). The corporate costs in comparative periods prior to the acquisition were based on estimates of the Pulp Business' share of Canfor's corporate costs (see note 1 to the Partnership's financial statements).

Effective July 1, 2006, the Partnership entered into an incidental services agreement with Canfor, under which the Partnership provides certain business and administrative services to Canfor. Total value of the services provided in 2006 was \$1.5 million (2005— \$1.5 million).

The Partnership markets bleached chemi-thermo mechanical pulp production from Canfor's Taylor Pulp Mill for which it earned commissions totaling \$2.3 million in 2006 (2005 — \$2.8 million). The Partnership also purchased pulp from the Canfor Taylor Pulp Mill for resale totaling \$10.1 million in 2006 (2005 — \$8.0 million). In respect of the products marketed and services provided for the Canfor Taylor Pulp Mill, the Partnership held balances of \$6.3 million in accounts receivable - trade and \$6.6 million in accounts payable to Canfor at December 31, 2006 (2005 — \$8.8 million accounts receivable - trade and \$9.8 million in accounts payable to Canfor).

The Partnership markets the NBSK pulp produced by Howe Sound Pulp and Paper Limited Partnership (HSLP) for which it earned commissions totaling \$4.7 million in 2006 (2005 — \$6.0 million). In respect of the products marketed

<sup>4</sup> comprised of long-term debt net of cash and cash equivalents

and service provided for HSLP, the Partnership held balances of \$31.9 million in accounts receivable - trade and \$23.1 million in accounts payable to HSLP at December 31, 2006 (2005 — \$32.3 million in accounts receivable - trade and \$35.6 million in accounts payable to HSLP).

On July 1, 2006, Canfor transferred the Pulp Business to the Partnership in exchange for a \$125 million promissory note, 14.254 million Class A Limited Partnership Units and 57.016 million Class B Exchangeable Limited Partnership Units. The Partnership paid this debt in full on November 30, 2006. Total interest paid or payable to Canfor was \$3.7 million in 2006.

At December 31, 2006, a total of \$14.3 million was outstanding as accounts payable to Canfor in respect of purchases of wood chips, hog fuel, services and amounts paid on behalf of the Partnership. At December 31, 2006, a total of \$0.8 million was payable to Lakeland Mills Ltd. and Winton Global Lumber Ltd. for wood chips (2005 - \$0.7 million).

During 2006, the Partnership declared distributions totaling \$88.5 million to its limited partners. Distributions to Canfor were \$57.9 million, of which \$45.0 million was paid, with the balance of \$12.9 million payable on December 31, 2006. Distributions to the Fund were \$30.6 million, of which \$17.7 million was paid, with the balance of \$12.9 million payable on December 31, 2006.

#### **LIQUIDITY AND FINANCIAL REQUIREMENTS**

On November 30, 2006, the Partnership completed a debt financing by private placement of US\$110 million (Cdn \$125.7 million) of unsecured notes (the Notes). The Notes bear interest at 6.41% and are repayable in full on their maturity date of November 30, 2013. The proceeds from the issuance of the Notes were used to repay the \$125 million Canfor promissory note. The Partnership also entered into a 3-year \$75 million syndicated unsecured revolving bank credit facility (the Revolving Facility) with \$30.6 million of the Revolving Facility reserved for a standby letter of credit for BC Hydro. The Revolving Facility bears interest and fees at rates that vary depending on the ratio of net debt to operating earnings before interest, taxes, depreciation and amortization (EBITDA) and which may, at the option of the Partnership, be based on lenders' Canadian prime rate, bankers acceptances, US base rate or US LIBOR rate.

Each agreement with respect to the Notes and Revolving Facility contains the same covenants with respect to certain financial ratios and at December 31, 2006 the Partnership was in compliance with all covenants.

#### **OUTSTANDING UNITS**

At February 16, 2007, there were a total of 71,270,025 Limited Partnership Units outstanding, consisting of 14,254,005 Class A Limited Partnership Units and 21,239,537 Class B Limited Partnership Units owned by the Fund through Canfor Pulp Trust and 35,776,483 Class B Exchangeable Limited Partnership Units owned indirectly by Canfor.

#### **CRITICAL ACCOUNTING ESTIMATES**

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts recorded in the financial statements. Management regularly reviews these estimates and assumptions based on currently available information. While it is reasonably possible that circumstances may arise which cause actual results to differ from these estimates, management does not believe it is likely that any such differences will materially affect the Partnership's financial condition.

#### **Employee Future Benefits**

The Partnership, in participation with Canfor, has funded and unfunded defined benefit plans, as well as a defined contribution plan, that provide pension, other retirement and post-employment benefits to substantially all salaried employees and for its hourly employees covered under collective agreements. The costs and related obligations of these plans are accrued in accordance with the recommendation of the Canadian Institute of Chartered Accountants.

Independent actuarial firms are used to perform actuarial valuations of the fair value of benefit obligations. The application of these recommendations requires judgments regarding certain assumptions that affect the benefit provisions and related expenses, including the discount rate used to calculate the present value of the obligation and the assumed health care cost trend rates. Management evaluates these assumptions annually based on its own experience and the recommendations of its actuarial firms. Changes in these assumptions result in actuarial gains or losses which are amortized over the average remaining service period of the group covered by the plans to the extent that it is in excess of 10% of the accrued benefit obligation.

#### **CHANGE IN ACCOUNTING POLICY – MAJOR MAINTENANCE COSTS**

The Partnership adopted the deferral method of accounting for major maintenance costs. Under this method an asset is recorded when expenditures for maintenance costs related to major maintenance are incurred. This asset is then amortized over the period to which the maintenance relates. The amounts in prior periods are not considered material for restatement.

#### **RECENT ACCOUNTING PRONOUNCEMENTS**

The CICA has issued three new pronouncements (Handbook Sections) which will apply to the Partnership as of January 1, 2007: Section 3855 “Financial Instruments”, Section 3865 “Hedges” and Section 1530 “Comprehensive Income.” Section 3855 prescribes when a financial instrument should be recognized on the balance sheet and at what amount. It also specifies how to present financial instrument gains and losses. Section 3865, which is optional, provides alternative treatments to Section 3855 for when qualifying transactions are designated as hedges for accounting purposes. Section 1530 introduces new requirements for situations when certain gains and losses must be temporarily presented outside of net income in a new Statement of Comprehensive Income.

The Partnership has not made a final decision with respect to the adoption of some of the presentation alternatives available under the new pronouncements, except for the one noted below. The adoption of these new pronouncements is not expected to have a material effect on the Partnership’s financial position or results of operation.

At December 31, 2006, the Partnership had deferred financing costs of \$1.6 million related to the credit facilities and long-term debt entered into on November 30, 2006. In accordance with the transitional provisions, this balance will be transferred to Opening Partners’ Equity at January 1, 2007.

#### **CONTRACTUAL OBLIGATIONS AND CONTINGENCIES**

In addition to the obligations noted in “Financial requirements and Liquidity”, the Partnership has committed to the following operating leases for property, plant and equipment. As at December 31, 2006, the future minimum lease payments under these operating leases were as follows:

(millions of dollars, unaudited)

2007	3.0
2008	1.5
2009	0.7
Thereafter	0.5
<b>Total minimum lease payments</b>	<b>5.7</b>

In 2003, Canfor entered into an agreement with BC Hydro to build an electrical cogeneration facility at the Prince George Pulp and Paper Mill. Under the agreement, BC Hydro contributed \$45.8 million of the project costs, with Canfor contributing the balance. The agreement was assigned to the Partnership effective July 1, 2006, with incentive payments totaling \$11.4 million outstanding. The final incentive payment of \$11.4 million was received August 9, 2006, and transferred to Canfor. The total incentive payments of \$45.8 million were accounted for as a credit to property, plant and equipment of the Partnership. The project was completed in the second quarter of 2005 at a net cost to the Pulp Business of \$69.6 million. The agreement entails a 15 year commitment with BC Hydro for power displacement at the cogeneration facility, whereby a proportionate repayment is required should the facility not

generate the minimum of 390 gigawatt hours of electricity per year. Under the agreement, the Partnership is required to post a letter of credit as security in annually decreasing amounts as minimum required amount of electricity is generated.

As of December 31, 2006, the Partnership has no repayment obligation under the terms of the agreement and a standby letter of credit in the amount \$30.6 million was issued to BC Hydro.

#### *Derivative Financial Instruments*

The Partnership utilizes derivative financial instruments in the normal course of its operations as a means to manage its foreign exchange and commodity price risk. For example, from time to time, it purchases foreign exchange forward contracts to hedge anticipated sales to customers in the United States and the related accounts receivable and also enters into swap transactions to reduce its exposure to fluctuating prices for the purchase of natural gas and the sale of NBSK pulp. The Partnership policy is not to utilize derivative financial instruments for trading or speculative purposes.

### **SUBSEQUENT EVENTS**

On January 24, 2007 the Partnership declared a distribution of \$0.14 per unit or \$10.0 million, payable on February 15, 2007 to unitholders of record on January 31, 2007. On February 16, 2007, the Partnership declared a distribution of \$0.14 per unit or \$10.0 million, payable on March 15, 2007, to unitholders of record on February 28, 2007.

### **RISKS AND UNCERTAINTIES RELATED TO THE BUSINESS AND INDUSTRY**

#### **Cyclicality of Product Prices**

The Partnership's financial performance is dependent upon the selling prices of its pulp and paper products, which have fluctuated significantly in the past. The markets for these products are highly cyclical and characterized by (i) periods of excess product supply due to industry capacity additions, increased production and other factors; and (ii) periods of insufficient demand due to weak general economic conditions. The economic climate of each region where the Partnership's products are sold has a significant impact upon the demand, and therefore, the prices for pulp and paper. In particular, the list price of pulp has historically been unpredictable.

#### **Currency Exchange Risk**

The Partnership's operating results are sensitive to fluctuations in the exchange rate of the Canadian dollar to the U.S. dollar, as prices for the Partnership's products are denominated in U.S. dollars or linked to prices quoted in U.S. dollars. Therefore, an increase in the value of the Canadian dollar relative to the U.S. dollar reduces the amount of revenue in Canadian dollar terms realized by the Partnership from sales made in U.S. dollars, which in turn, reduces the Partnership's operating margin and the cash flow available to fund distributions.

#### **Dependence on Canfor**

Approximately 65% of the fibre currently used by the Partnership is derived from the Fibre Supply Agreement with Canfor. The Partnership's financial results could be materially adversely affected if Canfor is unable to provide the current volume of wood chips as a result of mill closures, whether temporary or permanent.

#### **Raw Material Costs**

The principal raw material utilized by the Partnership in its manufacturing operations is wood chips. The Partnership's Fibre Supply Agreement with Canfor contains a pricing formula that currently results in the Partnership paying market prices for wood chips and contains provisions to adjust the pricing formula to reflect market conditions. Prices for wood chips are not within the Partnership's control and are driven by market demand, product availability, environmental restrictions, logging regulations, the imposition of fees or other restrictions on exports of lumber into the U.S. and other matters. The Partnership is not always able to increase the selling prices of its products in response to increases in raw material costs.

## **Competitive Markets**

The Partnership's products are sold primarily in North America, Europe, and Asia. The markets for the Partnership's products are highly competitive on a global basis, with a number of major companies competing in each market with no company holding a dominant position. Competitive factors include quality of product, reliability of supply and customer service. The Partnership's competitive position is influenced by the availability, quality and cost of raw materials, energy and labour costs, free access to markets, currency exchange rates, plant deficiencies and productivity in relation to its competitors.

## **Dependence on Key Customers**

In 2006, the Partnership's largest customer accounted for approximately 23% of its pulp sales. The Partnership is, therefore, dependent on this key customer. While the Partnership's relationship with this customer is long-standing and the sales agreement with this customer is evergreen with a three-year notice period required to terminate the Agreement, in the event that the Partnership cannot maintain this customer or the demand from this customer diminishes for any reason in the future, there is a risk that the Partnership would be forced to find alternative markets in which to sell its pulp, which, in turn, could result in lower prices or increased distribution costs thereby adversely affecting its sales margins and Distributable Cash.

## **Increased Production Capacity**

The Partnership currently faces substantial competition in the pulp industry and may face increased competition in the years to come if new manufacturing facilities are built or existing mills are improved. If increases in pulp production capacity exceed increases in pulp demand, selling prices for pulp could decline and adversely affect the Partnership's business, financial condition, results of operation and cash flows, and the Partnership may not be able to compete with competitors who have greater financial resources and who are better able to weather a prolonged decline in prices.

## **Obligations to BC Hydro**

Under the Cogeneration Agreement with BC Hydro, if the cogeneration project generates less than 390 GWh in any year and the shortfall cannot be made up by excess generation of up to 390 GWh in prior years or excess generation in the subsequent year, the Partnership is required to pay BC Hydro an amount equal to \$3.27 million multiplied by the ratio of the uncorrected shortfall to the annual requirement of 390 GWh.

## **Maintenance Obligations and Facility Disruptions**

The Partnership's manufacturing processes are vulnerable to operational problems that can impair the Partnership's ability to manufacture its products. The Partnership could experience a breakdown in any of its machines, or other important equipment, and from time to time the Partnership schedules planned and unplanned outages to conduct maintenance that cannot be performed safely or efficiently during operations. Such disruptions could cause significant loss of production, which could have a material adverse effect on the Partnership's business, financial condition and operating results.

## **Governmental Regulation**

The Partnership is subject to a wide range of general and industry-specific environmental, health and safety and other laws and regulations imposed by federal, provincial and local authorities. If the Partnership is unable to extend or renew a material approval, licence or permit required by such laws, or if there is a delay in renewing any material approval, licence or permit, the Partnership's business, financial condition, results of operations and cash flows could be materially adversely affected. In addition, future events such as any changes in these laws and regulations or any change in their interpretation or enforcement, or the discovery of currently unknown conditions, may give rise to unexpected expenditures or liabilities.

## **Capital Requirements**

The pulp and paper industries are capital intensive, and the Partnership regularly incurs capital expenditures to expand its operations, maintain its equipment, increase its operating efficiency and comply with environmental laws. The Partnership's total capital expenditures were approximately \$20 million during 2006, and it expects to spend about \$29 million on capital expenditures during 2007. The Partnership anticipates available cash resources and cash generated from operations will be sufficient to fund its operating needs and capital expenditures.

## **Work Stoppages**

Any labour disruptions and any costs associated with labour disruptions at the Partnership's mills could have a material adverse effect on the Partnership's production levels and results of operations. The Partnership's collective agreements with the CEP and PPWC have terms expiring on April 30, 2008. Any future inability to negotiate acceptable contracts could result in a strike or work stoppage by the affected workers and increased operating costs as a result of higher wages or benefits paid to unionized workers.

## **Native Land Claims**

Much of the fibre used by the Partnership is sourced from areas, which are located within areas where there are claims of Aboriginal rights and title. The courts have held that the Crown has an obligation to consult aboriginal people, and accommodate their concerns, where there is a reasonable possibility that a Crown-authorized activity, such as public forest tenure, may infringe asserted Aboriginal rights or title, even if those claims have not yet been proven. If the Crown has not consulted and accommodated aboriginal people as required, the courts may quash a tenure or attach conditions to the exercise of harvesting rights under the tenure that may affect the quantity of fibre that can be harvested from such tenure.

## **Transportation Services**

The Partnership relies primarily on third parties for transportation of its products, as well as delivery of raw materials principally by railroad, trucks and ships. If any of the Partnership's third party transportation providers were to fail to deliver the raw materials or products or distribute them in a timely manner, the Partnership may be unable to sell those products at full value, or at all, or unable to manufacture its products in response to customer demand and have a material adverse effect on its financial condition and operating results. In addition, if any of these third parties were to cease operations or cease doing business with the Partnership, the Partnership may be unable to replace them at reasonable cost.

## **Senior Management**

The Partnership's success depends, in part, on the efforts of its senior management. The senior management team, led by Paul Richards, President and CEO, has significant industry experience and would be difficult to replace. Members of the senior management team possess sales, marketing, engineering, manufacturing, financial and administrative skills that are critical to the operation of the Partnership's business. If the Partnership loses or suffers an extended interruption in the services of one or more of its other senior officers, the Partnership may become unable to implement its business strategy, resulting in lower profitability. Moreover, the market for qualified individuals is highly competitive, and the Partnership may not be able to attract and retain qualified personnel to replace or succeed members of senior management should the need arise. The Partnership does not maintain any key-man or similar insurance policies covering any of its senior management.

## **Environmental Issues**

In October 2006, the Partnership observed dark ponded water in an area on the banks of the Fraser River and reported the dark ponded water to the appropriate regulatory agencies. The Partnership also undertook certain remedial work and investigations to determine the source of the dark ponded water. The Partnership's experts have concluded that the source is likely a leak from the Partnership's Intercon mill ash pond.

The Partnership in conjunction with the BC Ministry of Environment is considering and developing remedial options. The cost to remediate the ash pond and surrounding area cannot be determined at this time, but the Partnership believes it will not have a material effect on its financial condition.

## Sensitivities

In addition, the sensitivity of Partnership's results to currency fluctuations and price changes for its principal products and input costs, when operating at full capacity, is estimated to be as follows:

(millions of dollars, unaudited)	Impact on annual Net income
Canadian dollar – US \$0.01 change per Canadian dollar	\$ 5
NBSK pulp – US \$10 change per tonne	8
Natural gas cost - \$1 change per gigajoule	4
Chip cost - \$10 change per tonne	24

## DISCLOSURE CONTROLS

The Partnership has established disclosure controls and procedures to provide reasonable assurance that information disclosed in this MD&A and the related financial statements was properly recorded, processed, summarized and reported to the Board and the Audit Committee of the general partner and the Audit Committee and Trustees of the Fund. The Partnership's Chief Executive Officer and Chief Financial Officer have evaluated and are satisfied with the effectiveness of these disclosure controls and procedures for the period ending December 31, 2006.

During 2006 there were no changes to our internal controls over financial reporting that occurred that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

## ADDITIONAL INFORMATION

Additional information about Canfor Pulp Income Fund and Canfor Pulp Limited Partnership, including the Annual Information Form, is available at [www.sedar.com](http://www.sedar.com) or [www.canforpulp.com](http://www.canforpulp.com).

**CANFOR PULP LIMITED PARTNERSHIP**  
**SUPPLEMENTARY FINANCIAL INFORMATION**

(millions of dollars, unaudited)	<b>Six months ended</b>	
	<b>December 31, 2006</b>	
<b>RECONCILIATION OF NET INCOME TO EBITDA</b>		
<b>Net Income</b>	<b>\$</b>	<b>86.7</b>
Add:		
Amortization		25.4
Interest		3.8
Foreign exchange loss on long-term debt		2.5
Business acquisition costs and other		6.0
<b>EBITDA (operating income before interest and amortization)</b>		<b>124.4</b>
<b>CALCULATION OF DISTRIBUTABLE CASH</b>		
<b>Cash flow from operating activities</b>		<b>99.9</b>
Change in working capital		22.8
Deduct:		
Financing costs		(1.6)
Capital expenditures		(11.1)
<b>Distributable cash</b>	<b>\$</b>	<b>110.0</b>
Distributable cash – per Partnership unit (in dollars)		1.54
<b>Cash distributions declared (paid and payable)</b>		<b>88.5</b>
Cash distributions declared – per Partnership unit (in dollars)	<b>\$</b>	<b>1.24</b>

Note: Distributable cash is only presented for the periods subsequent to inception of the Partnership's business on July 1, 2006.

**DISTRIBUTABLE CASH AND CASH DISTRIBUTIONS**

Management determines the level of cash distributions based on the level of cash flow from operations before working capital changes less actual and planned capital expenditures and a reserve for future major capital replacements (estimated at \$4 million per year) less a contingency reserve. During the year distributions are based on estimates of full year cash flow and capital spending and thus distributions may be adjusted as these estimates change. Capital expenditures during 2006, including the second half of the year, were below the level normally expected for the business and as a result the reserve for capital expenditures for the balance of the year was increased to provide a reserve for spending in future periods. It is expected that normal seasonal fluctuations in working capital will be funded from a revolving short-term credit facility and thus will not significantly affect the level of distributions.

Distributions are declared on a monthly basis with record date on the last day of the month and payable within 15 days following. The Partnership began active operation in July 2006, including monthly distributions, and thus there were no distributions in prior periods and no distributions will be paid for earnings from prior periods. The calculation of distributable cash in the table above for any periods prior to July 1, 2006 is provided for information purposes only.

*EBITDA and Distributable cash are not measures determined in accordance with Canadian generally accepted accounting principles and should not be considered as alternatives to net income or cash flow from operations. As there is no standardized method of calculating EBITDA or Distributable cash, the Partnership's use of these terms may not be directly comparable with similarly titled measures used by other companies or income funds.*