SOUTHERN CALIFORNIA GAS CO
Form DEF 14C
April 26, 2019

SCHEDULE 14C INFORMATION

Information Statement Pursuant to Section 14(c)

of the Securities Exchange Act of 1934 (Amendment No.)

Check the appropriate box:

Preliminary Information Statement

Confidential, for Use of the Commission Only (as permitted by Rule 14c-5(d)(2))

Definitive Information Statement

Southern California Gas Company

(Name of Registrant as Specified In Its Charter)

Payment of Filing Fee (Check the appropriate box):

No fee required.

Fee computed on table below per Exchange Act Rules 14c-5(g) and 0-11.

(1) Title of each class of securities to which transaction applies:

(2) Aggregate number of securities to which transaction applies:

(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (Set forth the amount on which the filing fee is calculated and state how it was determined):

(4) Proposed maximum aggregate value of transaction:

(5) Total fee paid:

Fee paid previously with preliminary materials.

Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

(1) Amount Previously Paid:

(2) Form, Schedule or Registration Statement No.:

(3) Filing Party:

(4) Date Filed:

SOUTHERN CALIFORNIA GAS COMPANY

NOTICE OF

ANNUAL SHAREHOLDERS MEETING

The Southern California Gas Company (SoCalGas or the company) Annual Shareholders Meeting will be held on May 24, 2019, at 9:00 a.m., local time, at 488 8th Avenue, San Diego, California. SoCalGas is an indirect subsidiary of Sempra Energy.

The 2019 Annual Shareholders Meeting will be held for the following purposes:

(1) To elect directors.

(2) To transact any other business that may properly come before the meeting.

Shareholders of record at the close of business on March 26, 2019, are entitled to notice of and to vote at the Annual Shareholders Meeting and any adjournment or postponement thereof.

The Annual Shareholders Meeting is a business-only meeting. It will not include any presentations by management and the company does not encourage shareholder attendance.

Only company shareholders at the close of business on March 26, 2019 are entitled to attend the Annual Shareholders Meeting and any adjournment or postponement thereof. Shareholders who own shares registered in their names will be admitted to the meeting upon verification of record share ownership. Shareholders who own shares through banks, brokers or other nominees must present proof of beneficial share ownership (such as the most recent account statement prior to March 26, 2019) to be admitted.

Additional information regarding the company is included in its joint Annual Report on Form 10-K for the year ended December 31, 2018 (2018 Form 10-K) and other documents filed with the U.S. Securities and Exchange Commission (SEC). These documents also are available on the Sempra Energy website at www.sempra.com under the Investors and SEC Filings tabs. The company will furnish a copy of its 2018 Form 10-K (excluding exhibits, except those that are specifically requested) without charge to any of its shareholders who so request by writing to the office of the Corporate Secretary at 488 8th Avenue, San Diego, California 92101-7123. Information on the website does not constitute part of this Information Statement.

Kari E. McCulloch

Corporate Secretary

Important Notice Regarding the Availability of Information Statement Materials for the

SoCalGas Annual Shareholders Meeting to be Held on May 24, 2019.

The Information Statement for the Annual Shareholders Meeting to be held on May 24, 2019

and the Annual Report to Shareholders are available on the Internet at

http://www.astproxyportal.com/ast/25974.

INFORMATION STATEMENT

WE ARE NOT ASKING YOU FOR A PROXY AND

YOU ARE REQUESTED NOT TO SEND US A PROXY

Southern California Gas Company is providing this Information Statement to its shareholders in connection with its Annual Shareholders Meeting to be held on May 24, 2019. The Notice of Annual Shareholders Meeting and Information Statement and the Annual Report to Shareholders are being mailed to shareholders beginning on or about April 26, 2019.

THE COMPANY

Southern California Gas Company, which we refer to as SoCalGas or the company, is an indirect subsidiary of Sempra Energy. SoCalGas principal executive offices are located at The Gas Company Tower, 555 West Fifth Street, Los Angeles, California 90013-1046. Its telephone number is (213) 244-1200.

OUTSTANDING SHARES AND VOTING RIGHTS

The SoCalGas Board of Directors has fixed March 26, 2019, as the record date for determining the shareholders of SoCalGas entitled to notice of and to vote at the SoCalGas Annual Shareholders Meeting and any adjournment or postponement thereof. On that date, SoCalGas outstanding shares consisted of 91,300,000 shares of common stock and 862,043 shares of preferred stock. All SoCalGas common stock and 50,970 shares of SoCalGas preferred stock are owned by Pacific Enterprises (PE), a wholly owned direct subsidiary of Sempra Energy.

In electing directors, each share is entitled to one vote for each of the four director positions and shareholders will be entitled to cumulate votes if any shareholder gives notice of an intention to do so at the meeting and prior to the voting. If that notice is given, all shareholders may cast all of their votes for any one director candidate whose name has been placed in nomination prior to the voting or distribute their votes among two or more such candidates in such proportions as they may determine. In voting on any other matters that may be considered at the Annual Shareholders Meeting and any adjournment or postponement thereof, each share is entitled to one vote. The company does not expect there to be any broker non-votes at the Annual Shareholders Meeting. However, if there are any broker non-votes, each will be counted for purposes of determining the presence or absence of a quorum for the transaction of business, but will not be considered a vote cast with respect to the election of directors or any other proposal.

The shares of SoCalGas owned by PE and indirectly owned by Sempra Energy represent over 99 percent of SoCalGas outstanding shares and the number of votes entitled to be cast on the matters to be considered at the Annual Shareholders Meeting and any adjournment or postponement thereof. PE has advised SoCalGas that it intends to vote FOR each of the nominees for election to the SoCalGas Board of Directors.

GOVERNANCE OF THE COMPANY

The business and affairs of SoCalGas are managed and all corporate powers are exercised under the direction of its Board of Directors in accordance with the California General Corporation Law as implemented by SoCalGas Restated Articles of Incorporation and Bylaws, as amended.

Board of Directors

Board Meetings; Annual Shareholders Meeting

During 2018, the Board of Directors of SoCalGas held 16 meetings and acted 15 times by unanimous written consent. Each director attended at least 75 percent of the meetings.

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The Annual Shareholders Meeting is a business-only meeting without presentations by management. The company does not encourage attendance at the meeting by public shareholders. The Board of Directors encourages all nominees standing for election as directors to attend the Annual Shareholders Meeting. Last year, all of the nominees standing for election as directors at the 2018 Annual Shareholders Meeting attended the 2018 meeting. You may request directions to be able to attend the meeting and vote in person by contacting the company s Corporate Secretary at 488 8th Avenue, San Diego, California 92101-7123.

Leadership Structure

SoCalGas does not have a lead independent director. As a subsidiary of Sempra Energy, SoCalGas is not subject to stock exchange listing standards requiring independent directors and various board committees and, accordingly, has not established independence standards for its directors. All of the directors of the company are also officers of the company or Sempra Energy and, as such, none qualifies as an independent director under the New York Stock Exchange Listing Standards (NYSE Listing Standards). The SoCalGas Board of Directors does not maintain any committees.

Nominees for election as directors are determined by the SoCalGas Board of Directors, and the board will not consider director candidates recommended by shareholders other than its direct and indirect parent companies. The board currently consists of J. Bret Lane, Chairman and Chief Executive Officer of SoCalGas, and three officers of Sempra Energy with varying professional and business expertise. The board has nominated four candidates for election to the board at the Annual Shareholders Meeting, three of whom are officers of Sempra Energy and the fourth of which is Mr. Lane. Although Sempra Energy and SoCalGas promote diversity in hiring employees and in the appointment of their officers, diversity is not further considered in selecting the individuals that serve as directors of the company.

Sempra Energy s Board of Directors is composed of a substantial majority of independent directors under the NYSE Listing Standards and maintains standing Audit, Compensation, Corporate Governance, and Environmental, Health, Safety and Technology Committees solely composed of independent directors. The Sempra Energy board also has adopted a Code of Business Conduct and Ethics for Directors and Senior Officers that is applicable to the directors and officers of SoCalGas, and officers of SoCalGas also are subject to Business Conduct Guidelines that apply to all employees of SoCalGas.

Risk Oversight

Assessing and monitoring risks and risk management are functions of the SoCalGas Board of Directors. The board reviews and oversees the company s strategic, financial and operating plans. SoCalGas management, including the company s Vice President and Chief Risk Officer, is responsible for identifying and moderating risk. SoCalGas has an Energy Procurement Risk Management Committee (EPRMC) composed of members of senior management and chaired by the company s Chief Financial Officer. The EPRMC is responsible for the oversight of risk management within the company s natural gas procurement department. The board fulfills its risk oversight function by, among other things, receiving direct reports by management and by scheduling periodic updates to the board by representatives of the EPRMC.

Review of Related Person Transactions

Securities and Exchange Commission rules require that SoCalGas disclose certain transactions involving more than $120,000 in which the company is a participant and any of its directors, nominees as directors or executive officers, or any member of their immediate families, has or will have a direct or indirect material interest. The SoCalGas Board of Directors has adopted a written policy that requires the board to review and approve or ratify any such related person transaction that is required to be disclosed.

Communications with the Board

Shareholders or interested parties who wish to communicate with the SoCalGas Board of Directors or an individual director may do so by writing directly to the board or the director at the address set forth above under the caption The Company.

Compensation of Directors

All of our directors are employees of SoCalGas or Sempra Energy and are not otherwise compensated for their service on the SoCalGas Board of Directors.

INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Representatives of Deloitte & Touche LLP, the independent registered public accounting firm for SoCalGas, are expected to attend the Annual Shareholders Meeting. They will have the opportunity to make a statement if they desire to do so and to respond to appropriate questions from shareholders. Deloitte & Touche LLP or its predecessors have continuously served as the independent registered public accounting firm for SoCalGas or its parent company since 1937. Deloitte & Touche LLP also serves as the independent registered public accounting firm for Sempra Energy and its other U.S. public subsidiary, San Diego Gas & Electric Company (SDG&E).

The following table shows the fees paid to Deloitte & Touche LLP for services provided to SoCalGas for 2018 and 2017 (in thousands of dollars).

	SoCalGas			
	2018		2017	
	Fees	% of Total	Fees	% of Total
Audit Fees				
Financial Statements and Internal Controls Audit	$ 2,719		$ 2,724	
Regulatory Filings and Related Services	101			
Total Audit Fees	2,820	90%	2,724	91%
Audit-Related Fees				
Employee Benefit Plan Audits	257		240	
Other Audit Related Services, Accounting Consultation	71		25	
Total Audit-Related Fees	328	10%	265	9%
Total Tax Planning and Compliance Fees				
All Other Fees	1		2	
Total Fees	$ 3,149		$ 2,991	

The Audit Committee of Sempra Energy s Board of Directors is directly responsible for the appointment, compensation, retention and oversight of the independent registered public accounting firm for Sempra Energy and its subsidiaries, including SoCalGas. As a matter of good corporate governance, the SoCalGas Board of Directors also reviewed the performance of Deloitte & Touche LLP and concurred with the determination by the Sempra Energy Audit Committee to retain them as its independent registered public accounting firm for 2019. Sempra Energy s Board of Directors has determined that each member of its Audit Committee is an independent director and is financially literate, and that Jack T. Taylor, who chairs the committee, is an audit committee financial expert as defined by the rules of the SEC.

Except where pre-approval is not required by the SEC rules, Sempra Energy s Audit Committee pre-approves all audit, audit-related and permissible non-audit services provided by Deloitte & Touche LLP for Sempra Energy and its subsidiaries, including SoCalGas. The committee s pre-approval policies and procedures provide for the general pre-approval of specific types of services and give detailed guidance to management as to the services that are eligible for general pre-approval. They require specific pre-approval of all other permitted services. For both types of pre-approval, the committee considers whether the services to be provided are consistent with maintaining the firm s independence. The policies and procedures also delegate authority to the chair of the committee to address any requests for pre-approval of services between committee meetings, with any pre-approval decisions to be reported to the committee at its next scheduled meeting.

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AUDIT REPORT

The Board of Directors of SoCalGas has reviewed and discussed with the company s management the audited financial statements of the company for the year ended December 31, 2018.

The Audit Committee of Sempra Energy (the Sempra Audit Committee) has discussed with Deloitte & Touche LLP the matters required to be discussed by the rules of the Public Company Accounting Oversight Board Auditing Standard No. 1301, Communications with Audit Committees. The Sempra Audit Committee also has received from Deloitte & Touche LLP a report providing the disclosures required by the applicable requirements of the Public Company Accounting Oversight Board regarding their communications with the Sempra Audit Committee concerning Deloitte & Touche LLP s independence, and the Sempra Audit Committee has discussed Deloitte & Touche LLP s independence with them.

Based on these considerations, the Board of Directors of SoCalGas directed that the audited financial statements of SoCalGas be included in its Annual Report on Form 10-K for the year ended December 31, 2018, for filing with the U.S. Securities and Exchange Commission.

BOARD OF DIRECTORS

Randall L. Clark

J. Bret Lane

Lisa Larroque Alexander

Trevor I. Mihalik

SHARE OWNERSHIP

All of the outstanding SoCalGas common stock is owned by PE and all of the outstanding common stock of PE is owned by Sempra Energy. None of the directors or officers of SoCalGas owns any preferred shares of SoCalGas, and SoCalGas is unaware of any person, other than PE, who beneficially owns more than 5.0 percent of its preferred shares.

The following table sets forth the number of shares of Sempra Energy common stock beneficially owned on April 1, 2019, by each director of SoCalGas, by each executive officer of SoCalGas named in the compensation tables of this Information Statement, and by all directors and executive officers of SoCalGas as a group. The shares of common stock beneficially owned by our directors and executive officers as a group total less than 1.0 percent of Sempra Energy s outstanding shares. In calculating this percentage, shares under the heading Phantom Shares are not included because these shares cannot be voted. In addition, these shares either may only be settled for cash or cannot be settled for common stock within 60 days of April 1, 2019.

Share Ownership (A)	Current Beneficial Holdings (B)	Shares Subject to Exercisable Options (C)	Total Without Phantom Shares	Phantom Shares (D)	Total Including Phantom Shares
P. Kevin Chase (E)	1,224		1,224		1,224
Jimmie I. Cho (F)	6,841		6,841	24	6,865
Randall L. Clark (G)	5,110		5,110	109	5,219
Bruce A. Folkmann	890		890		890
J. Bret Lane	17,298	875	18,173	1,071	19,244
Lisa Larroque Alexander (H)	152		152		152
Trevor I. Mihalik	9,931		9,931	2,687	12,618
Patricia K. Wagner (I)	20,743		20,743	279	21,022
Gillian A. Wright	6,073		6,073	35	6,108
Directors and Executive Officers as a Group (11 persons)	69,490	1,200	70,690	4,345	75,035

(A) Our directors and executive officers did not beneficially own shares of Sempra Energy s (i) 6% Mandatory Convertible Preferred Stock, Series A, or (ii) 6.75% Mandatory Convertible Preferred Stock, Series B, at April 1, 2019, therefore no such shares are shown in the table above.

(B) Includes unvested restricted stock units that are convertible into Sempra Energy common stock and that vest within 60 days of April 1, 2019. These total 1,898 unvested restricted stock units for Mr. Mihalik.

(C) Shares of Sempra Energy common stock which may be acquired through the exercise of stock options that currently are exercisable or will become exercisable within 60 days.

(D) The phantom shares represent deferred compensation deemed invested in shares of Sempra Energy common stock. These phantom shares track the performance of Sempra Energy common stock but cannot be voted and may only be settled for cash, or in the case of 39 vested common stock units deferred by Mr. Clark, cannot be settled for common stock within 60 days of April 1, 2019. Phantom shares and deferred units are either fully vested or will vest within 60 days.

(E) Mr. Chase separated from the company effective April 2, 2019 and ceased serving as Senior Vice President, Chief Information Officer and Chief Digital Officer of SoCalGas and SDG&E on that date.

(F) Mr. Cho became Chief Operating Officer of SoCalGas effective January 12, 2019.

(G) Mr. Clark became a director of SoCalGas effective April 6, 2019.

(H) Ms. Larroque Alexander became a director of SoCalGas effective March 18, 2019.

(I) Ms. Wagner resigned as Chief Executive Officer of SoCalGas effective November 16, 2018, and resigned as Chairman and as a director of SoCalGas effective March 18, 2019. Mr. Lane became the Chairman following the resignation of Ms. Wagner.

Based on filings made under Section 13(g) of the Securities Exchange Act of 1934, as amended the (Exchange Act), as of December 31, 2018, the only persons or entities known by us to be a beneficial owner of more than 5 percent of Sempra Energy common stock were as follows:

Name and Address of Beneficial Owner	Shares of Sempra Energy Common Stock	Percent of Class
T. Rowe Price Associates, Inc. (A) 100 E. Pratt Street Baltimore, MD 21202	32,425,914	11.8%
BlackRock, Inc. (B) 55 East 52nd Street New York, NY 10055	24,135,885	8.8%
The Vanguard Group (C) 100 Vanguard Blvd. Malvern, PA 19355	21,165,723	7.7%
Capital International Investors (D) 11100 Santa Monica Boulevard, 16th Floor Los Angeles, CA 90025	14,990,024	5.5%
Franklin Resources, Inc. (E) One Franklin Parkway San Mateo, CA 94403	14,968,122	5.4%

(A) The information regarding T. Rowe Price Associates, Inc. is based solely on a Schedule 13G/A filed by T. Rowe Price Associates, Inc. with the SEC on February 14, 2019 (the TRP 13G/A). According to the TRP 13G/A, includes sole voting power with respect to 13,454,705 shares and sole dispositive power with respect to 32,402,968 shares.

(B) The information regarding BlackRock, Inc. is based solely on a Schedule 13G/A filed by BlackRock, Inc. with the SEC on February 11, 2019 (the BlackRock 13G/A). According to the BlackRock 13G/A, includes sole voting power with respect to 21,426,224 shares and sole dispositive power with respect to 24,135,885 shares.

(C) The information regarding The Vanguard Group is based solely on a Schedule 13G/A filed by The Vanguard Group with the SEC on February 13, 2019 (the Vanguard 13G/A). According to the Vanguard 13G/A, includes sole voting power with respect to 369,079 shares, sole dispositive power with respect to 20,712,458 shares, shared voting power with respect to 142,244 shares and shared dispositive power with respect to 453,265 shares.

(D) The information regarding Capital International Investors is based solely on a Schedule 13G filed by Capital International Investors with the SEC on February 14, 2019 (the Capital 13G). According to the Capital 13G, includes sole voting power with respect to 14,916,086

shares and sole dispositive power with respect to 14,990,024 shares.

(E) The information regarding Franklin Resources, Inc. is based solely on a Schedule 13G filed by Franklin Resources, Inc. with the SEC on January 28, 2019 (the Franklin 13G). According to the Franklin 13G, includes 1,559,595 shares of common stock issuable on conversion of Sempra Energy preferred stock (as computed under Rule 13d-3(d)(1)(i) of the Exchange Act), sole voting power with respect to 14,916,122 shares and sole dispositive power with respect to 14,968,122 shares.

Section 16(a) Beneficial Ownership Reporting Compliance

Our directors and executive officers are required to file reports with the SEC regarding their ownership of our shares. Based solely on our review of the reports filed and written representations from directors and executive officers that no other reports were required, we believe that all filing requirements were timely met during 2018.

Related Party Transactions

David J. Barrett, Vice President and General Counsel and an executive officer of the company effective January 12, 2019, received an annual salary of $313,142, non-equity incentive plan compensation of $236,062 and restricted stock unit awards with a grant date fair value of $106,173, in each case for 2018 in his prior role as Sempra Energy s Associate General Counsel of Gas Infrastructure. Maryam S. Brown, President and an executive officer of the company effective March 23, 2019, received an annual salary of $315,000, non-equity incentive plan compensation of $283,500 and restricted stock unit awards with a grant date fair value of $252,292, in each case for 2018 in her prior role as Sempra Energy s Vice President Federal Government Affairs. Sharon L. Tomkins, previously Vice President and General Counsel and an executive officer of the company from August 2014 until June 1, 2018, received an annual salary of $314,500, non-equity incentive plan compensation of $240,100 and restricted stock unit awards with a grant date fair value of $251,766, in each case for 2018. Ms. Tomkins became Vice President Customer Solutions and Strategy of the company, effective June 2, 2018 and served in such position until she became Vice President Strategy and Engagement of the company effective March 16, 2019. She ceased serving as an executive officer of the company on June 1, 2018. Hal D. Snyder, Chief Human Resources Officer and Chief Administrative Officer and an executive officer of the company until his retirement on June 1, 2018, received an annual salary of $309,800 and non-equity incentive plan compensation of $97,800, in each case for 2018.

ELECTION OF DIRECTORS

At the Annual Shareholders Meeting, four directors will be elected to hold office until the next annual shareholders meeting and until their successors have been elected and qualified. The four director candidates receiving the highest number of affirmative votes will be elected as directors of the company. Votes against the directors and votes withheld will have no legal effect.

The following sets forth information, as of April 26, 2019, regarding the director candidates for election at the Annual Meeting, related to his or her biographical information, business experience and service on other boards. In addition, we discuss below the specific qualifications, attributes and skills that make each director candidate a well-qualified and valuable board member. The directors have held the positions set forth below or various positions with the same or affiliated organizations for at least the last five years.

Randall L. Clark, 49, became a director of SoCalGas on April 6, 2019. He became a Deputy General Counsel and the Chief Human Resources Officer of Sempra Energy on April 6, 2019. Mr. Clark served as the Chief Human Resources Officer and Chief Administrative Officer of SDG&E from March 2017 to April 5, 2019. Prior to that he served as Vice President Human Resources, Diversity and Inclusion for SDG&E from October 2015 to March 2017. He also served as Vice President Human Resources Services for Sempra Energy from September 2014 to October 2015 and as Vice President Compliance and Governance for Sempra Energy from January 2014 to September 2014.

Mr. Clark has served Sempra Energy and its affiliates in a broad range of management roles. His extensive and comprehensive management experience, including his experience overseeing leadership development and employee relations, makes him a valuable addition to our board.

J. Bret Lane, 59, became a director of SoCalGas on March 1, 2014 and executive Chairman of SoCalGas on March 19, 2019. He has been the Chief Executive Officer of SoCalGas since December 18, 2018 and has been the Principal Executive Officer of SoCalGas since November 17, 2018. Mr. Lane served as President of SoCalGas from September 2016 to March 23, 2019, and as the Chief Operating Officer of SoCalGas from January 2014 to December 18, 2018. Mr. Lane served as Senior Vice President Gas Operations and System Integrity for both SoCalGas and SDG&E from August 2012 to January 2014, where he was responsible for all aspects of gas delivery services, including regional operations, engineering, transmission, storage and pipeline safety. Mr. Lane held several senior level positions with SoCalGas and SDG&E from 2005 to 2012.

Mr. Lane has served our company and its affiliates in a broad range of management roles for over 30 years. His extensive experience and in-depth understanding of the natural gas industry, along with his comprehensive management experience, make him a valuable member of our board.

Lisa Larroque Alexander, 45, became a director of SoCalGas on March 18, 2019. She has been a Vice President Corporate Communications and Sustainability for Sempra Energy since May 19, 2018. Ms. Larroque Alexander served as Vice President Customer Solutions, Communications and Environmental Strategy for SoCalGas from April 2018 to May 2018, and Vice President Customer Solutions and Communications for SoCalGas from May 2016 to April 2018. Ms. Larroque Alexander held other positions since joining SoCalGas in 2011, including Director of Technology Solutions from March 2015 to May 2016, Director of Commercial and Industrial Services from August 2014 to March 2015, and Manager Integrated Customer Strategy from January 2014 to August 2014. Prior to joining SoCalGas, Ms. Larroque Alexander was a partner in a management consulting firm that advised utility companies on smart grids, clean energy and energy efficiency. Previously, as a management and marketing consultant, Ms. Larroque Alexander advised Fortune 500 companies on strategies for growth and customer service.

Ms. Larroque Alexander has served our company in a broad range of roles and her extensive experience and in-depth understanding of the company s business make her a valuable member of our board.

Trevor I. Mihalik, 52, became a director of SoCalGas on January 30, 2017. He has been Executive Vice President and Chief Financial Officer of Sempra Energy since May 1, 2018. Prior to that, he was the Senior Vice President of Sempra Energy from December 2013 to May 2018 and Controller and Chief Accounting Officer for Sempra Energy from July 2012 to May 2018. Mr. Mihalik serves as a director of SDG&E and on the Advisory Board for the University of San Diego s School of Business Administration.

Mr. Mihalik s extensive financial and accounting experience in the energy industry, including capital markets, financial reporting, accounting, treasury, market risk and credit risk, makes him a valuable member of our board.

EXECUTIVE COMPENSATION

COMPENSATION DISCUSSION AND ANALYSIS

EXECUTIVE SUMMARY

What information is provided in this section of the Information Statement?

In this Compensation Discussion and Analysis, we:

- Outline our compensation philosophy and discuss how the SoCalGas Board of Directors determines executive pay.
- Describe each element of executive pay, including base salaries, short-term and long-term incentives and executive benefits.

Who are the Named Executive Officers?

This Compensation Discussion and Analysis focuses on the compensation of our named executive officers:

- J. Bret Lane: Chairman and Chief Executive Officer[1]
- Bruce A. Folkmann: Vice President, Chief Financial Officer, Treasurer and Controller
- P. Kevin Chase: Senior Vice President, Chief Information Officer and Chief Digital Officer[2]
- Jimmie I. Cho: Chief Operating Officer[3]
- Gillian A. Wright: Chief Human Resources Officer and Chief Administrative Officer[4]
- Patricia K. Wagner: Former Chairman and Chief Executive Officer[5]

(1) Mr. Lane was promoted from President and Chief Operating Officer to Chief Executive Officer effective December 18, 2018 and to Chairman of the SoCalGas Board of Directors effective March 19, 2019.

(2) Mr. Chase became an officer of SoCalGas and SDG&E effective June 16, 2018. Prior to this, Mr. Chase served as Chief Information Officer of Sempra Energy. Mr. Chase separated from the company effective April 2, 2019 and ceased serving as Senior Vice President, Chief Information Officer and Chief Digital Officer of SoCalGas and SDG&E on that date.

(3) Mr. Cho was promoted from Senior Vice President Customer Services and Gas Distribution Operations to Chief Operating Officer effective January 12, 2019.

(4) Ms. Wright was promoted from Vice President Customer Services to Chief Human Resources and Chief Administrative Officer effective April 7, 2018.

(5) Ms. Wagner resigned as Chief Executive Officer effective November 17, 2018 and became Group President, U.S. Utilities of Sempra Energy effective November 17, 2018. Ms. Wagner resigned as a director and Chairman of the Board effective March 18, 2019.

The amounts shown in this Information Statement for Messrs. Chase and Folkmann reflect their total compensation as officers of both SoCalGas and SDG&E in 2018, the cost of which is allocated between SoCalGas and SDG&E. In addition, the amounts shown in this Information Statement (i) for Mr. Chase include both his 2018 compensation as an officer of SoCalGas and SDG&E and as an officer of Sempra Energy and (ii) for Ms. Wagner include both her 2018 compensation as an officer of SoCalGas and as an officer of Sempra Energy.

On April 19, 2019, in connection with Mr. Chase s separation from Sempra Energy s California utilities (SDG&E and SoCalGas), the California utilities and Mr. Chase entered into a severance agreement and mutual release. Pursuant to the agreement, Mr. Chase will receive (i) a payment of approximately $1,365,000, payable on or before October 2, 2019; (ii) a cash payment of approximately $770,000, equal to the value of the

service-based restricted stock units previously granted to Mr. Chase under Sempra Energy s Long Term Incentive Plan, which were forfeited upon his departure; (iii) upon his election, premium payments made directly to Mr. Chase s insurer to cover continued group health plan coverage through COBRA for up to 18 months; and (iv) outplacement services and financial advice planning services for twenty four months.

What is our Compensation Philosophy?

Our Board of Directors sets the company s executive pay philosophy.

Our compensation philosophy emphasizes:

- Alignment of pay with short-term and long-term company performance.
- Performance-based incentives aligned with shareholder value creation.
- Balance between short-term and long-term incentives.
- More pay tied to performance at higher levels of responsibility.

Elements of our 2018 executive pay program that exemplify our pay-for-performance philosophy include:

- Approximately 54 percent of our CEO s total target pay is performance-based. For our other named executive officers, performance-based compensation makes up an average of approximately 48 percent of 2018 total target pay.[1]
- Performance measures in our short-term incentive plan are directly linked to the financial and operational performance of SoCalGas, Sempra Energy s California utilities and Sempra Energy.
- Long-term incentive compensation is primarily delivered through performance-based restricted stock units. The performance measures for the annual performance-based restricted stock unit awards are based on Sempra Energy s relative total shareholder return and earnings per share growth.

We believe this compensation philosophy enables us to attract, motivate and retain key executive talent and promote strong, sustainable long-term performance.

What compensation governance measures are in place?

Our compensation program goals include:

- Aligning compensation with company performance and shareholders interests.
- Strongly linking executive compensation to both annual and long-term corporate, business and individual performance.
- Motivating executives to achieve superior performance.
- Attracting and retaining executives of outstanding ability and proven experience who demonstrate high standards of integrity and ethics.

Our compensation practices, which are highlighted below, reflect our pay-for-performance philosophy and our commitment to sound corporate governance.

What We Do:

- We use multiple performance measures in our annual and long-term incentive plans. These performance measures link pay to performance and shareholder interests. We use SoCalGas and Sempra Energy earnings, Sempra Energy s relative total shareholder return and Sempra Energy s earnings per share growth as the primary incentive plan financial performance measures. Our annual performance-based bonus plan also includes performance measures related to safety and operations, customer service and supplier diversity.
- We review external market data when making compensation decisions.
- Our clawback policy provides for the forfeiture, recovery or reimbursement of incentive plan awards as required by law or New York Stock Exchange rules. In addition, compensation may be recouped if the company determines that the results on which compensation was paid were not actually achieved, or in certain instances of an employee s fraudulent or intentional misconduct.
- All officers are subject to stock ownership requirements ranging from three times base pay for SoCalGas CEO, President, and COO to one times base pay for vice presidents.
- Executive perquisites constitute a small proportion of our executive total rewards program.
- The Sempra Energy 2013 Long-Term Incentive Plan, in which SoCalGas employees participate, includes a double trigger provision for vesting of equity in connection with a change in control of Sempra Energy. Restricted stock unit awards issued to date under the 2013 Long-Term Incentive Plan provide for continuation following a change in control through the new company s assumption of the awards or the issuance of replacement awards. Replacement awards must meet certain criteria,

which are described in Section 16 of the 2013 Long-Term Incentive Plan. If awards are not assumed or replaced or if an employee is eligible for retirement (age 55 or older with five or more years of service) as of the date of the change in control, awards would vest upon a change in control.

[1] Based on base salary and incentive targets as of December 31, 2018.

What We Don t Do:

- Long-term incentive plan grants are made from a Sempra Energy shareholder-approved plan that prohibits stock option repricing and cash buyouts without shareholder approval.
- Our anti-hedging policy prohibits employees from trading in puts, calls, options or other similar securities related to Sempra Energy common stock.
- Officers are prohibited from hedging or pledging Sempra Energy common stock.
- We do not provide for excise tax gross-ups upon a change in control in our named executive officers agreements, and no named executive officers received excise tax gross-ups.
- Change in control cash severance benefits are not provided upon a change in control only (single trigger). Change in control cash severance benefits are payable only upon a change in control with termination of employment (double trigger).
- None of the named executive officers has an employment contract.
- Named executive officers are not provided guaranteed bonuses or uncapped incentives.
- SoCalGas CEO does not participate in decisions regarding his own compensation. Our other executive officers also do not participate in decisions regarding their own compensation.

LABOR MARKET BENCHMARKING

How is external market data used in determining pay?

External pay data is used to help align executive compensation levels, in total and by component, with the labor market. The SoCalGas Board of Directors views the labor market for our most senior positions as a nationwide, broad cross-section of companies in various industries.

During this benchmarking process, we:

- Review external market data from the Aon Hewitt Total Compensation Management (TCM) Database covering non-financial Fortune 500 companies with revenues between $5.75 billion and $23.25 billion.
- Review summary statistics of the companies included in the TCM Database (but not company-specific information) with the goal of generally managing target pay opportunities, in total and by component (base salaries, target annual performance-based bonuses and target long-term incentives) to the median of this summary data. Positioning relative to the median may vary based on factors such as time in position, performance, and the comparability of market benchmark roles to the scope and structure of our positions. Actual pay levels also will rise above or fall below these standards as a result of actual company and individual performance.
- Analyze data for utility-specific positions periodically.

How is internal equity used in determining pay?

Internal equity is used to determine the compensation for positions that are unique or difficult to benchmark against market data. Internal equity is also considered in establishing compensation for positions considered to be equivalent in responsibilities and importance.

What is SoCalGas management s role in determining pay?

SoCalGas CEO attends the non-executive session of each SoCalGas board meeting. Our human resources department assists the board by preparing compensation information and analyses for its consideration. The board members generally receive presentation materials in advance of board meetings. Our accounting, finance and law departments also support the board with respect to compensation-related matters as needed.

None of our executive officers determine or approve any element or component of their own compensation, nor are they present during the board s deliberation regarding their own compensation. The board seeks our CEO s views on the performance of our other executive officers and pay recommendations for these officers.

COMPENSATION COMPONENTS

The primary components of our executive compensation program are:

- Base salaries
- Performance-based annual bonuses
- Long-term equity incentive awards granted by Sempra Energy

Additional benefits include health and welfare programs, retirement and savings plans, personal benefits and severance pay.

All of our executive officers generally participate in the same compensation programs. However, compensation for the named executive officers may vary substantially based upon the roles and responsibilities of individual officers.

Managing Risk in Compensation Plans

SoCalGas manages risk in incentive compensation plans by balancing short-term and long-term incentives and linking a higher proportion of total compensation to long-term incentives. Risk is also managed through the incentive plan design and selection of the performance measures.

Our risk management program is further strengthened by our clawback policy, which applies to both short-term and long-term incentive plans, our anti-hedging policy and our executive stock ownership requirements.

An independent consultant, Exequity, conducted a risk assessment of our incentive compensation programs. Their findings concluded that our incentive plans do not create risks that are likely to have a material adverse impact on the company. Specific examples of safeguards and risk-mitigating features found in our executive incentive compensation programs are listed below.

Our long-term incentive awards include the following risk-mitigation features:

- Using a payout scale that begins at zero for threshold performance. In contrast, many companies pay 25 percent or 50 percent for threshold performance.
- Avoiding cliffs in the payout scale to help eliminate the risk of pressure points.
  - An example of a cliff is a scale that pays 50 percent for threshold performance and zero for performance below threshold.
- Using multiple types of awards and performance measures, including a market-based performance measure, relative total shareholder return, as the performance measure for 50 percent of the grant date value of our 2018 restricted stock unit grants, a measure based on Sempra Energy s long-term earnings per share growth for 20 percent and service-based restricted stock units for the remaining 30 percent.
- Measuring Sempra Energy s total shareholder return against the Standard & Poor s (S&P) 500 Index and S&P 500 Utilities Index (excluding water companies) rather than against a peer group selected by the company. Using these indices ensures objectivity in the composition of our peer groups.

Our annual bonus plans include the following risk mitigation features:

- Using a payout scale that begins at zero for threshold performance. In contrast, many companies pay 25 percent or 50 percent for threshold performance.
- Using financial performance measures that are based on the earnings reported in our financial statements with certain pre-defined adjustments. These adjustments are limited and made only after thoughtful consideration by the SoCalGas Board of Directors.
- Incorporating several different performance measures, including both financial and operational measures.
- Providing the SoCalGas Board of Directors with upward and downward discretion over certain incentive plan payouts.

Pay Mix

What is Pay Mix ?

Pay mix is the relative value of each of the primary compensation components as a percentage of total target compensation. Figure 1 shows each component of our CEO s total 2018 pay at target company performance.

Figure 1.

Note: Based on salary and incentive targets as of December 31, 2018.

Why is pay mix important?

Our pay mix is designed to align the interests of executives with the interests of shareholders. It does this by providing a much greater portion of pay through performance-based annual and long-term incentives rather than through base salary. This means that most pay is variable and will go up or down in value based on company performance. Approximately 54 percent of Mr. Lane s target total pay is delivered through performance-based incentives and almost 70 percent was in variable incentive pay.

Actual pay mix may vary substantially from target pay mix. This may occur as a result of company and individual performance, which greatly affects annual bonuses, as well as future Sempra Energy common stock performance, which significantly impacts the value of stock-based awards.

Figure 2 shows the percent of total pay at company target performance that comes from each major pay component for each of our named executive officers.

Figure 2.

Note: Based on salary and incentive compensation targets as of December 31, 2018. Does not include special Long-Term Incentive Plan (LTIP) awards.

1. Base Salaries

Our executive compensation programs emphasize performance-based pay. This includes annual bonuses and equity-based long-term incentive awards. However, base salaries remain a necessary and typical part of compensation for attracting and retaining outstanding employees at all levels.

Salaries for our executive officers are targeted at the median of those for the non-financial Fortune 500 companies with revenues between $5.75 billion and $23.25 billion. Using national general industry comparisons helps us attract and retain top-quality executive talent from a broad range of backgrounds. The SoCalGas Board of Directors annually reviews base salaries for executive officers. The board considers the following factors in its review:

Peer group salary data	Succession planning
Individual contributions and performance	Retention needs
Labor market conditions	Reporting relationships
Company performance	Internal equity
Complexity and importance of roles and responsibilities	Experience

Base Salary Adjustments for 2018

Mr. Lane received a 4.2 percent salary planning increase effective January 1, 2018. Upon his promotion to CEO in December 18, 2018, he received a promotional increase of 8.1 percent. Messrs. Folkmann, Chase and Cho and Mss. Wright and Wagner each received salary planning increases of 3.2 percent effective January 1, 2018. Ms. Wright received a 9.9 percent promotional increase in connection with her April 7, 2018 promotion to Chief Human Resources Officer and Chief Administrative Officer. Ms. Wagner received a 17.8 percent increase in connection with her November 17, 2018 promotion to Group President U.S. Utilities, Sempra Energy.

2. Performance-Based Annual Bonuses

Performance Guidelines and Bonus Payments

Each year the SoCalGas Board of Directors establishes performance measures for bonus payments under the SoCalGas Executive Incentive Compensation Plan and SoCalGas and SDG&E Shared Services Executive Incentive Compensation Plan (the Shared Services Plan). Consistent with our pay-for-performance philosophy, the performance measures do not provide for any bonus payment unless threshold (minimum) performance levels are achieved. Bonus opportunities increase from zero for performance at the threshold level to 200 percent of target for performance at maximum.

Potential bonus opportunities at threshold, target and maximum company performance are expressed as a percentage of each named executive officer s base salary and are illustrated below.

Bonus Potential as of December 31, 2018 as a Percentage of Base Salary	Threshold	Target	Maximum
J. Bret Lane	0%	60%	120%
Bruce A. Folkmann	0%	45%	90%
Jimmie I. Cho	0%	50%	100%
P. Kevin Chase	0%	50%	100%
Gillian A. Wright	0%	45%	90%
Patricia K. Wagner[1]	0%	80%	160%

Table 1.

(1) The target shown above for Ms. Wagner is her target as Group President U.S. Utilities, Sempra Energy. Ms. Wagner s 2018 bonus was prorated between her pre-promotion target, which was 70 percent as Chairman and CEO, SoCalGas, and her post-promotion target.

What were the 2018 annual bonus performance goals for the named executive officers?

In 2018, Mr. Lane, Mr. Cho, Ms. Wright and Ms. Wagner (until her transfer to Sempra Energy) participated in the SoCalGas Executive Incentive Compensation Plan. The performance measures for this plan include (i) operational safety

performance measures, (ii) customer service and supplier diversity measures, (iii) SoCalGas, Sempra Energy California utilities, and Sempra Energy earnings adjusted for annual bonus plan purposes, and (iv) individual performance. The relative weights of these measures as a percentage of the overall target were 30 percent for operational safety measures, 15 percent for customer service and supplier diversity measures, 20 percent for utility financial measures, 15 percent for Sempra Energy earnings, and 20 percent for individual performance.

Mr. Folkmann participated in the Shared Services Plan because he provided services to the California utilities. Mr. Chase participated in the Sempra Energy annual bonus plan prior to his transfer to the California utilities and in the Shared Services Plan after his transfer to the California utilities. The performance measures for the Shared Services Plan were based 50 percent on the SoCalGas performance measures described above and 50 percent on SDG&E performance measures.

How were the 2018 annual bonus plan earnings goals determined?

The SoCalGas earnings target of $419 million was based on SoCalGas financial plan, with certain adjustments for incentive plan purposes. Targets for the operational measures were based on safety, customer service and supplier diversity goals.

SoCalGas earnings, California utilities earnings and Sempra Energy earnings for annual bonus plan purposes may be higher or lower than earnings reported in the companies financial statements due to certain pre-established adjustments.

Consistent with the approach taken in prior years, at the beginning of the year, it was determined that the calculation of SoCalGas earnings, California utilities earnings and Sempra Energy earnings for bonus purposes would be adjusted as follows:

- Exclude the impact of any unplanned changes in tax laws or regulations and accounting rule changes.
- Exclude certain items that do not have a material adverse impact on Sempra Energy s common stock price as determined by the Compensation Committee of the Sempra Energy Board of Directors. Such items may include, but are not limited to:
  - the pro forma earnings impact of any acquisition or divestiture (other than divestitures related to individual renewable assets) to the extent the earnings impact of such acquisition or divestiture or related transaction and integration cost is not included in the adjusted earnings target in the annual bonus plan of Sempra Energy or SoCalGas.
  - nonrecurring gains or losses related to RBS Sempra Commodities, which was sold in 2010 (does not apply to SoCalGas earnings).
- Exclude the variance from plan of the foreign exchange earnings or losses at Sempra Mexico, including any associated cost of hedging (does not apply to SoCalGas earnings).
- Exclude 90 percent of the variance from plan of earnings impacts related to new tax equity financing at Sempra Renewables with an earnings life of three years or less (does not apply to SoCalGas earnings).
- Exclude the variance from plan of one-time costs associated with board-approved corporate optimization or capital rotation efforts (including potential asset sales).
- Include 10 percent of any gains or losses related to asset sales and impairments in connection with a sale to the extent the earnings impact of such item is not included in the performance-based annual bonus plan earnings target.
- Exclude items that are required to be excluded from annual bonus plan compensation under the SDG&E and/or SoCalGas general rate case decisions.
- Exclude any earnings impact of any impairments of the San Onofre Nuclear Generating Station (SONGS) or any recoveries from third parties (net of reimbursement of legal costs), litigation costs, or any related earnings effect from purchased replacement power (does not apply to SoCalGas earnings).
- Exclude one-time nonqualified pension settlement charges and LTIP tax windfall or shortfall to the extent such items are not included in the performance-based annual bonus plan earnings target.
- Limit impact of rabbi trust results (net of deferred compensation) to +/-5% (percentage points) of the performance-based annual bonus plan result as calculated without such gains or losses.
- Exclude the impact of authorized decisions of the SoCalGas Board of Directors that could impact earnings including, but not limited to, issuing debt or preferred stock securities exceeding planned amounts to fund dividends, legal settlements or other strategic expenses approved by the board (does not apply to Sempra Energy earnings).

What were the performance results for the 2018 performance-based annual bonus plan?

Overall performance for the SoCalGas Executive Incentive Compensation Plan, excluding the individual performance measure, was at 170 percent of target performance. Details of the plan metrics and results are provided below:

2018 Performance Measures		ICP GOALS			Actual ICP
Financial and Strategic: Earnings Adjusted For Bonus Plan Purposes[1] (Dollars in Millions)	**Weight**	**Minimum**	**Target**	**Maximum**	**Performance**
SoCalGas Earnings	15%	$ 398	$ 419	$ 431	$ 429
Sempra Energy California Utilities Earnings	5%	$ 1,007	$ 1,060	$ 1,091	$ 1,104
Sempra Energy Earnings	15%	$ 1,428	$ 1,487	$ 1,546	$ 1,576
Subtotal: Financial and Strategic	**35%**				
Safety and Operating:					
Employee Safety Lost Time Incident Rate	6%	1.0		0.8	0.87
Employee Safety Environmental & Safety Compliance Management Program (ESCMP) Corrective Action	4%	90%		100%	100%
Employee Safety Controllable Motor Vehicle Incident Rate	4%	3.33		2.81	2.58
Pipeline Safety Enhancement Program Number of Base Valves Retrofitted and Closed Out	3%	35 valves	45 valves	55 valves	87 valves
Damage Prevention Damages per USA Ticket Rate	4%	3.85	3.70	3.54	3.79
Distribution Integrity Management Program (DIMP) Vintage Integrity Program	3%	65	75	85	104
Storage Integrity Management Program (SIMP)	4%	35	40	45	40
Mobile Home Park Retrofit Program	2%	1,200	1,700	2,200	2,275
Customer Insight Study (CIS): Public Opinion	4%	78.7%	81.0%	83.3%	80.1%
Incomplete Orders Reduction	4%	6,300	7,200	8,200	19,262
Customer Self Service Transactions	3%	57%	59%	60%	60%
Paperless Billing Increase	2%	212,544	239,112	265,680	243,633
Supplier Diversity	2%	32%	35%	38%	40%
Subtotal: Safety and Operating Goals	**45%**				
TOTAL	**80%**				
Actual Performance as a Percent of Target (Excluding Individual Performance Measure)					**169.59%**

Table 2.

[1] Earnings Adjusted for Bonus Plan Purposes is a non-GAAP financial measure (GAAP represents accounting principles generally accepted in the United States of America). GAAP Earnings for 2018 for SoCalGas, Sempra Energy California Utilities and Sempra Energy were $400 million, $1,069 million and $924 million, respectively. We provide a reconciliation of GAAP Earnings to Earnings Adjusted for Bonus Plan purposes below.

Overall performance for the Shared Services Plan in which Mr. Folkmann and Mr. Chase (after his transfer from Sempra Energy to the California utilities) participated was at 174 percent of target performance.

Shared Services Executive Incentive Compensation Plan Summary	Weight	Actual Performance as a Percent of Target
SoCalGas Executive Incentive Compensation Plan	50%	169.59%
SDG&E Executive Incentive Compensation Plan	50%	178.36%
SoCalGas and SDG&E Shared Services Executive Incentive Compensation Plan	**100%**	**173.98%**

Table 3.

What adjustments were applied to GAAP Earnings for Annual Bonus Plan Purposes?

A reconciliation of 2018 GAAP earnings to earnings adjusted for annual bonus plan purposes is provided below:

Southern California Gas Company Earnings *(Dollars in Millions)*	**Reconciliation**
Southern California Gas Company GAAP Earnings	$ 400
Exclude impacts associated with litigation	22
Other excluded items	7
Southern California Gas Company Earnings for Annual Bonus Plan Purposes	$ 429

Table 4.

Sempra Energy California Utilities Earnings *(Dollars in Millions)*	**Reconciliation**
Sempra Energy California Utilities GAAP Earnings	$ 1,069
Exclude impacts associated with litigation	22
Other excluded items	13
Sempra Energy California Utilities Earnings for Annual Bonus Plan Purposes	$ 1,104

Table 5.

Sempra Energy Earnings *(Dollars in Millions)*	**Reconciliation**
Sempra Energy GAAP Earnings	$ 924
Exclude gains and losses on divestitures and related impairments	407
Exclude impact of the enactment of tax reform legislation	100
Exclude impairment of investment in RBS Sempra Commodities, which was sold in 2010	67
Exclude variance to plan of foreign exchange gains or losses at Sempra Mexico	47
Exclude litigation settlement and certain unplanned items related to nonqualified pension and deferred compensation	39
Exclude earnings (including depreciation benefits) from assets held for sale, variance to plan for Oncor acquisition closing earlier than planned, unplanned costs related to pending acquisition, and unplanned mandatory preferred dividends and capital rotation costs, net of interest	(8)
Sempra Energy Earnings for Annual Bonus Plan Purposes	$ 1,576

Table 6.

2018 Performance-Based Annual Bonus Payments

As shown above, the overall annual bonus plan performance results, excluding the individual performance measure, were 170 percent of target for the SoCalGas plan, 174 percent of target for the Shared Services Plan, and 200 percent of target for the Sempra Energy plan that Mr. Chase participated in prior to his transfer to the California utilities. Based on this performance and its consideration of the contributions of each named executive officer, the SoCalGas Board of Directors approved the payment of the annual bonuses shown in Table 7.

Bonuses Paid to Named Executive Officers for 2018 Performance	Base Salary at Year-End 2018	Bonus Percentage[1]	Bonus[1]
J. Bret Lane	$540,300	102%	$549,800
Bruce A. Folkmann	$330,300	78%	$258,600
Jimmie I. Cho	$371,900	85%	$315,400
P. Kevin Chase[2]	$464,400	91%	$420,900
Gillian A. Wright	$285,000	76%	$217,500
Patricia K. Wagner[3]	$675,000	128%	$860,900

Table 7.

[1]For presentation purposes, the bonus percentage is rounded to the nearest whole percentage, and bonus amounts are rounded up to the nearest $100.

[2]Mr. Chase s bonus was prorated between the Shared Services and Sempra Energy plans.

[3]Ms. Wagner s bonus was prorated between the Sempra Energy and SoCalGas plans and between her pre-promotion and post-promotion targets (see Table 1 for additional information).

3. Long-Term Equity-Based Incentives

Long-term equity-based incentives are a large component of each named executive officer s total target compensation package. (See Figure 2 for these percentages.) Long-term equity-based incentives are granted to our executives by the Compensation Committee of the Sempra Energy Board of Directors based on the recommendations of the SoCalGas Board of Directors regarding such awards.

What type of equity is granted?

In accordance with our pay-for-performance philosophy, and without regard to the special 2018 awards granted to Mr. Lane and Ms. Wagner described below, 70 percent of the 2018 annual long-term incentive plan award for each of our named executive officers was in the form of performance-based restricted stock units. The remaining 30 percent was in the form of service-based restricted stock units. The 2018 performance-based and service-based restricted stock units are subject to vesting at the end of three years.

Why is this type of equity used?

This equity award structure was approved after considering many variables, including alignment with shareholder interests, retention, plan expense, share usage, market trends and feedback from Sempra Energy s shareholder outreach. The performance-based awards are based on Sempra Energy s relative total shareholder return (constituting 50 percent of target grant date value, with 35 percent based on Sempra Energy s performance relative to the S&P 500 Utilities Index (excluding water companies) and 15 percent based on Sempra Energy s performance relative to the S&P 500 Index) and Sempra Energy s earnings per share growth (constituting 20 percent of target grant date value).

What are general practices with respect to equity grants?

In making the annual grants:

A dollar value (based on a percentage of base salary) is specified for each named executive officer s award.

The number of shares underlying the awards granted each year is based on the specified dollar value, as opposed to a fixed number of shares for each named executive officer. This approach allows maintenance of the pay mix described previously. On the annual January grant date, we calculated the precise number of shares to be granted to each executive officer by dividing the total target value of each named executive officer s award by the applicable Monte Carlo value for the awards based on relative total shareholder return and by the grant date closing price of Sempra Energy common stock for the awards based on Sempra Energy s earnings per share growth and for the service-based restricted stock units. These target grant values are presented in Table 8 below.

Special equity awards also may be granted, including upon the hiring or promotion of executive officers, to award outstanding performance, or to promote retention, with the approval of the Compensation Committee of the Sempra Energy Board of Directors based on the recommendation of the SoCalGas Board of Directors regarding such awards. In January 2018, Mr. Lane received a special award of service-based restricted stock units in order to reward exemplary performance and encourage retention. In November 2018, Ms. Wagner received a promotional award of service-based restricted stock units in connection with her promotion to Group President U.S. Utilities, Sempra Energy.

What were the target values of the 2018 annual equity grants?

Table 8 illustrates the target grant values of 2018 annual long-term incentive awards as a percentage of base salary.

Target Grant Values for 2018	Performance-Based RSUs	Service-Based RSUs	Total[1]
J. Bret Lane	112%	48%	160%
Bruce A. Folkmann	56%	24%	80%
Jimmie I. Cho	84%	36%	120%
P. Kevin Chase	112%	48%	160%
Gillian A. Wright	56%	24%	80%
Patricia K. Wagner	133%	57%	190%

Table 8.

(1) Total target grant values, expressed as a percentage of base salary, that were used to calculate the 2018 annual long-term incentive plan grants in January 2018.

The grant date value of the special service-based restricted stock unit award granted to Mr. Lane and the promotional service-based restricted stock unit award granted to Ms. Wagner were approximately $300,000 and $750,000, respectively.

The actual amounts realized by equity award recipients will depend on future stock price performance and our earnings per share performance and the degree to which these performance measures are achieved. The actual amounts realized will not necessarily track with the target grant values.

What were the performance goals for the 2018 performance-based restricted stock units?

The 2018 long-term incentive plan awards included two performance measures Sempra Energy s relative total shareholder return and Sempra Energy s earnings per share growth. Fifty percent of the total target award value is linked to relative total shareholder return, with 35 percent based on total shareholder return relative to the S&P 500 Utilities Index (excluding water companies) and 15 percent based on total shareholder return relative to the S&P 500 Index. Twenty percent is linked to earnings per share growth.

1. Relative Total Shareholder Return

Each performance-based restricted stock unit represents the right to receive between zero and two shares of Sempra Energy common stock based on Sempra Energy s three-year cumulative total shareholder return compared with the S&P 500 Index and the S&P 500 Utilities Index (excluding water companies), as applicable.

If Sempra Energy s performance is at target (the 50th percentile of the applicable index), participants will earn one share for each restricted stock unit. If Sempra Energy s performance exceeds the 50th percentile of the applicable index, participants have the opportunity to earn up to two shares for each restricted stock unit. Participants may earn a partial share for performance between the 25th and 50th percentiles of the applicable index.

Cumulative Total Shareholder Return Percentile Rank vs. S&P 500 Utilities Index or S&P 500 Index (Measured Independently in Separate Award Components)	Sempra Energy Common Stock Shares Received for Each Restricted Stock Unit[1]
90th Percentile or Above	2.0
70th Percentile	1.5
50th Percentile	1.0
40th Percentile	0.7
30th Percentile	0.4
25th Percentile or Below	0.0

Table 9.

[1] Participants also receive additional shares for dividend equivalents, which are reinvested to purchase additional units that become subject to the same vesting conditions as the restricted stock units to which the dividends relate.

Note: If performance falls between the tiers shown in Table 9, the payout is calculated using linear interpolation.

The award component based on total shareholder return relative to the S&P 500 Index also includes a modifier based on Sempra Energy s absolute total shareholder return. While relative total shareholder return continues to be the primary performance measure, the inclusion of a modifier strengthens the focus on achieving both strong relative and absolute total shareholder return performance. In an instance in which both relative and absolute total shareholder return are high, the modifier may increase award payouts, but cannot cause the total award payout to exceed 200 percent (2.0 shares earned for each restricted stock unit).

The modifier was developed based on the approximate 25th and 75th percentiles of Sempra Energy s historical total shareholder return and historical estimated cost of equity. The modifier adds 20 percent to the award s payout (as initially calculated based on relative total shareholder return) for absolute total shareholder return performance in the top quartile of the distribution of the historical benchmark data. It reduces the award s payout by 20 percent for performance in the bottom quartile of the distribution of the historical benchmark data. For the 2018 award, the modifier is triggered if Sempra Energy s total shareholder return is at or above 35 percent or if Sempra Energy s total shareholder return is at or below -10 percent. If performance falls within the second or third quartiles, the modifier is not triggered and the payout is based solely on the relative total shareholder return performance result. The modifier cannot cause the total award payout to exceed 200 percent.

2. *Earnings Per Share Growth*

The 2018 long-term incentive plan awards also included a performance-based restricted stock unit award linked to relative earnings per share (EPS) growth.[1] The award measures the compound annual growth rate (CAGR) of Sempra Energy s earnings per share for the three-year period ending on December 31, 2020. The payout scale is based on the December 31, 2017 analyst consensus three-year earnings per share growth estimates for the S&P 500 Utilities Index peer companies. The threshold payout level is based on the 25th percentile of the analyst consensus estimates and the maximum is based on the 90th percentile.

[1] The award was designed to meet the conditions necessary to preserve the deductibility of the award under Section 162(m) of the Internal Revenue Code (prior to the changes to Section 162(m) under the Tax Cuts and Jobs Act of 2017, as discussed under Impact of Regulatory Requirements below) while providing flexibility to the Compensation Committee of the Sempra Energy Board of Directors in determining the payout under the award. In order for there to be any payout, Sempra Energy must achieve positive cumulative net income for the performance period. The Sempra Energy Compensation Committee may then apply negative discretion as described herein.

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The awards exclude the impact of stock buybacks not contemplated in the financial plans publicly communicated prior to the grant date of such awards.

Percentile of Analyst Estimates for S&P 500 Utilities EPS CAGR	Sempra Energy Common Stock Shares Received for Each Restricted Stock Unit[1]
90th Percentile (7.3 Percent or higher)	2.0
75th Percentile (6.6 Percent)	1.5
50th Percentile (5.3 Percent)	1.0
25th Percentile (4.2 Percent)	0.0

Table 10.

[1] Participants also receive additional shares for dividend equivalents, which are reinvested to purchase additional units that become subject to the same vesting conditions as the restricted stock units to which the dividends relate.

Note: If performance falls between the tiers shown in Table 10, the payout is calculated using linear interpolation.

For purposes of the long-term incentive award, the calculation of earnings per share may, at the discretion of the Compensation Committee of the Sempra Energy Board of Directors, include the same types of potential adjustments described above under How were the 2018 annual bonus plan earnings goals determined? , as well as adjustments related to, among other things, other unusual or non-operating items.

What were the results for the 2016-2018 performance-based restricted stock unit award cycles?

The performance period for the 2016-2018 award cycle concluded on January 2, 2019 (for the TSR-based awards) and December 31, 2018 (for the EPS-based awards) and were scheduled to vest in 2019. Sempra Energy s 2016-2018 relative total shareholder return was at the 23rd percentile of the S&P 500 Utilities Index and below the total shareholder return of the market-capitalization-weighted S&P 500 Index. As a result, these grants did not vest and were forfeited. The 2016-2018 awards based on earnings per share growth vested at 200 percent of target based on adjusted Sempra Energy earnings per share growth of 9.8 percent. For additional information, see Outstanding Equity Awards at Year-End and Option Exercises and Stock Vested below.

Earnings Per Share Growth (Diluted) for 2016-2018 Award	2015	2018
GAAP Earnings per Share	$ 5.37	$ 3.42
Pre-Defined Exclusions:		
Acquisitions and divestitures (other than Oncor); gains and losses on sales, related impairments, and related earnings impacts	(0.38)	1.43
Effect of changes in tax laws, changes in regulatory treatment of tax repairs allowance, litigation settlement, and foreign exchange gains or losses	(0.65)	0.46
Items related to RBS Sempra Commodities LLP, which was sold in 2010	(0.05)	0.25
Certain unplanned items related to nonqualified pension and deferred compensation and 2015 liquefied natural gas (LNG) development costs	0.02	0.08
90% of the impact of the SONGS impairment and related earnings effects from purchased replacement power	(0.05)	
Earnings per Share for 2016-2018 Award Purposes	$ 4.26	$ 5.64
Earnings per Share Growth for 2016-2018 Award Purposes		9.8%

Table 11.

Benefit Plans

Our named executive officers also participate in other benefit programs including: (1) health, life insurance and disability plans; (2) retirement plans; (3) 401(k) savings and deferred compensation plans; and (4) other benefit programs.

1. Health, Life Insurance and Disability Plans

Our named executive officers participate in life, disability, medical, dental and vision insurance group plans that are generally available to all employees. These are common benefits essential to attracting a high-quality workforce.

Do executives receive any benefits in addition to the basic group plans?

Mr. Lane and Ms. Wagner participate in a long-term disability plan providing additional protection upon disability (60 percent of base salary and average bonus) and restoring benefits otherwise capped under the company s basic long-term disability plan.

Mr. Lane and Ms. Wagner receive an annual executive benefit program allowance described below under Other Benefit Programs which may be used to cover out-of-pocket costs for health and welfare benefits, as well as certain other costs.

2. Retirement and Savings Plans

Our named executive officers participate in the Sempra Energy Cash Balance Plan and Mr. Lane and Ms. Wagner participate in the Sempra Energy Supplemental Executive Retirement Plan. Mr. Folkmann, Mr. Cho, Mr. Chase, and Ms. Wright participate in the Cash Balance Restoration Plan, which restores the benefits that would otherwise be provided under the Cash Balance Plan but for Internal Revenue Service limits applicable to tax-qualified pension plans.

What is the Cash Balance Plan?

The Cash Balance Plan is a tax-qualified pension plan generally available to all U.S.-based employees of Sempra Energy and its eligible subsidiaries.

Why does the company offer a supplemental retirement plan?

Our Board of Directors and the Compensation Committee of the Sempra Energy Board of Directors believe that retirement, savings and deferred compensation plans, in general, and the Supplemental Executive Retirement Plan in particular, are important elements of an overall compensation package. This package is designed to recruit and retain executive talent, especially mid-career executives, and to retain longer-term executive participants.

How are benefits calculated?

The Sempra Energy Supplemental Executive Retirement Plan, or SERP, provides executive officers with retirement benefits based on the executive s:

final average pay[1]
actual years of service
age at retirement

[1] Final average pay is the average base salary for the two consecutive years of highest base salary prior to retirement plus the average of the three highest annual bonuses during the 10 years prior to retirement.

SERP benefits are reduced by benefits otherwise payable under the broad-based Cash Balance Plan.

The Cash Balance Plan, Cash Balance Restoration Plan and the SERP use only base salary and annual incentive bonuses in calculating benefits. The value of long-term incentive awards is not included.

3. 401(k) Savings and Deferred Compensation Plans

Our named executive officers, together with most other company employees, participate in a broad-based, tax-qualified 401(k) Savings Plan. Officers and other key management employees may also participate in a deferred compensation plan.

What is the 401(k) Savings Plan?

Employees may contribute a portion of their pay to a tax-qualified 401(k) savings plan. Contributions to the plan may be invested on a tax-deferred or after-tax basis (including a Roth option effective January 1, 2019). The Internal Revenue Code limits the amount of compensation eligible for deferral under tax-qualified plans.

Employees may receive company contributions of up to four percent of eligible pay. Eligible pay generally includes base salary and annual bonus, net of any amounts contributed under the deferred compensation plan. The basic company matching contribution is equal to one-half of the first six percent of the employee s contributions. In addition, employees receive a stretch match equal to one-fifth of the next five percent of the employee s contributions.

All employee contributions and investment earnings in the 401(k) Savings Plan vest immediately. Employees are eligible to participate in the plan and receive company matching contributions upon hire. Company matching contributions (including related earnings) vest after one year of service.

What is the deferred compensation plan?

Our executive officers and other key management employees also may defer up to 85 percent of their base salary and bonus under a nonqualified deferred compensation plan, the Employee and Director Savings Plan. Executive officers also may defer all or a portion of certain performance-based restricted stock unit awards upon vesting.

Participants can direct these deferrals into:

- Funds that mirror the investments available under the 401(k) savings plan, including a Sempra Energy phantom stock account.
- A fund providing interest at the greater of 110 percent of the Moody s Corporate Bond Yield or the Moody s Corporate Bond Yield plus one percent.

Deferrals of performance-based restricted stock unit awards must be directed into the Sempra Energy phantom stock account and cannot be transferred to other investments.

The Internal Revenue Code places annual limits on the amounts that employees and employers can defer into a 401(k) savings plan. Because of these limits, the company makes matching contributions for deferred compensation plan participants through the deferred compensation plan. Deferred compensation plan participants receive company contributions equal to three percent of base salary and annual bonus deferrals plus three percent of eligible pay in excess of the 401(k) plan limits. In total, an employee who participates in both the 401(k) savings plan and the deferred compensation plan may receive company matching contributions of up to three percent of eligible pay under the 401(k) savings plan and three percent of eligible pay under the deferred compensation plan. There are no company matching contributions on deferrals of performance-based restricted stock units.

Effective January 1, 2019, the deferred compensation matching contribution is equal to one-half of the first six percent of the employee s contributions plus one-fifth of the next five percent of the employee s contributions, less an offset for 401(k) matching contributions.

All employee contributions, matching company contributions and investment earnings in the deferred compensation plan vest immediately. Prior to January 1, 2019, eligibility to receive company matching contributions began after one year of service. Effective January 1, 2019, new participants are immediately eligible for company matching contributions and company matching contributions (including related earnings) vest after one year of service.

4. Other Benefit Programs

We provide certain other typical benefits to our executive officers. We review the level and types of these benefits each year. We believe that these benefits are reasonable and important in attracting and retaining executive talent.

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These benefits include financial planning services, excess personal liability insurance, and a charitable contribution matching program. Mr. Lane and Ms. Wagner also received an annual executive benefit program allowance of $20,000 and $30,000, respectively, which was available to cover out-of-pocket costs for health and welfare benefits as well as the cost of financial planning and excess personal liability benefits. Any unused allowance is paid out at year-end.

None of these benefits includes a tax gross-up provision.

SEVERANCE AND CHANGE IN CONTROL ARRANGEMENTS

Our executive officers have severance pay agreements that include change in control features. The agreements do not contain excise tax gross-up provisions. Equity awards granted include a double trigger change in control provision. None of our officers has an employment agreement.

Why does the company provide severance agreements?

We believe that severance agreements, which are a prevalent market practice, are effective in:

- attracting executives who are leaving an existing employer;
- mitigating legal issues upon a separation of employment; and
- retaining talent during uncertain times.

By mitigating the adverse effects of potential job loss, severance agreements reinforce management continuity, objectivity and focus on shareholder value. This is particularly critical in actual or potential change in control situations. Payments are not required when terminations are for cause.

What benefits do severance agreements provide?

The severance agreements provide for cash payments and the continuation of certain other benefits for a limited period when:

- the company terminates an executive s employment for reasons other than cause, or
- when the executive resigns for good reason.

What does resignation for good reason mean?

A resignation for good reason may occur if there is an adverse change in scope of duties or in compensation and benefit opportunities and, following a change in control of Sempra Energy, changes in employment location.

These provisions provide safeguards against arbitrary actions that effectively force an executive to resign. In order to receive some of the benefits in the agreement, the executive must comply with contractual confidentiality, non-solicitation and non-disparagement obligations.

Do the severance agreements for the named executive officers provide for a tax gross-up to offset any taxes incurred by the executive as a result of the severance payment?

The severance agreements do not contain a tax gross-up provision.

What happens to outstanding equity awards upon certain terminations or a change in control?

Awards granted under the Sempra Energy 2013 Long-Term Incentive Plan are subject to a double trigger change in control provision. Except as described below, awards do not automatically vest upon a change in control. Rather, vesting is only accelerated upon a termination of employment that meets certain conditions following a change in control of Sempra Energy, except as described below.

Restricted stock unit awards issued to date under the Sempra Energy 2013 Long-Term Incentive Plan provide for continuation following a change in control of Sempra Energy through the new company s assumption of the awards or the

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issuance of replacement awards. Replacement awards must meet certain criteria, which are described in Section 16 of the Sempra Energy 2013 Long-Term Incentive Plan. If awards are not assumed or replaced or are held by an employee who is eligible for retirement (age 55 or older with five or more years of service) as of the date of the change in control, such awards would vest upon a change in control. Vesting of service-based restricted stock units will also accelerate upon an executive s death.

With respect to performance-based awards, if an executive s employment is terminated after the executive has attained age 55 and completed five years of service, and the termination occurs after one year of the applicable performance period has been completed (or after November 30th of the year in which the grant was made if the executive has attained age 62), the executive s award is not forfeited as a result of the termination of employment but continues to be subject to forfeiture based upon the extent to which the related performance goals have been satisfied at the end of the applicable performance period.

The Sempra Energy 2019 Long-Term Incentive Plan, which remains subject to Sempra Energy shareholder approval and is described under Proposal 4 in Sempra Energy s 2019 proxy statement, also contains a double trigger change in control provision.

See Compensation Tables Severance and Change in Control Benefits below for additional information.

SHARE OWNERSHIP REQUIREMENTS

Share ownership requirements for officers further strengthen the link between company executive and shareholder interests.

The requirements set minimum levels of Sempra Energy share ownership that our officers must achieve and maintain. For officers, the requirements are:

Executive Level	Share Ownership Requirements
Chief Executive Officer; President; and Chief Operating Officer	3x base salary
Chief Information Officer, Sr. Vice Presidents and Vice Presidents	1x base salary

Table 12.

For purposes of the requirements, we include shares owned directly or through our 401(k) Savings Plan. We also count deferred compensation that executives invest in phantom shares of Sempra Energy common stock (including deferred restricted stock units that have vested), unvested service-based restricted stock units and the vested portion of certain in-the-money stock options.

We expect officers to meet these requirements within five years of hire or promotion to an officer-level position and within three years after promotion to a role with a higher ownership requirement. All of our named executive officers are in compliance with the requirements or have additional time within which to comply with any higher level requirements as a result of a promotion. Executive officers stock ownership requirements also provide that until such time as the stock ownership requirements are met, executive officers are expected to retain (and not sell) a number of shares equal to at least 50 percent of the net after-tax shares acquired through equity compensation awards.

ANTI-HEDGING POLICY

The company maintains an anti-hedging policy, which prohibits employees and directors from trading in puts, calls, options or other future rights to purchase or sell shares of Sempra Energy common stock. Officers and directors are also prohibited from pledging shares of Sempra Energy common stock.

IMPACT OF REGULATORY REQUIREMENTS

Many Internal Revenue Code provisions, Securities and Exchange Commission regulations and accounting rules affect the design of executive pay. They are taken into consideration to create and maintain plans that are effective and are intended to comply with these requirements.

Section 162(m) of the Internal Revenue Code places a limit of $1 million on the annual amount of compensation that publicly held companies may deduct for federal income tax purposes for covered employees. Prior to the Tax Cuts and Jobs Act of 2017, SoCalGas was not considered publicly held for purposes of Section 162(m). As part of the Tax Cuts and Jobs Act of 2017, the definition of companies to which Section 162(m) applies was expanded and SoCalGas became subject to the provisions of Section 162(m). In addition, the definition of covered employees was expanded to generally include all named executive officers.

The SoCalGas Board of Directors believes that tax deductibility is one important factor in evaluating a compensation program. Although we historically maintained certain performance-based incentive plans that originally were intended to permit the payment of compensation deductible under Section 162(m), subject to the limited transition relief rules in the Tax Cuts and Jobs Act of 2017, we are no longer able to take a deduction for any compensation in excess of $1 million that is paid to a covered employee.

Providing salary levels and other compensation that are not fully tax deductible may be required by competitive or other circumstances, and may be in the best interests of our shareholders. Accordingly, the Compensation Committee may exercise judgment to provide compensation that may not be fully tax deductible by the company.

COMPENSATION REPORT OF THE BOARD OF DIRECTORS

The Board of Directors of SoCalGas has reviewed and discussed with management of the company the Compensation Discussion and Analysis included in this Information Statement and, based upon that review and discussion, authorized that it be so included.

BOARD OF DIRECTORS

Randall L. Clark

J. Bret Lane

Lisa Larroque Alexander

Trevor I. Mihalik

COMPENSATION TABLES

Summary Compensation Table

In the table below, we summarize our named executive officers compensation for the last three years.

Summary Compensation Table	Year	Salary	Stock Awards (F)	Non-Equity Incentive Plan Compensation	Change in Pension Value and Non-Qualified Deferred Compensation Earnings (G)	All Other Compen-sation (H)	Total
			Restricted stock and restricted stock units	*Performance-based annual cash bonus*	*Pension accruals and above-market interest on non-qualified deferred compensation*		
J. Bret Lane (A)	2018	$ 501,546	$ 1,100,329	$ 549,800	$ 547,163	$ 61,489	$ 2,760,327
Chief Executive Officer	2017	$ 480,000	$ 1,122,517	$ 492,400	$ 1,000,156	$ 55,798	$ 3,150,871
	2016	$ 437,972	$ 733,466	$ 411,400	$ 1,108,666	$ 55,049	$ 2,746,553
Bruce A. Folkmann	2018	$ 330,300	$ 264,382	$ 258,600	$ 52,553	$ 32,762	$ 938,597
Vice President, Chief Financial Officer,	2017	$ 320,000	$ 258,504	$ 264,400	$ 68,524	$ 31,518	$ 942,946
Treasurer and Controller	2016	$ 303,568	$ 223,779	$ 236,000	$ 70,408	$ 27,852	$ 861,607
P. Kevin Chase (B) Senior Vice President, Chief Information Officer and Chief Digital Officer	2018	$ 464,400	$ 743,211	$ 420,900	$ 64,201	$ 38,696	$ 1,731,408
Jimmie I. Cho (C) Senior Vice President, Customer Services and Distribution Operations	2018	$ 371,900	$ 446,452	$ 315,400	$ 68,750	$ 36,021	$ 1,238,523
Gillian A. Wright (D) Vice President and Chief Human Resources and Chief Administrative Officer	2018	$ 278,214	$ 207,616	$ 217,500	$ 36,925	$ 24,117	$ 764,372
Patricia K. Wagner (E)	2018	$ 585,400	$ 1,838,741	$ 860,900	$ 790	$ 49,052	$ 3,334,883
Former Chairman and Chief Executive Officer	2017	$ 555,000	$ 1,094,240	$ 664,200	$ 1,758,376	$ 46,480	$ 4,118,296

(A) Mr. Lane was appointed as Chief Executive Officer effective December 18, 2018. He previously served as President and Chief Operating Officer.

(B) Mr. Chase assumed the position of Senior Vice President, Chief Information Officer and Chief Digital Officer on June 16, 2018. He previously served as Chief Information Officer for Sempra Energy. 2018 reported compensation reflects annual compensation totals for both roles. Mr. Chase separated from the company effective April 2, 2019 and ceased serving as Senior Vice President, Chief Information Officer and Chief Digital Officer of SoCalGas and SDG&E on that date.

(C) Mr. Cho was appointed Chief Operating Officer effective January 12, 2019. He previously served as Senior Vice President of Customer Services and Distribution Operations.

(D) Ms. Wright was appointed Chief Human Resources and Chief Administrative Officer effective April 7, 2018. She previously served as Vice President, Customer Services.

(E) On November 17, 2018, Ms. Wagner assumed the position of Group President of U.S. Utilities for Sempra Energy. She previously served as Chairman and Chief Executive Officer of the Company. 2018 reported compensation reflects annual compensation totals for both roles.

(F) Grant date fair value of stock awards granted during the year. These amounts reflect our grant date estimate of the aggregate compensation expense that we will recognize over the service period of the award. They are calculated in accordance with GAAP using the assumptions described in Note 10 of the Notes to Consolidated Financial Statements included in Sempra Energy s Annual Report to Shareholders for the year ended December 31, 2018 (the Annual Report) but disregarding estimates of forfeitures related to service-based vesting conditions. Stock awards consist of performance-based and service-based restricted stock units. For the performance-based restricted stock units with a performance measure based on Sempra Energy s relative total shareholder return, a Monte Carlo valuation model was used to reflect the probable outcome of performance conditions and calculate grant date fair value. For the 2018 performance-based restricted stock units with a performance measure based on Sempra Energy s earnings per share growth, the maximum values, assuming the highest level of performance conditions were achieved, would be $320,054 for Mr. Lane; $105,772 for Mr. Folkmann; $297,298 for Mr. Chase; $178,674 for Mr. Cho; $83,016 for Ms. Wright; and $435,516 for Ms. Wagner.

The value actually realized by executives from stock awards will depend upon the extent to which performance and service-based vesting conditions are satisfied and the market value of the shares of Sempra Energy common stock subject to the award.

For additional information regarding equity awards, please see the discussions under Grants of Plan-Based Awards and Outstanding Equity Awards at Year-End.

(G) Represents (i) the aggregate change in the actuarial present value of accumulated benefits under pension plans at year-end over the prior year-end and (ii) above-market interest (interest in excess of 120 percent of the federal long-term rate) on compensation deferred on a basis that is not tax-qualified. The 2018 amounts are:

2018 Change in Pension Value and Above Market Interest	Change in Accumulated Benefits[1]	Above-Market Interest	Total
J. Bret Lane	$ 531,854	$ 15,309	$ 547,163
Bruce A. Folkmann	$ 45,226	$ 7,327	$ 52,553
P. Kevin Chase	$ 62,994	$ 1,207	$ 64,201
Jimmie I. Cho	$ 60,694	$ 8,056	$ 68,750
Gillian A. Wright	$ 35,050	$ 1,875	$ 36,925
Patricia K. Wagner	$ (106,575)	$ 790	$ (105,875)

[1] The changes in the actuarial value of pension benefits are due to the accrual of additional age, service, pay and changes in actuarial assumptions such as mortality and interest rates.

For additional information regarding pension benefits and deferred compensation, please see the discussions under Pension Benefits and Nonqualified Deferred Compensation.

(H) All Other Compensation amounts for 2018 are:

2018 All Other Compensation	Company 401(k) and Deferred Compensation Plan Contributions	Insurance Premiums	Other	Total
J. Bret Lane	$ 31,399	$ 10,090	$ 20,000	$ 61,489
Bruce A. Folkmann	$ 22,934	$ 1,828	$ 8,000	$ 32,762
P. Kevin Chase	$ 29,118	$ 1,828	$ 7,750	$ 38,696
Jimmie I. Cho	$ 24,693	$ 1,828	$ 9,500	$ 36,021
Gillian A. Wright	$ 15,289	$ 1,828	$ 7,000	$ 24,117

Patricia K. Wagner	$ 10,007	$ 9,045	$ 30,000	$ 49,052

Amounts shown in the Insurance Premiums column include premiums for supplemental disability benefits (for Mr. Lane and Ms. Wagner only) and personal liability insurance benefits.

Amounts shown in the Other column consist of our contributions to charitable, educational and other non-profit organizations to match the personal contributions of executive officers on a dollar-for-dollar basis; financial and estate planning services; and executive benefit program allowances for Mr. Lane and Ms. Wagner of $20,000 and $30,000, respectively. Amounts shown do not include parking at company offices and the occasional personal use by executive officers of company property and services (including club memberships and entertainment events which would not otherwise be used for the business purposes for which they were obtained) for which we incur no more than nominal incremental cost or for which we are reimbursed by the executive for the incremental cost of personal use.

Grants of Plan-Based Awards

Executive officers participate in incentive compensation plans that are designed to encourage high levels of performance on both a short-term and long-term basis. Shorter-term incentives, typically annual performance-based cash bonuses, are provided under the executive incentive plan. Longer-term incentives, typically Sempra Energy performance-based and service-based restricted stock unit awards, are provided under Sempra Energy s 2013 Long-Term Incentive Plan.

In the following table, we summarize 2018 grants of plan-based awards to each of the named executive officers.

2018 Grants of Plan-Based Awards			Estimated Possible Payouts Under Non-Equity Incentive Plan Awards (Performance-Based Annual Bonus) (B)			Estimated Future Payouts Under Equity Incentive Plan Awards (Number of Shares) (C)			All Other Stock Awards (D) Number of	Grant Date Fair Value of Stock
	Grant Date (A)	Authorization Date (A)	Threshold	Target	Maximum	Threshold	Target	Maximum	Shares	Awards (E)
J. Bret Lane										
Performance-Based Restricted Stock Units based on TSR vs. S&P 500 Utilities Index	1/02/18	12/14/17					2,671	5,342		$ 280,092
Performance-Based Restricted Stock Units based on TSR vs. S&P 500 Index	1/02/18	12/14/17					1,144	2,288		$ 120,080
Performance-Based Restricted Stock Units based on EPS Growth	1/02/18	12/14/17					1,519	3,038		$ 160,027
Service-Based Restricted Stock Units	1/02/18	12/14/17							2,279	$ 240,093
Service-Based Restricted Stock Units Special	1/02/18	12/14/17							2,848	$ 300,037
Annual Bonus			$	$ 324,200	$ 648,400					
Bruce A. Folkmann										
Performance-Based Restricted Stock Units based on TSR vs. S&P 500 Utilities Index	1/02/18	12/14/17					882	1,764		$ 92,490
Performance-Based Restricted Stock Units based on TSR vs. S&P 500 Index	1/02/18	12/14/17					378	756		$ 39,677
Performance-Based Restricted Stock Units based on EPS Growth	1/02/18	12/14/17					502	1,004		$ 52,886
Service-Based Restricted Stock Units	1/02/18	12/14/17							753	$ 79,329
Annual Bonus			$	$ 148,700	$ 297,400					
P. Kevin Chase										
Performance-Based Restricted Stock Units based on TSR vs. S&P 500 Utilities Index	1/02/18	12/14/17					2,481	4,962		$ 260,168
Performance-Based Restricted Stock Units based on TSR vs. S&P 500 Index	1/02/18	12/14/17					1,062	2,124		$ 111,473
Performance-Based Restricted Stock Units based on EPS Growth	1/02/18	12/14/17					1,411	2,822		$ 148,649
Service-Based Restricted Stock Units	1/02/18	12/14/17							2,116	$ 222,921
Annual Bonus			$	$ 232,200	$ 464,400					

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2018 Grants of Plan-Based Awards	Grant Date (A)	Authorization Date (A)	Estimated Possible Payouts Under Non-Equity Incentive Plan Awards (Performance-Based Annual Bonus) (B) Threshold	Target	Maximum	Estimated Future Payouts Under Equity Incentive Plan Awards (Number of Shares) (C) Threshold	Target	Maximum	All Other Stock Awards (D) Number of Shares	Grant Date Fair Value of Stock Awards (E)
Jimmie I. Cho										
Performance-Based Restricted Stock Units based on TSR vs. S&P 500 Utilities Index	1/02/18	12/14/17					1,490	2,980		$ 156,247
Performance-Based Restricted Stock Units based on TSR vs. S&P 500 Index	1/02/18	12/14/17					638	1,276		$ 66,968
Performance-Based Restricted Stock Units based on EPS Growth	1/02/18	12/14/17					848	1,696		$ 89,337
Service-Based Restricted Stock Units	1/02/18	12/14/17							1,271	$ 133,900
Annual Bonus			$	$ 186,000	$ 372,000					
Gillian A. Wright										
Performance-Based Restricted Stock Units based on TSR vs. S&P 500 Utilities Index	1/02/18	12/14/17					693	1,386		$ 72,671
Performance-Based Restricted Stock Units based on TSR vs. S&P 500 Index	1/02/18	12/14/17					297	594		$ 31,175
Performance-Based Restricted Stock Units based on EPS Growth	1/02/18	12/14/17					394	788		$ 41,508
Service-Based Restricted Stock Units	1/02/18	12/14/17							591	$ 62,262
Annual Bonus			$	$ 128,300	$ 256,600					
Patricia K. Wagner										
Performance-Based Restricted Stock Units based on TSR vs. S&P 500 Utilities Index	1/02/18	12/14/17					3,633	7,266		$ 380,971
Performance-Based Restricted Stock Units based on TSR vs. S&P 500 Index	1/02/18	12/14/17					1,556	3,112		$ 163,326
Performance-Based Restricted Stock Units based on EPS Growth	1/02/18	12/14/17					2,067	4,134		$ 217,758
Service-Based Restricted Stock Units	1/02/18	12/14/17							3,100	$ 326,585
Service-Based Restricted Stock Units Promotional	11/17/18	10/26/18							6,530	$ 750,101
Annual Bonus			$	$ 480,800	$ 961,600					

(A) Grant and authorization dates are applicable to equity incentive awards, which consist of performance-based restricted stock units and service-based restricted stock units. Awards are authorized as part of annual compensation planning that is typically completed in December with salary adjustments becoming effective on January 1 and awards granted on the first trading day of January. The Compensation Committee of the Sempra Energy Board of Directors approves a dollar value and other terms for the awards to be granted to each executive officer. Special equity awards also may be granted at other times, including upon the hiring or promotion of executive officers, for outstanding performance, or to promote retention. In accordance with the terms approved by the Compensation Committee of the Sempra Energy Board of Directors, on the grant date, the precise number of shares to be granted to each executive officer (including the special service-based restricted stock unit awards granted to Mr. Lane and Ms. Wagner) was calculated by using the closing price for shares of Sempra Energy common stock on that date (for the total shareholder return-based awards, the applicable Monte Carlo valuation was used).

(B) Non-equity incentive plan awards consist of annual performance-based bonuses payable under the SoCalGas executive incentive plan or the Shared Services Plan. Amounts reported in the table represent target and maximum bonuses for 2018 to be paid under performance guidelines established at the beginning of the year by our Board of Directors (but taking into consideration subsequent promotions that resulted in changes to base salary and/or bonus targets). In no event will annual bonuses exceed the maximum bonuses established under the plan for each executive. The performance guidelines were satisfied at levels resulting in above-target bonus payouts. These amounts are reported in the Summary Compensation Table as non-equity incentive plan compensation.

(C) Equity incentive plan awards consist of Sempra Energy performance-based restricted stock units granted under Sempra Energy s 2013 Long-Term Incentive Plan. During the performance period for the performance-based restricted stock units, dividends paid, or that would have been paid, on the shares subject to the award are reinvested or deemed reinvested to purchase additional shares, at their fair market value, which become subject to the same forfeiture and performance vesting conditions as the shares to which the dividends relate. Due to the inability to forecast stock prices at which future dividends would be reinvested, the amounts shown in the table do not include such dividends.

If the performance criteria are not satisfied or the executive s employment is terminated during the performance period and the executive has not met the retirement eligibility criteria specified in the award agreements or the termination is for cause, the award is forfeited subject to earlier vesting upon a change in control of Sempra Energy. For a discussion of the change in control vesting provisions applicable to these awards, see Severance and Change in Control Arrangements.

Shares subject to the performance-based restricted stock units granted in 2018 will vest or be forfeited in early 2021 based upon Sempra Energy s total return to shareholders and earnings per share growth in 2018 - 2020. Mr. Chase s awards were forfeited upon his separation from service effective April 2, 2019. On April 19, 2019, in connection with his separation from Sempra Energy s California utilities (SDG&E and SoCalGas), the California utilities and Mr. Chase entered into a severance agreement and mutual release. Pursuant to the severance agreement, Mr. Chase will receive a cash payment of approximately $770,000, equal to the value of the forfeited service-based restricted stock units.

For the two components of performance-based restricted stock units with a total shareholder return performance measure, the target number of shares will vest if Sempra Energy has achieved a cumulative three-year total return to shareholders that places it among the top 50 percent of the companies in the S&P 500 Utilities Index or S&P 500 Index, as applicable, with additional shares vesting ratably for performance above the 50th percentile of the applicable index to the maximum number (200 percent of the target number) for performance at or above the 90th percentile of that index. If Sempra Energy s performance does not place Sempra Energy among the top 50 percent, but is above the 25th percentile of the companies in the applicable index, the number of shares that will vest will decline from the target number of shares at the 50th percentile to zero at the 25th percentile. The number of vesting shares under the total shareholder return award component based on performance against the S&P 500 Index may be adjusted upward or downward by 20 percent based on Sempra Energy s absolute total shareholder return for the period compared to benchmarks based on historical performance. The modifier cannot cause the total award payout to exceed 200 percent of target.

For the performance-based restricted stock units with an earnings per share growth performance measure, the target number of shares will vest, subject to the discretion of the Compensation Committee of the Sempra Energy Board of Directors, if Sempra Energy has achieved a compound annual growth rate of 5.3 percent. If performance is at 6.6 percent, 150 percent of the target number of shares will vest, and if performance is at 7.3 percent or higher, the maximum number (200 percent of the target number) of shares will vest. If Sempra Energy s compound annual earnings per share growth rate is less than 5.3 percent, shares will vest for performance above 4.2 percent declining from the target number of shares at 5.3 percent to zero at 4.2 percent. Such awards will not vest if Sempra Energy does not achieve positive net income for the performance period.

Unless the named executive officer instructs otherwise, the company will withhold a sufficient number of shares to which the participant would otherwise be entitled to pay the minimum amount of withholding taxes that become payable.

(D) With the exception of the special awards granted to Mr. Lane and the promotional award granted to Ms. Wagner, represents service-based restricted stock units that vest at the end of three years. Mr. Lane received a special grant of 2,848 service-based restricted stock units on January 2, 2018. Mr. Lane s award (including reinvested dividend equivalents) is subject to vesting 50 percent on January 2, 2019, 25 percent on January 2, 2020 and 25 percent on January 4, 2021. Ms. Wagner received a promotional grant of 6,530 restricted stock units on November 17, 2018. The award (including reinvested dividend equivalents) is subject to three-year ratable vesting.

During the service period, dividends paid or that would have been paid on the shares subject to the award are reinvested or deemed reinvested to purchase additional shares, at their fair market value, which become subject to the same forfeiture and vesting conditions as the shares to which the dividends relate. Due to the inability to forecast stock prices at which future dividends would be reinvested, the amounts shown in the table do not include such dividends.

Unless the named executive officer instructs otherwise, the company will withhold a sufficient number of shares to which the participant would otherwise be entitled to pay the minimum amount of withholding taxes that become payable.

If an executive s employment is terminated during the service period, the award is forfeited, subject to earlier vesting upon a change in control of Sempra Energy or at the discretion of the Compensation Committee of the Sempra Energy Board of Directors. For a discussion of the change in control vesting provisions applicable to these awards, see Severance and Change in Control Arrangements. Mr. Chase s awards were forfeited upon his separation from service effective April 2, 2019. On April 19, 2019, in connection with his separation from Sempra Energy s California utilities (SDG&E and SoCalGas), the California utilities and Mr. Chase entered into a severance agreement. Pursuant to the severance agreement and mutual release, Mr. Chase will receive a cash payment of approximately $770,000, equal to the value of the forfeited service-based restricted stock units.

(E) These amounts reflect our grant date estimate of the aggregate compensation expense that we will recognize over the service period of the award. They are calculated in accordance with GAAP using the assumptions described in Note 10 of the Notes to Consolidated Financial Statements included in Sempra Energy s Annual Report but disregarding estimates of forfeitures related to service-based vesting conditions. The value actually realized by executives from stock awards will depend upon the extent to which performance- and service-based vesting conditions are satisfied and the market value of the shares of Sempra Energy common stock subject to the award.

Outstanding Equity Awards at Year-End

In the table below, we summarize grants of Sempra Energy equity awards that were outstanding at December 31, 2018 for our named executive officers. The grants consist solely of stock options and restricted stock units under Sempra Energy s Long-Term Incentive Plans.

Outstanding Equity Awards at Year-End		Option Awards (Service-Based Stock Options) (A)				Performance-Based Restricted Stock Units (B)		Service-Based Restricted Stock Units (C)	
	Grant Date	Number of Shares Underlying Unexercised Options Exercisable	Number of Shares Underlying Unexercised Options Unexercisable	Exercise Price	Expiration Date	Number of Unearned/ Unvested Shares (D)	Market Value of Unearned/ Unvested Shares	Number of Unearned/ Unvested Shares (D)	Market Value of Unearned/ Unvested Shares
J. Bret Lane	01/02/18					0	$ 0	2,333	$ 252,412
	01/02/18					1,643	177,703	2,916(H)	315,431
	01/02/18					1,555	168,237		
	01/03/17					511	55,309	3,131(H)	338,781
	01/03/17					1,845	199,639	2,003	216,729
	01/03/17					1,202	130,037		
	01/04/16					0(F)	0	2,018(H)	218,279
	01/04/16					2,430(G)	262,873		
	01/04/10	875	0	$ 55.90	01/03/20				
		875	**0**	**$ 55.90(E)**		**9,186**	**$ 993,798**	**12,401**	**$ 1,341,632**
Bruce A. Folkmann	01/02/18					0	$ 0	771	$ 83,399
	01/02/18					543	58,716		
	01/02/18					514	55,599		
	01/03/17					160	17,338	633	68,441
	01/03/17					579	62,660		
	01/03/17					380	41,064		
	01/04/16					0(F)	0	618(H)	66,892
	01/04/16					738(G)	79,801		
	01/04/10	900	0	$ 55.90	01/03/20				
		900	**0**	**$ 55.90(E)**		**2,914**	**$ 315,178**	**2,022**	**$ 218,732**
P. Kevin Chase	01/02/18					0	$ 0	2,166	$ 234,358
	01/02/18					1,525	164,965		
	01/02/18					1,444	156,276		
	03/04/17					444	48,027	1,740	188,212
	03/04/17					1,603	173,409	970(H)	104,942
	03/04/17					1,044	112,927		
						6,060	**$ 655,604**	**4,876**	**$ 527,512**
Jimmie I. Cho	01/02/18					0	$ 0	1,301	$ 140,770
	01/02/18					916	99,103		
	01/02/18					868	93,921		
	01/03/17					356	38,491	1,392	150,570

&nb; 59,367(2) 76,884(2)

Working capital (deficit)	28,388	15,544	6,328	(48,947)[3]	(122,474)[3]
Total assets	429,724	429,593	599,750	935,905[4]	1,192,727
Debt, current portion, and note payable	29,822	25,752	17,138	17,178	16,868
Note payable, construction in progress[5]			15,000		
Debt, Stendal, current portion				80,000	50,000
Debt, less current portion[6]	221,772	216,871	205,393	255,901	234,317
Debt, Stendal, less current portion[5]			146,485	324,238	476,301
Shareholders' equity	133,497	131,613	124,969	132,855	121,595

	Year Ended December 31,				Nine Months Ended September 30,	
	2000	2001[1]	2002[1]	2003	2003	2004
					(unaudited)	
	(in thousands, except for ratio and ADMT data)					
Other Data:						
Net cash from (used in) operating activities	€ 43,395	€ 30,364	€ 40,446	€ 31,440	€ 6,969	€ (1,185)
Capital expenditures[7]	€ 27,028	€ 10,097	€ 13,800	€ 14,647	€ 9,485	€ 6,611
Operating EBITDA[8]	€ 73,711	€ 36,298	€ 24,469	€ 19,564	€ 15,616	€ 15,592
Ratio of earnings to fixed charges[9]	3.11	0.83[10]	[10]	0.32[10]	[10]	[10]
Rosenthal Mill Operating Data[11]:						
Sales volume (ADMTs)[12]	239,552	285,654	293,607	303,655	221,926	229,462
Productivity (ADMTs produced per day)	736	858	887	898	893	914
Average price realized (per ADMT)[12]	€ 667	€ 512	€ 443	€ 417	€ 416	€ 452
Cash production costs (per ADMT produced)[13]	€ 353	€ 342	€ 312	€ 307	€ 310	€ 300
Income (loss) from operations	€ 49,594	€ 18,610	€ 3,421	€ 1,931	€ (22)	€ 13,004
Depreciation and amortization[14]	€ 20,481	€ 21,422	€ 21,567	€ 21,881	€ 16,311	€ 14,166
Capital expenditures	€ 23,766	€ 7,416	€ 8,426	€ 6,869	€ 3,459	€ 2,924

(1) In December 2001, we acquired Landqart, which operates a specialty paper mill, for approximately $2.7 million. Results from the Landqart mill are not included in our results for 2001, but are included for 2002. The Landqart mill sold approximately 18,222 ADMTs for €39.7 million in the year ended December 31, 2002. At the end of 2002, we transferred 20% of our interest in Landqart to a Swiss bank and exchanged our remaining 80% interest for an indirect 39% minority interest through a limited partnership on a non-cash basis. As of December 31, 2002, our interest in the Landqart mill was no longer consolidated and is included in our financial

results on an equity basis.

(2)

As at December 31, 2003, this amount is comprised of €15.2 million for payment of construction in progress costs payable and €19.1 million in a debt service account, relating to construction in progress at the site of the Stendal mill, as well as €25.1 million in a debt service account relating to the Rosenthal mill. As at September 30, 2004, this amount is comprised of €29.3 million for payment of construction costs payable and €19.1 million in a debt service account, both relating to the Stendal project, as well as €28.5 million in a debt service account related to the Rosenthal mill.

(3)

We had a working capital deficit of €48.9 million and €122.5 million at December 31, 2003 and September 30, 2004, respectively, primarily because we had Stendal construction costs payable of €42.8 million and €161.0 million at December 31, 2003 and September 30, 2004, respectively, for which we had not yet drawn down under the Stendal project finance facility and, under our accounting policies, we do not record certain government grants until they are received. The Stendal construction costs will be paid pursuant to the Stendal

project finance facility in the ordinary course. At September 30, 2004, we qualified for additional investment grants related to the Stendal mill totaling approximately €65.2 million from the federal and state governments of Germany, which we expect to receive in 2005. Approximately €61.2 million of these grants, when received, will be applied to repay the amounts drawn under the dedicated tranche of the Stendal project finance facility. The grants are not reported in our income and reduce the cost basis of the assets purchased when they are received. We expect to qualify for additional investment grants totaling €23.3 million when such Stendal construction costs have been substantially paid.

(4)

Includes approximately €503.2 million as at December 31, 2003 related to properties construction in progress at the site of the Stendal mill.

(5)

Construction of the Stendal mill commenced in August 2002 and was completed substantially on its planned schedule and budget in the third quarter of 2004. As a result, as at September 30, 2004, liabilities relating to the construction of the Stendal mill were no longer classified as construction in progress.

(6)

As at September 30, 2004, this includes €66.4 million aggregate principal amount of 8.5% convertible senior subordinated notes due October 2010, convertible at any time by the holder into our shares of beneficial interest at $7.75 per share.

(7)

Excluding capital expenditures of approximately €186.9 million, €399.4 million, €284.1 million and €235.1 million during the years ended December 31, 2002 and 2003 and the nine months ended September 30, 2003 and 2004, respectively, relating to the Stendal project.

(8)

Net Income (Loss) to Operating EBITDA Reconciliation:

	Year Ended December 31,				Nine Months Ended September 30,	
	2000	2001	2002	2003	2003	2004
					(unaudited)	
	(in thousands)					
Net income (loss)	€ 32,013	€ (2,823)	€ (6,322)	€ (3,593)	€ (9,173)	€ (12,604)
Minority interest			(10,965)	(5,647)	(8,499)	(3,936)
Income taxes	117	83	(264)	3,172	226	(37)
Interest expense	15,198	16,170	13,753	11,523	6,887	9,554
Investment income	2,337	(2,872)	(436)	(1,653)	(1,055)	(1,679)
Derivative financial instruments		2,504	6,679	(16,168)	3,604	1,077
Impairment of investments				7,825	5,511	
Other		270	(3,590)		(20)	
Income (loss) from operations	49,665	13,332	(1,145)	(4,541)	(2,519)	(7,625)
Add: Depreciation and amortization	24,046	22,966	25,614	24,105	18,135	17,217
Impairment charge						6,000
Operating EBITDA	€ 73,711	€ 36,298	€ 24,469	€ 19,564	€ 15,616	€ 15,592

In connection with Mercer's results for the third quarter of 2004, our management determined to record and our audit committee approved a non-cash impairment charge of €6.0 million to write-off the carrying value of our Fährbrücke paper mill assets. We determined to take the impairment charge as the Fährbrücke mill has generated weaker than expected returns over a period of time despite changes to its product mix. We do not expect the impairment charge in and of itself to result in future cash expenditures as we intend to continue to operate the Fährbrücke mill.

We define Operating EBITDA for this purpose as income from operations plus depreciation and amortization and non-recurring capital asset impairment charges. Management uses Operating EBITDA as a benchmark measurement of its own operating results and as a benchmark relative to its competitors. Management considers it to be a meaningful supplement to operating income as a performance measure primarily because depreciation expense is not an actual cash cost and varies widely from company to company in a manner that management considers largely independent of the underlying cost efficiency of their operating facilities. In addition, we believe it is commonly used by securities analysts, investors and other interested parties to

evaluate our financial performance. Operating EBITDA does not reflect the impact of a number of items that affect our net income (loss), including financing costs and the effect of derivative instruments. Management also believes Operating EBITDA facilitates operating performance comparisons from period to period by backing out the significant impact caused by our derivative instruments which are marked to market for each reporting period or settled. Operating EBITDA is not a measure of financial performance under GAAP and should not be considered as an alternative to net income (loss) or income from operations as a measure of performance, nor as an alternative to net cash from operating activities as a measure of liquidity. Operating EBITDA has significant limitations as an analytical tool, and you should not consider it in isolation, or as a substitute for analysis of our results as reported under GAAP. Because of these limitations, Operating EBITDA should not be considered as a measure of discretionary cash available to us to invest in the growth of our business. See the Statements of Cash Flows included in our consolidated financial statements included elsewhere in this prospectus supplement. Because all companies do not calculate Operating EBITDA in the same manner, Operating EBITDA as calculated by us may differ from Operating EBITDA as calculated by other companies.

(9)

For purposes of computing the ratio of earnings to fixed charges, earnings consist of income before income taxes, minority interest, income (loss) from equity investee and fixed charges. Fixed charges consist of interest expense plus capitalized interest.

(10)

For the years ended December 31, 2001, 2002 and 2003, our deficiency of earnings to fixed charges was €2.7 million, €20.7 million, €19.5 million, respectively. For the nine months ended September 30, 2003 and 2004, our deficiency of earnings to fixed charges was €29.0 million and €43.2 million, respectively. On a pro forma basis for the year ended December 31, 2003, and nine months ended September 30, 2003 and 2004, the deficiency of earnings to fixed charges was €29.9 million, €57.8 million and €45.7 million, respectively.

(11)

Construction of the Stendal mill was completed in the third quarter of 2004. Although the Stendal mill had approximately 13 days of operations in September 2004, it is currently in the start-up phase. As a result, management believes that the operating data relating to the Stendal mill during the third quarter of 2004 would not provide an accurate representation of the mill's actual operating performance in the future. Accordingly, we have provided only the operating data relating to the Rosenthal mill.

(12)

For external sales only.

(13)

Cost of production per ADMT produced excluding depreciation. Total cash production costs for the nine months ended September 30, 2003 and 2004 may not be comparable on an annualized basis due to the timing of maintenance expenditures.

(14)

The Stendal pulp mill was substantially complete and ready for its intended use on September 18, 2004. Effective September 18, 2004, we began expensing all of the costs, including interest, related to the Stendal mill and began depreciating it. A depreciation period of 25 years was established based on the expected useful life of the production assets. Depreciation was computed using the straight-line method in accordance with our accounting policies. In conjunction with establishing the depreciation period for the Stendal mill, we also reviewed the useful life of the Rosenthal mill, which resulted in a change in the estimate of its useful life from an initial 15 to 25 years. The change in estimate was reflected effective July 1, 2004. As the Rosenthal mill had been depreciated for approximately 5 years as of July 1, 2004, the change in estimate reflects a remaining depreciable life of approximately 20 years. The total effect of the change in estimate resulted in a decrease of approximately €2.2 million in depreciation, cost of sales and net loss, and a decrease in basic and diluted net loss per share of €0.13 for the nine months ended September 30, 2004.

SELECTED HISTORICAL FINANCIAL INFORMATION OF CELGAR

The following tables set forth selected historical financial and operating data of Celgar as at and for the periods indicated. The following selected financial and operating data is qualified in its entirety by, and should be read in conjunction with, the financial statements and related notes of Celgar included elsewhere in this prospectus supplement.

The selected historical financial and operating data of Celgar as at and for the three years ended December 31, 2003 presented below has been derived from Celgar's audited financial statements. The selected historical financial and operating data of Celgar as at and for the nine months ended September 30, 2004 and 2003 and the year ended December 31, 2000 presented below has been derived from Celgar's unaudited financial statements. It should be noted that the results of operations for any interim period are not necessarily indicative of the results of operations for the entire fiscal year.

Please note that the selected historical financial and operating data of Celgar presented below and the financial statements for Celgar included in this prospectus supplement reflect the entire assets, liabilities and operations of Celgar for the periods and as at the dates indicated. However, we are only acquiring substantially all of the operating assets of Celgar which, pursuant to the terms of the Acquisition Agreement, do not include the finished goods inventory and receivables of Celgar. Further, we are not assuming certain liabilities of Celgar including indebtedness for borrowed money for pre-and post-bankruptcy periods which aggregated approximately C$1.1 billion at December 31, 2003 and September 30, 2004, respectively. Accordingly, we are only providing selected balance sheet data for Celgar. See "The Acquisition" for more information.

Celgar prepares its financial statements in accordance with Canadian GAAP, which differs in certain respects from GAAP. For a discussion of the differences between Canadian GAAP and GAAP as they pertain to Celgar, see Note 10 of the unaudited financial statements of Celgar for the nine month period ended September 30, 2004 and 2003 and Note 12 of the audited financial statements of Celgar for the year ended December 31, 2003 included elsewhere in this prospectus supplement.

	Year Ended December 31,				Nine Months Ended September 30,	
	2000[(1)]	2001[(2)]	2002	2003	2003	2004
	(unaudited)				(unaudited)	
	(in thousands, except for ADMT data)					
Statement of Operations Data:						
Sales	C$ 363,570	C$ 246,139	C$ 249,366	C$ 271,566	C$ 207,593	C$ 214,886
Operating expenses:						
Costs of sales	C$ 231,494	C$ 239,938	C$ 213,602	C$ 230,555	C$ 182,903	C$ 167,637
Depreciation and amortization	C$ 38,807	C$ 38,966	C$ 38,932	C$ 39,225	C$ 29,320	C$ 22,833
General and administrative	C$ 29,045	C$ 25,877	C$ 30,642	C$ 38,069	C$ 28,220	C$ 22,784
Impairment loss on property, plant and equipment						C$ 129,204[(3)]
Income (loss) from operations[(4)]	C$ 64,224	C$ (58,642)	C$ (33,810)	C$ (36,283)	C$ (32,850)	C$ (127,572)[(3)]
Balance Sheet Data:						
Working capital	C$ 82,268	C$ 55,424	C$ 56,058	C$ 52,456	C$ 48,081	C$ 60,003
Property, plant and equipment	C$ 503,029	C$ 470,326	C$ 436,542	C$ 402,633	C$ 411,206	C$ 252,613[(3)]
Other Data:						
Net cash from operating activities	C$ 84,648	C$ (7,401)	C$ 8,085	C$ 13,232	C$ 10,199	C$ 706
Capital expenditures	C$ 3,579	C$ 6,262	C$ 3,912	C$ 5,201	C$ 3,985	C$ 2,017
Operating EBITDA[(4)(5)]	C$ 103,031	C$ (19,676)	C$ 5,122	C$ 2,942	C$ (3,530)	C$ 24,465
Operating Data:						
Sales volume (ADMTs)	379,377	365,133	400,101	427,860	329,253	292,233
Productivity (ADMTs produced per day)	1,172	1,198	1,155	1,202	1,181	1,209
Average price realized (per ADMT)	C$ 958	C$ 674	C$ 623	C$ 635	C$ 630	C$ 735
Cash production costs (per ADMT produced)[(6)]	C$ 565	C$ 571	C$ 491	C$ 499	C$ 513	C$ 533

(1) In connection with Celgar's results for 2000, audited financial statements were prepared for the twelve month period ended March 31, 2000 and for the nine month period ended December 31, 2000. Audited financial statements for the twelve month period ended December 31, 2000 were not prepared and, as a result, the selected financial information presented for 2000 is based on unaudited financial statements prepared for such period.

(2) The Celgar mill was shut down for approximately 50 days in 2001 for market related reasons.

(3) As at and for the nine month period ended September 30, 2004, Celgar recorded an impairment charge of C$129.2 million to write-down the carrying value of its property, plant and equipment to the fair value of the assets as a result of the Acquisition.

(4) "Income (loss) from operations" and "Operating EBITDA" include costs (benefits) relating to a burner misalignment in the lime kiln at the Celgar mill, for which the vendor of the Celgar mill has an insurance claim outstanding, foreign exchange losses (gains) on current receivables and payables and fees paid to KPMG Inc., as receiver and trustee in bankruptcy of Celgar as follows:

	Year Ended December 31,				Nine Months Ended September 30,	
	2000	2001	2002	2003	2003	2004
	(unaudited)				(unaudited)	
	(in thousands)					
Lime kiln costs				C$ 3,136	C$ 2,036	C$ 96
Foreign exchange losses (gains)	C$ (1,333)	C$ (1,769)	C$ 792	C$ 5,965	C$ 4,952	C$ 921
Receiver and trustee costs	C$ 1,965	C$ 2,025	C$ 1,812	C$ 1,899	C$ 1,747	C$ 772

See "Management's Discussion and Analysis of Financial Condition and Results of Operations of Celgar".

(5)

Income (Loss) from Operations to Operating EBITDA Reconciliation:

	Year Ended December 31,				Nine Months Ended September 30,	
	2000	2001	2002	2003	2003	2004
	(unaudited)				(unaudited)	
			(in thousands)			
Income (loss) from operations	C$ 64,224	C$ (58,642)	C$ (33,810)	C$ (36,283)	C$ (32,850)	C$ (127,572)
Add: Depreciation and amortization	C$ 38,807	C$ 38,966	C$ 38,932	C$ 39,225	C$ 29,320	C$ 22,833
Impairment loss on property, plant and equipment						C$ 129,204
Operating EBITDA	C$ 103,031	C$ (19,676)	C$ 5,122	C$ 2,942	C$ (3,530)	C$ 24,465

Mercer is presenting Operating EBITDA for Celgar for comparative purposes only. Operating EBITDA for Celgar has not been reconciled to net income (loss) as Mercer is acquiring substantially all of the assets of Celgar and will not be assuming certain liabilities of Celgar, including indebtedness for borrowed money for pre- and post-bankruptcy periods. Operating EBITDA is defined as income (loss) from operations plus depreciation and amortization and non-recurring capital asset impairment charges.

(6)

Cost of production per ADMT produced excluding depreciation. Total cash production costs for the nine months ended September 30, 2003 and 2004 may not be comparable on an annualized basis due to the timing of maintenance expenditures.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS OF MERCER

For the purposes of this Management's Discussion and Analysis of Financial Condition and Results of Operations of Mercer, all references to "we", "our", "us", the "Company" or "Mercer" mean Mercer International Inc. and its subsidiaries without giving effect to the Acquisition.

The following discussion and analysis of our financial condition and results of operations as at and for the nine months ended September 30, 2003 and 2004 and the three years ended December 31, 2003 should be read in conjunction with the consolidated financial statements and related notes included elsewhere in this prospectus supplement. Effective January 1, 2002, we changed our reporting currency from the U.S. dollar to the Euro. Accordingly, our financial statements as at and for the nine months ended September 30, 2003 and 2004 and the years ended December 31, 2002 and 2003 included in this prospectus supplement are stated in Euros and our financial statements for periods prior to the year ended December 31, 2002 included in this prospectus supplement have been restated in Euros and reclassified to conform to the current presentation. The following management discussion and analysis of our financial condition and results of operations is based upon the restated financial statements for all periods.

Results of Operations

We operate in the pulp and paper business and our operations are located primarily in Germany. Our manufacturing facilities are comprised of: (a) an NBSK pulp mill operated by our wholly-owned subsidiary, Rosenthal, near Blankenstein, Germany, which has an annual production capacity of approximately 310,000 ADMTs; (b) a newly constructed, state-of-the-art NBSK pulp mill, with a design production capacity of approximately 552,000 ADMTs per year, near Stendal, Germany built and being started up by our 63.6% owned subsidiary, Stendal; and (c) two paper mills located at Heidenau and Fährbrücke, Germany, which produce specialty papers and printing and writing papers and, based upon their current product mix, have an aggregate annual production capacity of approximately 70,000 ADMTs.

The Stendal mill was completed substantially on its planned schedule and budget in the third quarter of 2004. Total investment costs in respect of the Stendal mill are approximately €1.0 billion, the majority of which was financed under a senior project finance facility, referred to as the "Stendal Loan Facility", in the amount of €828 million and arranged with Bayerische Hypo-und Vereinsbank AG, referred to as "HVB". The Stendal mill is currently in the start-up phase and underwent extensive testing and evaluation in December 2004. Samples of the pulp produced during such testing have been sent to laboratories for qualitative testing and the results are expected to be received by mid-January 2005. The mill substantially passed all of the quantitative tests, although the test was extended due to an operator error relating to the recovery boiler. See "Business Stendal Pulp Mill Project and Financing". Effective September 18, 2004, we commenced expensing all of the costs, including interest, related to the Stendal mill. Prior to that date, most of the costs, including interest, relating to the Stendal mill were capitalized. Our results for the nine months ended September 30, 2004 include operating and interest costs of €9.8 million related to the Stendal mill. During such period, we did not report any pulp sales revenues from Stendal. Some lower quality pulp produced at the Stendal mill prior to September 18, 2004 was sold, but the revenues therefrom were capitalized against testing costs in property, plant and equipment.

Our financial performance depends on a number of variables that impact sales and production costs. Sales and production results are influenced largely by the market price for products and raw materials, the mix of products produced and foreign currency exchange rates. Kraft pulp and paper markets are highly cyclical, with prices determined by supply and demand. Demand for kraft pulp and paper is influenced to a significant degree by global levels of economic activity and supply is driven by

industry capacity and utilization rates. Our product mix is important because premium grades of kraft pulp and specialty papers generally achieve higher prices and profit margins.

Our production costs are influenced by the availability and cost of raw materials, energy and labor, and our plant efficiencies and productivity. Our main raw material is fiber in the form of wood chips and pulp logs for pulp production, and waste paper and pulp for paper production. Wood chip and pulp log costs are primarily affected by the supply of, and demand for, lumber and pulp, which are both highly cyclical. Production costs also depend on the total volume of production. High operating rates and production efficiencies permit us to lower our average cost by spreading fixed costs over more units.

Global economic conditions, changes in production capacity and inventory levels are the primary factors affecting kraft pulp and paper prices. Historically kraft pulp and paper prices have been cyclical in nature. The average annual European list prices for NBSK pulp between 1990 and 2003 ranged from a low of $444 per ADMT in 1993 to a high of $875 per ADMT in 1995. Following a decline in demand in 2001, list prices for NBSK pulp also declined and averaged approximately $463 per ADMT in 2002. An increase in demand resulting from improving American and major European economies and the weakening of the U.S. dollar against the Euro and other major currencies in 2003 resulted in list prices for kraft pulp in Europe increasing to approximately $560 per ADMT in December 2003 despite relatively high inventory levels. List prices for kraft pulp in Europe continued to strengthen in 2004 due to the relatively weak U.S. dollar and improving world economies. List prices increased to approximately $660 per ADMT in July 2004, before falling to approximately $585 per ADMT in October 2004 and subsequently recovering to approximately $625 per ADMT in December 2004. A producer's sales realizations will reflect customer discounts, commissions and other items and it is likely that NBSK pulp prices will continue to fluctuate in the future.

Our financial performance for any reporting period is also impacted by changes in the U.S. dollar to Euro exchange rate and in interest rates. Changes in currency rates affect our operating results because the price for our principal product, NBSK pulp, is generally based on a global industry benchmark that is quoted in U.S. dollars, even though our sales are invoiced in Euros. Therefore, a weakening of the U.S. dollar against the Euro will generally reduce the amount of Euro revenues of our pulp operations. Most of our costs, including our debt obligations, are incurred in Euros. These do not fluctuate with the U.S. dollar to Euro exchange rate. Thus, a weakening of the U.S. dollar against the Euro tends to reduce our sales revenue, gross profit and income from operations. The continuing deterioration of the U.S. dollar against the Euro in the fourth quarter of 2004 will adversely affect our operating performance for the quarter, which we currently anticipate would be largely offset by realized gains on our hedging transactions.

Changes in interest rates can impact our operating results because the indebtedness we incurred under the credit facilities for establishing the Rosenthal and Stendal pulp mills provide for floating rates of interest.

Changes in currency exchange and interest rates also impact certain foreign currency and interest rate derivatives Rosenthal and Stendal use to partially protect against the effect of such changes. Gains or losses on such derivatives are included in our earnings, either as they are settled or as they are marked to market for each reporting period. See " Quantitative and Qualitative Disclosures about Market Risk".

Stendal, as required under its project financing, entered into variable-to-fixed rate interest swaps, referred to as the "Stendal Interest Rate Swaps", in August 2002 to fix the interest rate on approximately €612.6 million of indebtedness for the full term of the Stendal Loan Facility. Rosenthal has also entered into forward interest rate and interest cap contracts, referred to as the "Rosenthal Interest Rate Contracts" and, together with the Stendal Interest Rate Swaps, the "Interest Rate

Contracts", in respect of a portion of its long-term indebtedness under its bank loan facility, referred to as the "Rosenthal Loan Facility".

In the nine months ended September 30, 2004 and year ended December 31, 2003, we recorded a net non-cash holding loss of €15.8 million and €13.1 million, respectively, before minority interests on the marked to market valuation of the Interest Rate Contracts versus a net loss of €22.8 million and €32.4 million before minority interests thereon in the nine months ended September 30, 2003 and year ended December 31, 2002, respectively.

In March 2004, to protect against a weakening U.S. dollar, Rosenthal entered into two currency swaps in the aggregate principal amount of €184.5 million to convert all of its long-term indebtedness under the Rosenthal Loan Facility into U.S. dollars and a currency forward in the notional amount of €40.7 million, referred to as the "Rosenthal Currency Derivatives". In the same month, Stendal entered into a currency swap in the principal amount of €306.3 million to convert approximately one-half of its indebtedness under the Stendal Loan Facility into U.S. dollars and a currency forward in the notional amount of €20.6 million, referred to as the "Stendal Currency Derivatives" and, together with the Rosenthal Currency Derivatives, the "Currency Derivatives". Primarily as a result of a weakening of the U.S. dollar versus the Euro and changes in interest rates related to such currencies, in the nine months ended September 30, 2004, we recognized a net non-cash holding gain of approximately €14.7 million before minority interests on the Currency Derivatives. In the nine months ended September 30, 2003, we recognized a net gain of approximately €19.2 million before minority interests on the then outstanding currency derivatives of Rosenthal and Stendal. In the year ended December 31, 2003, we recognized a gain of €29.3 million before minority interests on the then outstanding currency derivatives of Rosenthal and Stendal, compared to a net gain of €25.7 million before minority interests in 2002 on the then outstanding currency derivatives of Rosenthal. Stendal did not have any currency derivatives outstanding in the year ended December 31, 2002. See "   Quantitative and Qualitative Disclosures about Market Risk".

In December 2004, we settled the Currency Derivatives due to the substantial weakening of the U.S. dollar versus the Euro in 2004. We realized a gain of approximately €44.5 million upon the settlement of these derivatives, €14.7 million of which we had already booked as an unrealized gain as at September 30, 2004. We expect to enter into similar derivatives in the future and could record realized or unrealized marked to market non-cash holding gains or losses on such derivatives in the future.

Improving world economies resulted in an increase in interest rates in the first half of 2004. If world economies continue to strengthen, we would expect interest rates to continue to rise from their historically low levels. Higher interest rates could result in our recording marked to market non-cash holding gains on the Interest Rate Contracts in future periods, which may be offset in part by higher interest rates payable on Rosenthal's debt obligations. However, a fall in interest rates could result in our recording non-cash holding losses on the Interest Rate Contracts in future periods when they are marked to market. See "   Quantitative and Qualitative Disclosures about Market Risk".

Selected sales data for each of our last three years and the nine months ended September 30, 2003 and 2004 is as follows:

	Year Ended December 31,			Nine Months Ended September 30,	
	2001	2002	2003	2003	2004
			(ADMTs)		
Sales Volume by Product Class					
Pulp[1]	285,654	293,607	303,655	221,926	229,462
Papers					
Specialty papers	40,437[2]	61,727[2]	40,621	30,420	28,144
Printing papers	26,815	23,195	21,397	16,568	19,357
Total papers	67,252	84,922	62,018	46,988	47,501
Total[1]	352,906	378,529	365,673	268,914	276,963
			(in thousands)		
Revenues by Product Class					
Pulp[1]	€ 146,245	€ 130,173	€ 126,594	€ 92,418	€ 103,743
Papers					
Specialty papers	35,959[2]	79,358[2]	40,082	30,185	28,039
Printing papers	22,797	18,352	15,780	12,332	13,302
Total papers	58,756	97,710	55,862	42,517	41,341
Total[1]	€ 205,001	€ 227,883	€ 182,456	€ 134,935	€ 145,084

(1) Excluding intercompany sales volumes of 10,447, 10,768 and 5,527 ADMTs of pulp and intercompany net sales revenues of approximately €5.8 million, €4.9 million and €2.3 million in 2001, 2002 and 2003, respectively, and intercompany sales volumes of 5,166 and 3,897 ADMTs of pulp and intercompany net sales revenues of approximately €2.2 million and €1.8 million in the nine months ended September 30, 2003 and 2004, respectively.

(2) We acquired Landqart, which operates a specialty paper mill, in December 2001 for approximately $2.7 million. As of December 31, 2002, our interest in Landqart is no longer consolidated and is included in our financial results on an equity basis. Accordingly, sales from the Landqart specialty paper mill are not included in our results for 2001, but are included for 2002. The Landqart mill sold approximately 18,222 ADMTs for approximately €39.7 million in 2002.

Acquisition of the Celgar Mill

On November 22, 2004, we entered into the Acquisition Agreement to acquire substantially all of the assets of Celgar. The purchase price of the Acquisition is $210 million (subject to certain adjustments and excluding fees and expenses), of which $170 million is payable in cash and $40 million is payable in our shares, plus an amount for the defined working capital of the Celgar mill on closing of the Acquisition. The cash portion of the purchase price and the working capital amount is to be paid in part from the proceeds of the Share Offering and the balance is to be paid from this offering. See "The Financings" and "The Acquisition".

The Celgar mill is a modern NBSK pulp mill that produces high quality NBSK pulp. It has a current annual production capacity of approximately 430,000 ADMTs, and is located near the city of Castlegar, British Columbia, Canada. In the early 1990's, it was completely

rebuilt through a C$850 million modernization and expansion project. See "Business" for more information relating to the Celgar mill.

Nine Months Ended September 30, 2004 Compared to Nine Months Ended September 30, 2003 (Unaudited)

Total revenues for the nine months ended September 30, 2004 increased to €153.9 million from €144.1 million in the comparative period of 2003, primarily because of higher pulp sales. Pulp and paper revenues were €145.1 million in the current period, versus €134.9 million in the comparative period of 2003.

Costs of pulp and paper sales in the nine months ended September 30, 2004 decreased to €131.4 million from €131.8 million in the comparative period of 2003, primarily as a result of lower pulp production costs at our Rosenthal mill.

In the current period, pulp sales increased to €103.7 million from €92.4 million in the same period a year ago as a result of higher prices and production from our Rosenthal mill. We did not report any revenues from the sale of pulp from the Stendal mill in either period. List prices for NBSK pulp in Europe were approximately €519 ($635) per ADMT in the third quarter of 2004, compared to approximately €444 ($550) per ADMT in the third quarter of last year. The increase in NBSK pulp prices was partially offset by the weakness of the U.S. dollar versus the Euro in the current period. In the current period, pulp sales by volume were 229,462 ADMTs, compared to 221,926 ADMTs in the comparative period of 2003.

Pulp sales realizations were €452 per ADMT on average in the current period, compared to €416 per ADMT in the comparative period of 2003.

Transportation and other revenues for the pulp operations were €8.9 million in the period ended September 30, 2004, compared to €8.2 million in the comparative period of last year.

Cost of sales and general, administrative and other expenses for the pulp operations increased to €108.8 million in the nine months ended September 30, 2004 from €104.6 million in the comparative period of 2003, primarily as a result of the inclusion of €7.9 million of operating costs related to the Stendal mill.

On average, fiber costs for pulp production decreased by approximately 4.3% compared to the first nine months of last year.

Depreciation for the pulp operations was €15.0 million in the current period, versus €16.3 million in the year ago period. A change effective July 1, 2004 in our depreciation estimate in respect of our Rosenthal mill resulted in a decrease of €2.2 million in cost of sales and net loss, and a decrease in net loss per share of €0.13 for the nine months ended September 30, 2004.

For the nine months of 2004, our pulp operations generated operating income of €5.7 million, versus an operating loss of €1.8 million in the year ago period.

Paper sales in the current period were €41.3 million, compared with €42.5 million in the same period of last year. Sales of specialty papers in the nine months ended September 30, 2004 were €28.0 million versus €30.2 million in the comparative period of 2003, primarily as a result of a shift in the product mix. For the current period, total paper sales volumes were 47,501 ADMTs, versus 46,988 ADMTs in the nine months ended September 30, 2003. On average, prices for specialty papers realized in the current period increased slightly, reflecting a shift in the product mix. Average prices for our printing papers decreased by approximately 7.7% reflecting generally weak demand.

Cost of sales and general, administrative and other expenses for the paper operations in the nine months ended September 30, 2004 increased to €52.2 million from €41.7 million in the comparative period of 2003, primarily as a result of a non-cash €6.0 million impairment charge relating to our paper operations. On November 3, 2004, our management determined to record and our audit committee approved a non-cash impairment charge of €6.0 million to write-off the carrying value of our Fährbrücke paper mill assets. Based upon its current product mix, the mill has an annual production

capacity of approximately 35,000 ADMTs and produces primarily printing and writing paper. We determined to take the impairment charge as the Fährbrücke mill has generated weaker than expected returns over a period of time despite changes to its product mix. We do not expect the impairment charge in and of itself to result in future cash expenditures as we intend to continue to operate the Fährbrücke mill.

Depreciation for the paper operations was €1.7 million in the current period, compared to €1.5 million in the same period last year.

For the nine months ended September 30, 2004, our paper operations generated an operating loss of €10.6 million, which included the non-cash impairment charge of €6.0 million, compared to operating income of €1.6 million in the same period of last year.

In the current period, we reported a loss from operations of €7.6 million, compared to €2.5 million in the same period last year. Interest expense (excluding capitalized interest of €27.2 million relating to the Stendal pulp mill) in the period ended September 30, 2004 increased to €9.6 million from €6.9 million a year ago, due to higher borrowings resulting primarily from our convertible note issue in October 2003 and the inclusion of interest expense of €1.9 million relating to the Stendal project after September 18, 2004.

In the period ended September 30, 2004, we recorded a net non-cash holding loss of €15.8 million before minority interests on the marked to market valuation of the Interest Rate Contracts versus a net loss of €22.8 million before minority interests thereon in the prior period of 2003. In addition, in the nine months ended September 30, 2004, we recorded a net non-cash holding gain of approximately €14.7 million before minority interests on the valuation of the Currency Derivatives as a result of the weakening of the U.S. dollar versus the Euro and changes in interest rates related to such currencies. In the prior period of 2003, we recorded a net gain of €19.2 million before minority interests on the then outstanding currency derivatives of Rosenthal and Stendal.

In the nine months ended September 30, 2004, minority interest, representing the two minority shareholders' proportionate interest in the Stendal project, was €3.9 million, compared to €8.5 million in the comparative period of 2003.

Our results for the prior period of 2003 included an adjustment of €5.5 million for the non-cash impact of other-than-temporary impairment losses on our available-for-sale securities.

We reported a net loss for the nine months ended September 30, 2004 of €12.6 million, or €0.73 per basic and diluted share, which reflected the non-cash €6.0 million impairment charge related to our paper operations, the inclusion of €9.8 million of operating and interest costs related to our Stendal mill and the net non-cash holding loss on the marked to market valuation of our derivative instruments. In the comparative period of 2003, we reported a net loss of €9.2 million, or €0.54 per basic and diluted share.

We generated "Operating EBITDA" of €15.6 million in the nine months ended September 30, 2004 and 2003, respectively. Operating EBITDA is defined as income (loss) from operations plus depreciation and amortization and non-recurring capital asset impairment charges. Operating EBITDA is calculated by adding depreciation and amortization and non-recurring capital asset impairment charges of €23.2 million and €18.1 million to the loss from operations of €7.6 million and €2.5 million for the nine-month periods ended September 30, 2004 and 2003, respectively.

Management uses Operating EBITDA as a benchmark measurement of its own operating results, and as a benchmark relative to its competitors. Management considers it to be a meaningful supplement to operating income as a performance measure primarily because depreciation expense and non-recurring capital asset impairment charges are not an actual cash cost, and depreciation expense varies widely from company to company in a manner that management considers largely independent

of the underlying cost efficiency of their operating facilities. In addition, we believe Operating EBITDA is commonly used by securities analysts, investors and other interested parties to evaluate our financial performance.

Operating EBITDA does not reflect the impact of a number of items that affect our net income (loss), including financing costs and the effect of derivative instruments. Operating EBITDA is not a measure of financial performance under GAAP, and should not be considered as an alternative to net income (loss) or income (loss) from operations as a measure of performance, nor as an alternative to net cash from operating activities as a measure of liquidity.

Operating EBITDA has significant limitations as an analytical tool, and should not be considered in isolation, or as a substitute for analysis of our results as reported under GAAP. Some of these limitations are: (i) Operating EBITDA does not reflect our cash expenditures, or future requirements, for capital expenditures or contractual commitments; (ii) Operating EBITDA does not reflect changes in, or cash requirements for, working capital needs; (iii) Operating EBITDA does not reflect the significant interest expense, or the cash requirements necessary to service interest or principal payments, on our outstanding debt; (iv) Operating EBITDA does not reflect minority interests on our Stendal operations; (v) Operating EBITDA does not reflect the impact of marked to market changes in our derivative positions, which can be substantial; and (vi) Operating EBITDA does not reflect the impact of impairment charges against our investments or assets. Because of these limitations, Operating EBITDA should only be considered as a supplemental performance measure and should not be considered as a measure of liquidity or cash available to us to invest in the growth of our business. See the Statement of Cash Flows set out in our consolidated financial statements included herein. Because all companies do not calculate Operating EBITDA in the same manner, Operating EBITDA as calculated by us may differ from Operating EBITDA as calculated by other companies. We compensate for these limitations by using Operating EBITDA as a supplemental measure of our performance and relying primarily on our GAAP financial statements.

The following table provides a reconciliation of net loss to loss from operations and Operating EBITDA for the periods indicated:

	Nine Months Ended September 30,	
	2003	2004
	(in thousands)	
Net loss	€ (9,173)	€ (12,604)
Minority interest	(8,499)	(3,936)
Income taxes	226	(37)
Interest expense	6,887	9,554
Investment income	(1,055)	(1,679)
Derivative financial instruments	3,604	1,077
Impairment of investments	5,511	
Other	(20)	
Loss from operations	(2,519)	(7,625)
Add: Depreciation and amortization	18,135	17,217
Impairment charge		6,000
Operating EBITDA	€ 15,616	€ 15,592

Year Ended December 31, 2003 Compared to Year Ended December 31, 2002

In the year ended December 31, 2003, total revenues decreased to €194.6 million from €239.1 million in the year ended December 31, 2002, primarily as the current period does not include

the revenues of the Landqart AG, referred to as "Landqart", specialty paper mill, which we reorganized in December 2002 and now account for under the equity method. Primarily as a result thereof, pulp and paper revenues decreased to €182.5 million in the current period from €227.9 million in 2002.

Cost of pulp and paper sales in the year ended December 31, 2003 decreased to €179.7 million from €213.5 million in the year ended December 31, 2002, primarily as a result of the deconsolidation of Landqart.

Pulp sales in the current period were €126.6 million, compared to €130.2 million in 2002. U.S. dollar denominated list pulp price increases were mostly offset by a 17% decline in the U.S. dollar against the Euro in 2003. Average list prices for NBSK pulp in Europe were approximately €420 ($440) per ADMT at the end of 2002, approximately €441 ($480) per ADMT in the first quarter of 2003, approximately €484 ($550) per ADMT in the second quarter of 2003, approximately €444 ($500) per ADMT in the third quarter of 2003 and approximately €444 ($560) per ADMT in the fourth quarter of 2003. Our pulp sales realizations were €417 per ADMT on average in the current period, compared to €443 per ADMT in 2002. Pulp sales by volume increased to 303,655 ADMTs in the current period from 293,607 ADMTs in 2002.

Cost of sales and general and administrative expenses for the pulp operations were €136.6 million for the year ended December 31, 2003, compared to €138.9 million for the year ended December 31, 2002. On average, fiber costs for pulp production in the current period generally remained at the same level as in the year ended December 31, 2002. Depreciation within the pulp segment was €21.9 million in the current period, compared to €21.6 million in 2002.

Our pulp operations generated operating income of €0.1 million in the year ended December 31, 2003, compared to operating income of €1.8 million in 2002.

Results for our paper segment during the current period reflect the aforementioned exclusion of the results from the Landqart specialty paper mill, which were included in the results for the prior year. Paper sales in the current period decreased to €55.9 million from €97.7 million in 2002. Sales of specialty papers in the year ended December 31, 2003 decreased to €40.1 million from €79.4 million in the year ended December 31, 2002. Total paper sales volumes decreased to 62,018 ADMTs in the year ended December 31, 2003 from 84,922 ADMTs in the year ended December 31, 2002. On average, prices for specialty papers realized in the year ended December 31, 2003 decreased by approximately 23.3% as our product mix changed upon the deconsolidation of the Landqart mill, and for printing papers decreased by approximately 6.8%, compared to the year ended December 31, 2002.

Cost of sales and general and administrative expenses for the paper operations decreased to €57.9 million in the current period from €101.0 million in 2002 as a result of lower paper sales. Paper segment depreciation decreased to €2.0 million in the year ended December 31, 2003 from €4.0 million in the prior period.

Our paper operations generated operating income of €0.1 million in the year ended December 31, 2003, compared to an operating loss of €4.5 million in the year ended December 31, 2002.

Consolidated general and administrative expenses decreased to €19.3 million in the year ended December 31, 2003 from €25.0 million in the year ended December 31, 2002, primarily as a result of the exclusion of the results of the Landqart mill and a decrease in professional fees in the current period.

For the year ended December 31, 2003, we reported a loss from operations of €4.5 million, compared to €1.1 million in 2002. Interest expense (excluding capitalized interest of €17.4 million in respect of the Stendal project) in the current period decreased to €11.5 million from €13.8 million in 2002, primarily as a result of lower borrowing costs and lower indebtedness for our operating units.

During the current period, we made principal repayments of €13.2 million in respect of the indebtedness of the Rosenthal pulp mill.

Pursuant to the Stendal Loan Facility, Stendal entered into the Stendal Interest Rate Swaps for the full term of the facility to manage the risk exposure with respect to an aggregate maximum amount of approximately €612.6 million of the principal amount of the Stendal Loan Facility. Under these swaps, Stendal pays a fixed rate and receives a floating rate with respect to interest payments calculated on a notional amount. These swaps manage the exposure to variable cash flow risk from the variable interest payments under the Stendal Loan Facility. Stendal also entered into a currency forward contract in connection with the Stendal Loan Facility in the third quarter of 2003. These derivatives are marked to market at the end of each reporting period and all unrealized gains and losses are recognized in earnings for such period. In 2003, we recorded a non-cash holding loss of approximately €13.0 million when these swaps were marked to market at the end of the period, compared to a non-cash holding loss of approximately €30.1 million in 2002. A non-cash holding gain of €0.7 million before minority interests was recognized in respect of the currency forward in the year ended December 31, 2003. We determine market valuations based primarily upon values provided by our counterparties.

In addition, Rosenthal had entered into currency swaps to manage its exposure with respect to an aggregate amount of approximately €198.4 million of the principal long-term indebtedness of the Rosenthal mill under the Rosenthal Loan Facility. Rosenthal had also entered into currency forwards and forward interest rate and interest cap contracts in connection with certain indebtedness relating to the Rosenthal mill. The currency swaps and the currency forwards were settled in December 2003. These derivatives are also marked to market at the end of each reporting period, and all gains and losses are recognized in earnings for such period. Primarily as a result of the weakening of the U.S. dollar versus the Euro, in the current year we recognized a net gain of €28.5 million upon the settlement of the currency swaps and currency forwards and the marked to market valuation of the forward interest rate and interest cap contracts. In 2002, we recognized a net gain of €23.4 million from these derivative contracts.

Minority interest in the year ended December 31, 2003 amounted to €5.6 million and represented the proportion of the loss of the Stendal project allocated to the two minority shareholders of Stendal. Minority interest in the year ended December 31, 2002 amounted to €11.0 million.

Our results for the year ended December 31, 2003 include an adjustment of €5.6 million for the non-cash aggregate pre-tax earnings impact of other-than-temporary impairment losses on certain of our available-for-sale securities. This adjustment was recorded in other income (expense) in our consolidated statement of operations. This adjustment did not affect our shareholders' equity since all of our available-for-sale securities are marked to market on a quarterly basis and unrealized gains or losses are reported through the statement of comprehensive income in our financial statements and recorded in other comprehensive income (loss) within shareholders' equity on our balance sheet. Such unrealized gains or losses, the cost base and the current marked to market value of our available-for-sale securities are further described in the notes to our annual financial statements. These were legacy investments and unrelated to our pulp and paper operations and were largely sold in December 2003.

SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*, EITF 03-1, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments*, and SEC Staff Accounting Bulletin 59, *Accounting for Noncurrent Marketable Equity Securities*, provide guidance on determining when an impairment is other-than-temporary, which requires judgment. In making this judgment, we evaluate, among other factors, the duration and extent to which the fair value of an investment is less than its cost; the financial health of and business outlook for the investee, including factors such as industry and sector performance, changes in technology, operational and financing cash flow, the investee's financial position including its appraisal and net asset value, market prices, its business plan and investment strategy; and our intent and ability to hold the investment.

During 2003, we recorded a reserve for potential tax obligations of €3.0 million and an asset write-down of €2.3 million related to the valuation of certain assets in which we have a non-controlling interest as a result of the Landqart reorganization in 2002. No similar reserves or write-downs were recorded in 2002. Our results for 2003 also include a one-time pre-tax charge of approximately €1.0 million for settlement expenses relating to a proxy solicitation and settlement agreement with respect to our 2003 annual meeting.

For the year ended December 31, 2003, we reported a net loss of €3.6 million, or €0.21 per share on a basic and diluted basis, compared to a net loss of €6.3 million, or €0.38 per share on a basic and diluted basis, in the year ended December 31, 2002.

As the Stendal project was under construction and because of its overall size relative to our other facilities, management uses consolidated operating results excluding derivative items relating to the Stendal project to measure the performance and results of our operating units. Management believes this measure provides meaningful information for it and securityholders on the performance of our operating facilities for a reporting period. Upon completion of the ramp-up phase for the Stendal mill, the Stendal project will be evaluated with our other operating units. For the year ended December 31, 2003, we reported a net loss of €3.6 million or €0.21 per share on a diluted basis. If we had excluded items relating to the Stendal project by adding the loss on derivative financial instruments of €13.0 million on the Stendal Interest Rate Swap Agreements to, and subtracting the gain on the currency forward relating to the Stendal Loan Facility of €0.7 million and minority interest of €5.6 million from, the reported net loss of €3.6 million, we would have reported net income of €3.1 million or €0.18 per share on a diluted basis. For the year ended December 31, 2002, we reported a net loss of €6.3 million or €0.38 per share on a diluted basis. If we had excluded items relating to the Stendal project by adding the loss on derivative financial instruments of €30.1 million on the Stendal Interest Rate Swap Agreements to, and subtracting minority interests of €11.0 million from, the reported net loss of €6.3 million, we would have reported net income of €12.8 million or €0.76 per share on a diluted basis. This measure has significant limitations as an analytical tool, and should not be considered in isolation, or as a substitute for analysis of our results as reported under GAAP.

We generated "Operating EBITDA" of €19.6 million in the current period, compared to Operating EBITDA of €24.5 million in 2002. Operating EBITDA is defined as income (loss) from operations plus depreciation and amortization and non-recurring capital asset impairment charges. Operating EBITDA is calculated by adding depreciation and amortization of €24.1 million and €25.6 million to the loss from operations of €4.5 million and €1.1 million for the years ended December 31, 2003 and 2002, respectively.

Operating EBITDA has significant limitations as an analytical tool, and should not be considered in isolation, or as a substitute for analysis of our results as reported under GAAP. See the discussion of our results for the nine months ended September 30, 2004 for additional information relating to Operating EBITDA.

The following table provides a reconciliation of net loss to loss from operations and Operating EBITDA for the periods indicated:

	Year Ended December 31,	
	2002	2003
	(in thousands)	
Net loss	€ (6,322)	€ (3,593)
Minority interest	(10,965)	(5,647)
Income taxes	(264)	3,172
Interest expense	13,753	11,523
Investment income	(436)	(1,653)
Derivative financial instruments	6,679	(16,168)
Impairment of investments		7,825
Other	(3,590)	
Loss from operations	(1,145)	(4,541)
Add: Depreciation and amortization	25,614	24,105
Operating EBITDA	€ 24,469	€ 19,564

Year Ended December 31, 2002 Compared to the Year Ended December 31, 2001

In 2002, total revenues increased by approximately 10.5% to €239.1 million from €216.4 million in 2001, primarily as a result of increased sales of specialty papers resulting from the acquisition of the Landqart mill in December 2001. In 2002, pulp and paper revenues increased by approximately 11.2% to €227.9 million from €205.0 million in 2001, on a 66.3% increase in paper sales partially offset by an 11.0% decrease in pulp sales.

Costs of sales in 2002 increased to €213.5 million from €184.7 million in 2001, primarily as a result of higher revenues.

Pulp sales in 2002 decreased to €130.2 million from €146.2 million in 2001, as global economic weakness and high producer inventory levels led to lower prices. List prices for kraft pulp in Europe decreased from approximately €528 ($470) per ADMT at the end of 2001 to approximately €420 ($440) per ADMT at the end of the fourth quarter of 2002, before improving in early 2003 due primarily to supply disruptions. Our pulp sales realizations in 2002 decreased to €443 per ADMT from €512 per ADMT in 2001 as a result of such lower sales prices and the weaker dollar versus the Euro during 2002 compared to the prior period. Pulp sales by volume increased to 293,607 ADMTs in 2002 from 285,654 ADMTs in 2001, when we had 19 days of unscheduled technical downtime at the Rosenthal mill.

Cost of sales and general and administrative expenses for our pulp operations decreased to €138.9 million in 2002 from €140.4 million in 2001 despite higher production and sales volumes. On average, our fiber costs per ADMT for pulp production decreased by approximately 5.8% in 2002 compared to 2001 primarily because of lower fiber costs. Additionally, efficiency improvements at the Rosenthal mill also reduced energy and chemical costs relative to 2001. Depreciation was €21.6 million in 2002 compared to €21.4 million in 2001. In 2002, our average production costs per ADMT (excluding depreciation) were reduced by approximately 9% compared to 2001.

Our pulp operations generated €1.8 million of income from operations in 2002, compared to €18.6 million in 2001.

Paper sales in 2002 increased to €97.7 million from €58.8 million in 2001. Sales of specialty papers in 2002 increased to €79.4 million from €36.0 million in 2001 as a result of the inclusion of the results of the Landqart mill, which contributed sales volumes of 18,222 ADMTs in 2002. Excluding Landqart,

our sales volumes for these grades increased to 43,505 ADMTs in 2002 from 40,437 ADMTs in 2001. This increase in specialty paper sales is largely the result of our strategy to focus on niche products. In response to market conditions, we adjusted our product mix to more specialty products at our Heidenau mill where volumes of printing papers decreased to 23,195 ADMTs in 2002 from 26,815 ADMTs in the prior period. On average, prices for specialty papers realized in 2002 increased by approximately 44.6% and for printing papers decreased by approximately 6.9%, compared to 2001.

Cost of sales and general and administrative expenses for our paper operations increased to €101.0 million in 2002 from €61.7 million in 2001 as a result of the inclusion of Landqart. This increase was partially offset by lower raw material prices, particularly for virgin pulp and waste paper as compared to 2001. Furthermore, the flooding experienced at our Heidenau and Fährbrücke paper mills in August 2002 resulted in a period of reduced production and increased costs. Depreciation increased to €4.0 million in 2002 from €1.5 million in the prior year, as a result of the inclusion of Landqart.

A loss from operations of €4.5 million was recorded by our paper operations in 2002 relative to a €2.5 million loss from operations in 2001.

General and administrative expenses increased to €25.0 million in 2002 from €18.4 million in 2001, primarily as a result of the inclusion of the results of the Landqart mill and a foreign exchange transaction loss of €3.0 million in 2002. In 2001, we recorded a foreign exchange transaction gain of €3.4 million.

We had a loss from operations of €1.1 million in 2002, compared to income from operations of €13.3 million in 2001. Interest expense (excluding capitalized interest of €3.1 million in respect of the Stendal project) in 2002 decreased to €13.8 million from €16.2 million in 2001, primarily as a result of repayments made on outstanding indebtedness.

We recognized a holding loss of €30.1 million before minority interests in respect of the Stendal Interest Rate Swaps for the year ended December 31, 2002.

During 2002, we settled two currency swaps which were entered into earlier in the year to realize gains. We then subsequently re-entered into two currency swaps and one of them was settled and a gain was realized in December 2002. In addition, we have entered into currency forwards and forward interest rate and interest cap contracts in connection with certain indebtedness relating to the Rosenthal mill. These derivatives are also marked to market at the end of each reporting period and all gains and losses are recognized in earnings for a reporting period. In 2002, we realized a total gain of €23.4 million from these derivative contracts.

Income tax impacts were negligible in both 2002 and 2001 given the pre-tax losses sustained in both years. Minority interest in 2002 amounted to €11.0 million and represented the minority shareholders' interest in the losses of Stendal. There was no minority interest in 2001.

For 2002, we reported a net loss of €6.3 million, or €0.38 per share on a basic and diluted basis, compared to a net loss of €2.8 million, or €0.17 per share on a basic and diluted basis, in 2001.

For 2002, excluding items related to the Stendal project, net income would have been €12.8 million, or €0.76 per share on a diluted basis, which was determined by adding the loss on derivative financial instruments of €30.1 million to, and subtracting minority interests of €11.0 million from, the reported net loss of €6.3 million. As the Stendal project is currently under construction and because of its overall size relative to our other facilities, management uses our consolidated operating results excluding items relating to the Stendal project to measure the performance and results of our operating units. Management believes this measure provides meaningful information on the performance of our operating facilities for a reporting period.

We generated "Operating EBITDA" of €24.5 million in the current period, compared to Operating EBITDA of €36.3 million in 2001. Operating EBITDA is defined as income (loss) from operations plus depreciation and amortization and non-recurring capital asset impairment charges. Operating EBITDA

is calculated by adding depreciation and amortization of €25.6 million and €23.0 million to the income (loss) from operations of €(1.1) million and €13.3 million for the years ended December 31, 2002 and 2001, respectively.

Operating EBITDA has significant limitations as an analytical tool, and should not be considered in isolation, or as a substitute for analysis of our results as reported under GAAP. See the discussion of our results for the nine months ended September 30, 2004 for additional information relating to Operating EBITDA.

The following table provides a reconciliation of net loss to income (loss) from operations and Operating EBITDA for the periods indicated:

	Year Ended December 31,	
	2001	2002
	(in thousands)	
Net loss	€ (2,823)	€ (6,322)
Minority interest		(10,965)
Income taxes	83	(264)
Interest expense	16,170	13,753
Investment income	(2,872)	(436)
Derivative financial instruments	2,504	6,679
Impairment of investments		
Other	270	(3,590)
Income (loss) from operations	13,332	(1,145)
Add: Depreciation and amortization	22,966	25,614
Operating EBITDA	€ 36,298	€ 24,469

Liquidity and Capital Resources

The following table is a summary of selected financial information for the periods indicated:

	As at December 31,		As at September 30, 2004
	2002	2003	
	(in thousands)		
Financial Position			
Cash and cash equivalents	€ 30,261	€ 51,993	€ 42,643
Working capital (deficit)	6,328	(48,947)[(1)]	(122,474)[(1)]
Properties, net	441,990	745,178	942,249
Total assets	599,750	935,905	1,192,727
Long-term liabilities	384,892	625,702	778,939
Shareholders' equity	124,969	132,855	121,595

(1) As at December 31, 2003 and September 30, 2004, we had a working capital deficit of €48.9 million and €122.5 million, respectively, primarily as a result of Stendal construction costs payable of €42.8 million and €161.0 million during the respective periods for which we had not drawn down under the Stendal Loan Facility. We qualify for investment grants from the federal and state governments of Germany and had claim expenditures of €82.1 million and €65.2 million outstanding at December 31, 2003 and September 30, 2004, respectively. We expect to receive our currently outstanding claim expenditures in 2005. However, in accordance with our accounting policies, we do not record these grants until they are received.

At September 30, 2004, our cash and cash equivalents were €42.6 million, compared to €52.0 million at December 31, 2003. We also had €29.3 million of cash restricted to pay construction costs payable and €19.1 million of cash restricted in a debt service account, both related to the Stendal

project. In addition, we had €28.5 million of cash restricted in a debt service account relating to the Rosenthal Loan Facility. At September 30, 2004, we had a working capital deficit of €122.5 million, primarily because we had Stendal construction costs payable of €161.0 million for which we had not yet drawn down under the Stendal Loan Facility and, under our accounting policies, we do not record certain government grants until they are received. The Stendal construction costs will be paid pursuant to the Stendal Loan Facility in the ordinary course. At September 30, 2004, we qualified for investment grants related to the Stendal mill totaling approximately €65.2 million from the federal and state governments of Germany, which we expect to receive in 2005. Approximately €61.2 million of these grants, when received, will be applied to repay the amounts drawn under the dedicated tranche of the Stendal Loan Facility. The grants are not reported in our income and reduce the cost basis of the assets purchased when they are received. We expect to qualify for additional investment grants totaling €23.3 million when such Stendal construction costs have been substantially paid.

In October 2003, we completed the sale of $82.5 million in aggregate principal amount of convertible senior subordinated notes due October 2010. The notes bear interest at a rate of 8.5% per annum and are convertible into our shares of beneficial interest at a conversion price of $7.75 per share. The net proceeds from the offering of approximately $78.4 million were used to repay in full our indebtedness, including fees and accrued interest, under two bridge loan facilities aggregating approximately $66.9 million and the balance was used for general corporate purposes, including working capital.

We expect to continue to generate sufficient cash flow from operations to pay our interest and debt service expenses and meet the working and maintenance capital requirements for our current operations. Our only revolving credit facility is at our Stendal mill. We intend to enter into two new working capital facilities for the Rosenthal and Celgar mills. See "Use of Proceeds", "The Financings" and "Description of Certain Indebtedness New Working Capital Facilities".

From time to time, we have entered into project specific credit facilities to finance capital projects and expect to continue to do so, subject to availability. We expect to meet the capital requirements for the Stendal mill, including working capital and potential losses during start-up, through shareholder advances already made to Stendal, the Stendal Loan Facility, the receipt of government grants and cash flow from operations. See "Business Stendal Pulp Mill Project and Financing" and "Description of Certain Indebtedness Stendal Pulp Mill Project Financing".

Operating Activities

Operating activities in 2003 provided cash of €31.4 million, compared to €40.4 million in 2002. Net changes in trading securities provided cash of €0.3 million in 2003, compared to €4.4 million in 2002. An increase in receivables due primarily to higher sales in December 2003 used cash of €4.7 million in 2003, compared to a decrease in receivables providing cash of €18.2 million in 2002. An increase in inventories due primarily to the build up of fiber in connection with the start-up of the Stendal mill used cash of €7.5 million in 2003, compared to a decrease in inventories providing cash of €1.7 million in 2002. A decrease in cumulative unrealized gains on derivatives provided cash of €3.8 million in 2003, compared to an increase in the same using cash of €3.3 million in 2002. An increase in accounts payable and accrued expenses provided cash of €1.1 million in 2003, compared to a decrease in the same using cash of €12.7 million in 2002.

Operating activities in the nine months ended September 30, 2004 used cash of €1.2 million, compared to providing cash of €7.0 million in the comparative period of 2003. An increase in receivables related primarily to the start-up of the Stendal mill used cash of €2.1 million in the nine months ended September 30, 2004, compared to using cash of €8.1 million in the comparative period of 2003. Higher inventories due primarily to the build up of fiber and finished goods in connection with the start-up of the Stendal mill used cash of €35.8 million in the first nine months of 2004, compared to higher inventories using cash of €6.6 million in the first nine months of 2003. We expect that as the

Stendal mill ramps up operations, inventory levels at the mill will decrease to more normalized levels. An increase in accounts payable and accrued expenses related primarily to the start-up of the Stendal mill provided cash of €26.3 million in the nine months ended September 30, 2004, compared to providing cash of €11.6 million in the comparative period of 2003.

Investing Activities

Investing activities in 2003 used cash of €318.5 million, primarily as a result of the acquisition of properties, net of investment grants, of which €316.7 million was attributable to the Stendal project, compared to €195.7 million in 2002, of which €186.6 million was attributable to the Stendal project. Sales of available-for-sale securities provided cash of €6.4 million in 2003.

Investing activities in the nine months ended September 30, 2004 used cash of €211.8 million, primarily as a result of the acquisition of properties, net of investment grants, of which €206.9 million was attributable to the Stendal project, compared to using cash of €225.9 million in the nine months ended September 30, 2003, of which €145.9 million was attributable to the Stendal project. Sales of certain legacy available-for-sale securities provided cash of €1.2 million in the nine months ended September 30, 2004.

We qualify for investment grants from the federal and state governments of Germany and had claim expenditures of €65.2 million outstanding as of September 30, 2004. We expect to receive our currently outstanding claim expenditures in 2005. We received investment grants totaling €82.7 million and €103.0 million with respect to the Stendal project during 2003 and the first nine months of 2004, respectively. In accordance with our accounting policies, we do not record these grants until they are received. These grants reduce the cost basis of the assets purchased with them. See "Business Government Financing".

We are in the process of constructing a wastewater treatment plant at the Fährbrücke mill and have completed reconstructing the landfill at the Rosenthal mill. See "Business Environmental" and "Business Capital Expenditures".

In August 2002, we completed financing arrangements for the Stendal project. Total investment costs in connection with the project are approximately €1.0 billion, the majority of which was provided under the Stendal Loan Facility. We also contributed approximately €63.5 million to Stendal. For more information about the Stendal project, see "Business Stendal Pulp Mill Project and Financing" and "Business Capital Expenditures".

Financing Activities

Financing activities provided cash of €307.1 million in the year ended December 31, 2003. A net increase in indebtedness, primarily related to the Stendal project, provided cash of €299.0 million. An increase in restricted cash used cash of €11.1 million in 2003. We made principal repayments of €13.2 million in connection with the Rosenthal Loan Facility in the year ended December 31, 2003. The issuance of shares in connection with the exercise of options provided cash of €0.9 million in 2003. Financing activities provided cash of €174.7 million in 2002, primarily as a result of a net increase in indebtedness relating to the Stendal project.

Financing activities provided cash of €203.6 million in the nine months ended September 30, 2004. A net increase in indebtedness, primarily related to the Stendal project, provided cash of €104.1 million. An increase in construction costs payable provided cash of €118.2 million. An increase in restricted cash used cash of €17.5 million. We made principal repayments of €20.1 million in connection with the Rosenthal Loan Facility in the nine months ended September 30, 2004. The balance outstanding under such facility at September 30, 2004, net of cash in a restricted debt service account, was €143.1 million. The issuance of shares in connection with the exercise of options provided cash of €0.6 million in the nine months ended September 30, 2004. Financing activities provided cash of €206.2 million in the first nine months of 2003, primarily as a result of an increase in construction costs payable relating to the Stendal project and an increase in indebtedness primarily in connection with the Stendal project.

In 2003, our paper operations secured two term credit facilities aggregating approximately €2.5 million, which facilities along with certain government grants were utilized to repair flooding damage suffered by the mills in 2002. For information about these credit facilities, see "Description of Certain Indebtedness Paper Mill Project Facilities".

In addition, in 2003, our Fährbrücke paper mill secured three credit facilities aggregating €5.5 million, which facilities along with certain government grants are utilized to finance equipment and construction costs associated with expanding, adapting and improving the efficiency of the paper machine at the mill. In September 2004, we repaid the majority of the outstanding amounts under these credit facilities and permanently reduced the aggregate amount available thereunder to €2.2 million. For information about these credit facilities, see "Description of Certain Indebtedness Paper Mill Project Facilities". As at September 30, 2004, we had utilized the entire €4.7 million available under the five credit facilities relating to the paper operations.

Other than the Acquisition Agreement, we have no material commitments to acquire assets or operating businesses. The Acquisition is being financed through the offering of notes hereunder and the Share Offering. We anticipate that there will be acquisitions of businesses or commitments to projects in the future. To achieve our long-term goals of expanding our asset and earnings base through the acquisition of interests in companies and assets in the pulp and paper and related businesses, and organically through high return capital expenditures at our operating facilities, we will require substantial capital resources. The required necessary resources for such long-term goals will be generated from cash flow from operations, cash on hand, the sale of securities and/or assets, and borrowing against our assets, subject to the restrictions in the indenture governing the notes issued hereunder.

In addition, we have amounts available under the revolving portion of the Stendal Loan Facility, and the two new revolving working capital facilities to be established for the Rosenthal and Celgar mills. See "The Financings" and "Description of Certain Indebtedness New Working Capital Facilities".

Contractual Obligations and Commitments

The following table sets out our contractual obligations and commitments as at December 31, 2003 in connection with our long-term liabilities. These obligations and commitments are expected to increase in the future to reflect the start-up of the Stendal mill and the Acquisition.

	Payments Due By Period				
Contractual Obligations	**2004**	**2005-2006**	**2007-2008**	**Beyond 2008**	**Total**
			(in thousands)		
Long-term debt[1]	€ 15,801	€ 34,116	€ 38,836	€ 182,949	€ 271,702
Construction in progress, Stendal[2]		18,248	48,877	267,467	334,592
Capital lease obligations[3]	1,932	1,854	453		4,239
Operating lease obligations[4]	2,097	3,149	3,280	80	8,606
Purchase obligations[5]	37,764	44,382	4,117		86,263
Other long-term liabilities[6]	27		125	57	209
Total	€ 57,621	€ 101,749	€ 95,688	€ 450,553	€ 705,611

(1) This reflects principal only relating primarily to indebtedness under the Rosenthal Loan Facility, which will be repaid from the proceeds of the Financings, and credit facilities relating to the paper mills, but does not reflect indebtedness relating to the Stendal project. See "Description of Certain Indebtedness", footnote 2 below and Note 9 to our annual financial statements included herein for a description of such indebtedness. Does not include amounts associated with derivatives entered into in connection with indebtedness relating to the Rosenthal mill, which we intend to settle as part of the Rosenthal refinancing. See " Quantitative and Qualitative Disclosure about Market Risk" for information about our derivatives.

(2) This reflects principal only in connection with indebtedness relating to the Stendal project, including under the Stendal Loan Facility and convertible notes. See "Description of Certain Indebtedness" and Note 9 to our annual financial statements included herein for a description of such indebtedness. Does not include amounts associated with derivatives entered into in connection with the Stendal Loan Facility. See " Quantitative and Qualitative Disclosure about Market Risk" for information about our derivatives.

(3) Capital lease obligations relate to transportation vehicles and production equipment. These amounts reflect principal and interest.

(4) Operating lease obligations relate to transportation vehicles and other production and office equipment.

(5) Purchase obligations relate primarily to take-or-pay contracts made in the ordinary course of business, of which purchases of raw materials and supplies totaled approximately €85.0 million.

(6) Other long-term liabilities relate primarily to pension liability. Does not include obligations under employment agreements.

Capital Resources

In addition to our new €40 million and $30 million revolving credit facilities for the Rosenthal and Celgar mills, respectively, we may seek to raise future funding in the debt markets if our indenture permits, subject to compliance with the indenture. The indenture governing the notes will contain various restrictive covenants, including several that are based on a formulation of the financial measure EBITDA, which is net income (loss) adjusted to exclude interest, taxes, depreciation and amortization, certain non-cash charges and extraordinary or otherwise unusual gains or losses, and certain other items. We refer to this formulation of EBITDA as "Indenture EBITDA" which is defined in the note indenture as Consolidated EBITDA.

The following table sets forth the applicable components of Indenture EBITDA for the pro forma restricted group and also serves as a reconciliation to net income (loss) on a GAAP basis for the periods indicated:

	Pro Forma Restricted Group		
		Nine Months Ended September 30,	
	Year Ended Dec. 31, 2003	2003	2004
		(unaudited) (in thousands)	
Net loss, GAAP	€ (3,447)	€ (23,965)	€ (435)
Foreign exchange gain on indebtedness	(14,571)	(11,654)	(1,791)
Marked to market gain (loss) on hedging obligations	(27,347)	367	(1,293)
Indenture net income	(45,365)	(35,252)	(3,519)
Equity losses	1,676	912	554
Indenture consolidated net income	(43,689)	(34,340)	(2,965)
Income taxes	3,172	226	(37)
Interest expense	29,297	21,781	22,521
Depreciation and amortization	33,985	25,269	23,587
Impairment of investments	6,735	4,441	
Mercer stock compensation expense[1]	454	432	690
Mercer special shareholder costs[2]	601	212	
Acquisition expenses			58
Mercer corporate reorganization costs[3]	251		567
Celgar foreign exchange losses[4]	3,769	3,119	566
Celgar lime kiln costs[5]	1,982	1,283	59
Accrued interest income	(3,582)	(2,966)	(1,104)
Indenture EBITDA	€ 32,975	€ 19,457	€ 43,942

(1) Mercer stock compensation expense is a non-cash expense related to stock options issued to trustees and officers.

(2) Mercer special shareholder costs are related to a proxy contest which occurred in connection with our annual meeting of shareholders held on August 22, 2003 resulting in additional proxy solicitation, settlement and related costs.

(3) Mercer corporate reorganization costs are related to an internal corporate reorganization effected by Mercer within its German subsidiaries.

(4) Celgar foreign exchange losses are related to foreign exchange losses on current receivables and payables resulting from currency fluctuations.

(5) Celgar lime kiln costs are additional incremental costs related to a burner misalignment at the Celgar lime kiln.

The indenture governing the notes will provide that, in order to enter into certain types of transactions, including the incurrence of additional indebtedness, the making of restricted payments and the completion of mergers and consolidations, we must meet a minimum ratio of Indenture EBITDA to Fixed Charges as defined in the note indenture of 2.0 to 1.0 on a pro forma basis for the most recently ended four full fiscal quarters. This ratio is referred to and defined as the Fixed Charge Coverage Ratio in the note indenture. See "Description of the Notes". Indenture EBITDA provides additional information with respect to our ability to incur debt and make distributions and should be used primarily for the purposes of determining our ability to incur additional debt beyond our revolving credit facilities and certain other permitted borrowings that are independent of this ratio.

Fixed charges, as defined in the note indenture, for the pro forma restricted group were comprised only of interest expense for the year ended December 31, 2003 and for the nine months ended September 30, 2003 and 2004. For the four quarters ending September 30, 2004, we calculate the Fixed Charge Coverage Ratio for the pro forma restricted group to be 1.9.

For a description of our credit facilities, see "Description of Certain Indebtedness".

Sensitivity Analysis

The pulp and paper business is cyclical in nature and markets for our principal products are characterized by periods of supply and demand imbalance, which in turn affects product prices. The markets for pulp and paper are highly competitive and sensitive to changes in industry capacity and in the economy, both of which can have a significant influence on our selling prices and earnings. Approximately €126.6 million, or approximately 69.4%, of our revenues in 2003 were from pulp sales and approximately €103.7 million, or approximately 71.5%, of our revenues in the nine months ended September 30, 2004 were from pulp sales. The following table illustrates the effect on our net operating results in 2003 and the first nine months of 2004 of a $20 change in our average selling price per ADMT for NBSK pulp in 2003 and the first nine months of 2004, based upon our pulp sales during each period and translated into Euros at the average exchange rate for the U.S. dollar to the Euro for the period:

	Year Ended December 31, 2003	Nine Months Ended September 30, 2004
	(in thousands, except per share amounts)	
NBSK Pulp $20 per ADMT change		
Change in net loss	€ 5,367	€ 3,744
Change in net loss per share	0.32	0.22

As our Stendal mill only started production in the third quarter of 2004, we expect our sensitivity to pulp prices to increase significantly both on an absolute and per share basis in the future.

Foreign Currency

Effective January 1, 2002, we changed our reporting currency from the U.S. dollar to the Euro as a significant majority of our business transactions are originally denominated in Euros. By adopting the Euro, most cumulative foreign currency translation losses were eliminated. However, we hold certain assets and liabilities in U.S. dollars, Swiss francs and, to a lesser extent, in Canadian dollars. Accordingly, our consolidated financial results are subject to foreign currency exchange rate fluctuations.

We translate foreign denominated assets and liabilities into Euros at the rate of exchange on the balance sheet date. Unrealized gains or losses from these translations are recorded in our consolidated statement of comprehensive income and impact on shareholders' equity on the balance sheet but do not affect our net earnings.

In the year ended December 31, 2003, we reported a net €2.5 million foreign exchange translation gain and in the nine months ended September 30, 2004, we reported a net €0.3 million foreign exchange translation loss, and, as a result, the cumulative foreign exchange translation gain increased to €6.0 million at December 31, 2003 from €3.5 million at December 31, 2002 and decreased to €5.7 million at September 30, 2004 from €6.0 million from December 31, 2003.

Based upon the exchange rate at December 31, 2003, the U.S. dollar decreased by approximately 17% in value against the Euro since December 31, 2002 and, based on the average exchange rate for the nine months ended September 30, 2004, the U.S. dollar decreased by approximately 6.2% in value

against the Euro since September 30, 2003. See " Quantitative and Qualitative Disclosures about Market Risk".

Critical Accounting Policies

The preparation of financial statements and related disclosures in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Estimates are used for, but not limited to, the accounting for doubtful accounts, depreciation and amortization, asset impairments, income taxes, and contingencies. Actual results could differ from these estimates.

Our management routinely makes judgments and estimates about the effects of matters that are inherently uncertain. As the number of variables and assumptions affecting the probable future resolution of the uncertainties increase, these judgments become even more subjective and complex. We have identified certain accounting policies, described below, that are the most important to the portrayal of our current financial condition and results of operations. Our significant accounting policies are disclosed in Note 1 to our annual audited consolidated financial statements included elsewhere in this prospectus supplement. In addition, we had a change in our depreciation estimate relating to the Rosenthal mill in the nine months ended September 30, 2004. See Note 8 to our interim consolidated financial statement included elsewhere in this prospectus supplement.

Derivative Instruments. We adopted Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" effective January 1, 2001. Derivative instruments are measured at fair value and reported in the balance sheet as assets or liabilities. Accounting for gains or losses depends on the intended use of the derivative instruments. Gains or losses on derivative instruments which are not designated hedges are recognized in earnings in the period of the change in fair value. Accounting for gains or losses on derivative instruments designated as hedges depends on the type of hedge and these gains or losses are recognized in either earnings or other comprehensive income.

We reported a non-cash holding loss of €13.0 million before minority interests in respect of the Stendal Interest Rate Swaps, a non-cash holding gain of €0.7 million before minority interests in respect of the Stendal currency forward contract and a gain of €28.5 million in respect of the Rosenthal Interest Rate Contracts and settlement of the Rosenthal currency swaps and currency forwards in our loss for the year ended December 31, 2003.

Impairment of Long-Lived Assets. We periodically evaluate long-lived assets whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In performing the review of recoverability, we estimate future cash flows expected to result from the use of the asset and its eventual disposition. The estimates of future cash flows, based on reasonable and supportable assumptions and projections, require our management to make subjective judgments. In addition, the time periods for estimating future cash flows is often lengthy, which increases the sensitivity of the assumptions made. Depending on the assumptions and estimates used, the estimated future cash flows projected in the evaluation of long-lived assets can vary within a wide range of outcomes. Our management considers the likelihood of possible outcomes in determining the best estimate of future cash flows.

Deferred Taxes. We currently have deferred tax assets which are comprised primarily of tax loss carryforwards and deductible temporary differences, both of which will reduce taxable income in the future. We assess the realization of these deferred tax assets on a periodic basis to determine whether a valuation allowance is required. We determine whether it is more likely than not that all or a portion

of the deferred tax assets will be realized, based on currently available information, including, but not limited to, the following:

- the history of the tax loss carryforwards and their expiry dates;
- our projected earnings; and
- tax planning opportunities.

If we believe that it is more likely than not that some of these deferred tax assets will not be realized, based on currently available information, an income tax valuation allowance is recorded against these deferred tax assets. As at December 31, 2003, we had €84.5 million in deferred tax assets and €74.5 million in valuation allowances, resulting in a net deferred tax asset of €10.0 million.

If market conditions improve or tax planning opportunities arise in the future, we will reduce our valuation allowances, resulting in future tax benefits. If market conditions deteriorate in the future, we will increase our valuation allowances, resulting in future tax expenses. Any change in tax laws, particularly in Germany, will change the valuation allowances in future periods.

Environmental. Our operations are subject to a wide range of German federal, state and local environmental laws and regulations, dealing primarily with water, air and land pollution control. In recent years, we have devoted significant financial and management resources to comply with all applicable environmental laws and regulations. We believe our operations are currently in substantial compliance with the requirements of all applicable environmental laws and regulations and our respective operating permits.

Under German state environmental rules relating to effluent discharges, industrial users are required to pay wastewater fees based upon the amount of their effluent discharge. These rules also provide that an industrial user which undertakes environmental capital expenditures and lowers certain effluent discharges to prescribed levels may offset the amount of these expenditures against the wastewater fees that they would otherwise be required to pay in a three-year period. The requirement and timing of capital expenditures and the amount of wastewater fee charges are subject to negotiation with government agencies. As a result, we believe that our capital investment programs for our manufacturing plants will fully offset the wastewater fees that would have been payable for the past three years, subject to environmental audits. We estimate the aggregate wastewater fees offset by capital expenditures for the past three years to be approximately €9.6 million.

Other than wastewater fees, we accrue for environmental remediation liabilities on a site-by-site basis when it is probable that a loss can be reasonably estimated, or as a result of an environmental action or claim, environmental studies that we conduct or regulatory assessment. As at December 31, 2003, we recorded a liability for environmental conservation expenditures of €1.8 million, based on environmental studies that we conducted. We believe that the liability amount recorded is sufficient, subject to future changes in German environmental regulations.

Quantitative and Qualitative Disclosures about Market Risk

We are exposed to market risks from changes in interest rates, foreign currency exchange rates, particularly the exchange rate between the U.S. dollar and the Euro, and equity prices which may affect our results of operations and financial condition and, consequently, our fair value. We manage these risks through internal risk management policies as well as the use of derivatives. We use derivatives to reduce or limit our exposure to interest rate and currency risks. We may in the future use derivatives to reduce or limit our exposure to fluctuations in pulp prices. We also use derivatives to reduce our potential losses or to augment our potential gains, depending on our management's perception of future economic events and developments. These types of derivatives are generally highly speculative in

nature. They are also very volatile as they are highly leveraged given that margin requirements are relatively low in proportion to notional amounts.

Many of our strategies, including the use of derivatives, and the types of derivatives selected by us, are based on historical trading patterns and correlations and our management's expectations of future events. However, these strategies may not be fully effective in all market environments or against all types of risks. Unexpected market developments may affect our risk management strategies during this time, and unanticipated developments could impact our risk management strategies in the future. If any of the variety of instruments and strategies we utilize are not effective, we may incur losses.

Derivatives

Derivatives are contracts between two parties where payments between the parties are dependent upon movements in the price of an underlying asset, index or financial rate. Examples of derivatives include swaps, options and forward rate agreements. The notional amount of the derivatives is the contract amount used as a reference point to calculate the payments to be exchanged between the two parties and the notional amount itself is not generally exchanged by the parties.

The principal derivatives we use are foreign exchange derivatives and interest rate derivatives.

Foreign exchange derivatives include currency swaps which involve the exchange of fixed payments in one currency for the receipt of fixed payments in another currency. Such cross currency swaps involve the exchange of both interest and principal amounts in two different currencies. They also include foreign exchange forwards which are contractual obligations in which two counterparties agree to exchange one currency for another at a specified price for settlement at a pre-determined future date. Forward contracts are effectively tailor-made agreements that are transacted between counterparties in the over-the-counter market.

Interest rate derivatives include interest rate forwards (forward rate agreements) which are contractual obligations to buy or sell an interest-rate-sensitive financial instrument on a future date at a specified price. Forward contracts are effectively tailor-made agreements that are transacted between different counterparties in the over-the-counter market. They also include interest rate swaps which are over-the-counter contracts in which two counterparties exchange interest payments based upon rates applied to a notional amount.

We use foreign exchange derivatives to convert some of our costs (including currency swaps relating to our long-term indebtedness) from Euros to U.S. dollars. We use interest rate derivatives to fix the rate of interest on indebtedness under the Rosenthal Loan Facility and the Stendal Loan Facility.

All of the derivatives we entered into were pursuant to the Rosenthal Loan Facility and the Stendal Loan Facility, each of which provide facilities for foreign exchange derivatives, interest rate derivatives and commodities derivatives, subject to prescribed controls, including maximum notional and at-risk amounts. These credit facilities are secured by substantially all of the assets of the Rosenthal and Stendal pulp mills, respectively, and have the benefit of certain German governmental guarantees. These credit facilities do not have any separate margin requirements when derivatives are entered into pursuant to the terms and conditions thereof and are subsequently marked to market.

All of the derivatives of Rosenthal and Stendal are marked to market at the end of each reporting period, and all unrealized gains and losses are recognized in earnings for a reporting period. We determine market valuations based primarily upon valuations provided by our counterparties.

In March 2004, Rosenthal entered into the Rosenthal Currency Derivatives which include two currency swaps in the aggregate principal amount of €184.5 million that mature in September 2008 and September 2013, respectively. As NBSK pulp prices are quoted in U.S. dollars and the majority of our

business transactions are denominated in Euros, Rosenthal had entered into the currency swaps to reduce the effects of exchange rate fluctuations between the U.S. dollar and the Euro on notional amounts under the Rosenthal Loan Facility. Under these currency swaps, Rosenthal effectively pays the principal and interest in U.S. dollars and at U.S. dollar borrowing rates.

The Rosenthal Currency Derivatives also include a currency forward in the notional amount of €40.7 million which matures in March 2005 that was entered into by Rosenthal to reduce or limit its exposure to currency risks and to augment its potential gains or to reduce its potential losses. In addition, Rosenthal entered into the Rosenthal Interest Rate Contracts in 2002 to either fix or limit the interest rates in connection with certain of its indebtedness.

In August 2002, Stendal entered into the Stendal Interest Rate Swaps in connection with its long-term indebtedness relating to the Stendal project to fix the interest rate under the Stendal Loan Facility at the then low level, relative to its historical trend and projected variable interest rate. These contracts were entered into under a specific credit line under the Stendal Loan Facility and are subject to prescribed controls, including certain maximum amounts for notional and at-risk amounts. Under the Stendal Interest Rate Swaps, Stendal pays a fixed rate and receives a floating rate with the interest payments being calculated on a notional amount. The interest rates payable under the Stendal Loan Facility were swapped into fixed rates based on the Eur-Euribor rate for the repayment periods of the tranches under the Stendal Loan Facility. Stendal effectively converted the Stendal Loan Facility from a variable interest rate loan into a fixed interest rate loan, thereby reducing interest rate uncertainty.

In March 2004, Stendal also entered into the Stendal Currency Derivatives which are comprised of a currency swap in the principal amount of €306.3 million which matures in April 2011 and a currency forward contract for the notional amount of €20.6 million maturing in March 2005 to reduce or limit its exposure to currency risks and to augment its potential gains or reduce its potential losses.

In December 2004, we settled the Currency Derivatives due to the substantial weakening of the U.S. dollar versus the Euro in 2004.

We are exposed to very modest credit related risks in the event of non-performance by counterparties to derivative contracts. However, we do not expect that the counterparties, which are major financial institutions, will fail to meet their obligations.

As of September 30, 2004, we have not entered into any material financial derivatives outside of our project companies, Rosenthal and Stendal, under their existing lines of credit. As at September 30, 2004, no derivative contract had been executed with respect to pulp prices.

The following table sets forth the maturity date, the notional amount and the recognized gain or loss, for derivatives that were in effect during 2003 and the first nine months of 2004:

Derivative Instrument	Maturity Date	Notional Amount	Recognized Gain (Loss) Year Ended December 31, 2003	Notional Amount	Recognized Gain (Loss) Nine Months Ended September 30, 2004
				(unaudited)	(unaudited)
		(in millions)	(in thousands)	(in millions)	(in millions)
ROSENTHAL					
Forward Rate Agreements[1]	Settled	$ 149.0	€ (89)		
Forward Rate Agreements[2]	Settled	$ 124.8	(7)		
Currency Swap[3]	Settled	€ 74.5	10,002		
Currency Swap[4]	Settled	€ 124.2	14,057		
Currency Forward	Settled	$ 20.0	768		
Currency Forward	Settled	$ 30.0	3,751		
Forward Rate Agreement	Settled	$ 126.9	(127)		
Forward Rate Agreement[5]	Settled	$ 200.9	(343)		
			28,012		
		As at December 31, 2003		As at September 30, 2004	
				(unaudited)	
Interest Rate Cap Agreements[6]	September 2007	$ 192.6	455	$ 178.3	€ (0.1)
Currency Swap[7]	September 2008			€ 111.8	(0.4)
Currency Swap[8]	April 2011			€ 72.7	(0.2)
Currency Forward	March 2005			€ 40.7	0.4
			455		(0.3)
			€ 28,467		€ (0.3)
STENDAL					
Stendal Interest Rate Swaps[9]	October 2017	€ 1,419.3	€ (13,042)	€ 1,147.5	€ (15.7)
Currency Swap[10]	April 2011			€ 306.3	14.4
Currency Forward	March 2005			€ 20.6	0.5
Currency Forward	Settled	$ 10.0	743		
			€(12,299)		€ (0.8)

(1) Rosenthal entered into two forward interest rate contracts with notional amounts of $74.5 million and $74.5 million both maturing on September 30, 2003. These derivatives were settled in 2003.

(2)

The forward rate agreement was settled in 2003.

(3)

The interest component of the swaps was required under the terms of the Rosenthal Loan Facility, and became effective for the period starting September 30, 2002. For the outstanding principal amounts of €74.5 million under the Rosenthal Loan Facility, all repayment installments from September 30, 2002 until September 30, 2013, were swapped into U.S. dollar amounts at a rate of Euro 1.0050. The interest rate was swapped into the six-month U.S. dollar/Libor plus bank margin rate with a cap of 6.8% until September 28, 2007.

(4)

The interest component of the swaps was required under the terms of the Rosenthal Loan Facility, and became effective for the period starting January 23, 2003. For the outstanding principal amounts of €124.2 million under the Rosenthal Loan Facility, all repayment installments from January 23, 2003 until September 30, 2008, were swapped into U.S. dollar amounts at a rate of Euro 1.075. The interest rate was swapped into the three month U.S. dollar/Libor plus bank margin rate with a cap of 6.8% until September 28, 2007.

(5) Rosenthal entered into two forward interest rate contracts with notional amounts of $74.0 million and $126.9 million both maturing on March 30, 2004.

(6) Rosenthal entered into two interest rate cap contracts with notional amounts of $106.2 million (2003: $118.6 million) and $72.1 million (2002: $74.0 million), both maturing on September 28, 2007 with a strike rate of 6.8%.

(7) For €111.8 million of the outstanding principal amount under the Rosenthal Loan Facility, all repayment installments from March 30, 2004 until September 30, 2008 were swapped into U.S. dollar amounts at a rate of U.S. 1.2398. The interest rate was swapped into the following payments: pay a fixed rate of 4.5%, pay the three-month Libor plus a spread of 0.12% and receive the three-month Euribor until September 30, 2008. These derivatives were settled in December 2004.

(8) For €72.7 million of the outstanding principal amount under the Rosenthal Loan Facility, all repayment installments from March 30, 2004 until September 30, 2013 were swapped into U.S. dollar amounts at a rate of U.S. 1.2398. The interest rate was swapped into the six-month Libor plus a spread of 0.12% plus a bank margin of 0.7% until September 30, 2013. These derivatives were settled in December 2004.

(9) In connection with the Stendal Loan Facility, in the third quarter of 2002 Stendal entered into the Stendal Interest Rate Swap Agreements, which are variable-to-fixed interest rate swaps, for the term of the Stendal Loan Facility, with respect to an aggregate maximum amount of approximately € 612.6 million of the principal amount of the long-term indebtedness under the Stendal Loan Facility. The swaps took effect on October 1, 2002 and are comprised of three contracts. The first contract commenced in October 2002 for a notional amount of €4.1 million, gradually increasing to €464.9 million, with an interest rate of 3.795%, and matured in May 2004. The second contract commenced in May 2004 for a notional amount of €464.9 million, gradually increasing to €612.6 million, with an interest rate of 5.28%, and matures in April 2005. The third contract is to commence in April 2005 for a notional amount of €612.6 million, with an interest rate of 5.28%, and the notional amount gradually decreases and the contract terminates upon the maturity of the Stendal Loan Facility in October 2017. As at December 31, 2003 and September 30, 2004, the notional amounts of the two outstanding contracts was (i) €464.9 million and €534.9 million and (ii) €612.6 million and €612.6 million, respectively.

(10) For €306.3 million of the outstanding principal amount under the Stendal Loan Facility, all repayment installments from April 1, 2004 until April 1, 2011 were swapped into U.S. dollar amounts at a rate of U.S. 1.2218. The interest rate was swapped into the following payments: pay a fixed rate of 3.5% and receive the six-month Euribor. These derivatives were settled in December 2004.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS OF CELGAR

The following discussion and analysis of the financial condition and results of operations of Celgar as at and for the nine months ended September 30, 2003 and 2004 and the three years ended December 31, 2003 should be read in conjunction with the consolidated financial statements and related notes of Celgar included elsewhere in this prospectus supplement. Celgar prepares its financial statements in accordance with Canadian GAAP, which differs in certain respects from GAAP. For a discussion of the differences between Canadian GAAP and GAAP as they pertain to Celgar, see Note 10 of the unaudited financial statements of Celgar for the nine month periods ended September 30, 2003 and 2004 and Note 12 of the audited financial statements of Celgar for the year ended December 31, 2003 included elsewhere in this prospectus supplement. For the purposes of this offering and the Senior Note Offering, Celgar has reconciled its accounts to GAAP and will continue to do so for ongoing Mercer consolidated reporting.

The information presented below and the financial statements for Celgar included in this prospectus supplement reflect the entire assets, liabilities and operations of Celgar for the periods and as at the dates indicated. However, we are acquiring only the operating assets of Celgar which, pursuant to the terms of the Acquisition Agreement, do not include the finished goods inventory, receivables, cash on hand and certain insurance claims of Celgar. Further, we are not assuming certain liabilities of Celgar including indebtedness for borrowed money for pre- and post-bankruptcy periods which aggregated approximately C$1.1 billion at December 31, 2003 and September 30, 2004. See "The Acquisition" and "Selected Historical Financial Information of Celgar" for more information.

Results of Operations

The Celgar mill is a modern NBSK pulp mill that produces high quality NBSK pulp. It has a current annual production capacity of approximately 430,000 ADMTs. In 1998, primarily as a result of the indebtedness incurred by the Celgar mill during an C$850 million modernization process, its directors assigned Celgar into bankruptcy. KPMG Inc. was appointed trustee in bankruptcy. Immediately thereafter, two large institutional banks appointed KPMG Inc. as the receiver of all the assets and undertakings of Celgar under the security held by the banks. KPMG Inc. has operated the Celgar mill as trustee in bankruptcy since 1998.

The Celgar mill's financial performance depends on a number of variables that impact sales and production costs. Sales and production results are influenced largely by the market price for pulp and paper products and raw materials, the geographic sales mix of products produced and foreign currency exchange rates. Kraft pulp markets are highly cyclical, with prices determined by supply and demand. Demand for kraft pulp is influenced to a significant degree by global levels of economic activity and supply is driven by industry capacity and utilization rates. Primarily as a result of adjustments to inventory levels by Asian buyers in the fourth quarter of 2004, there was weaker demand and lower prices in the Asian market in the 2004 fourth quarter.

The Celgar mill's production costs are influenced by the availability and cost of raw materials, energy and labor, and its plant efficiencies and productivity. The Celgar mill's main raw material is fiber in the form of wood chips and pulp logs for pulp production. Fiber costs are primarily affected by the supply of, and demand for, pulp, which is highly cyclical. Production costs also depend on the total volume of production and plant efficiency. Throughout the later part of 2003, the Celgar mill experienced technical problems relating to a burner misalignment in its lime kiln causing improper heating which resulted in the kiln being shut down on several different occasions. Management at the Celgar mill has determined that the burner misalignment in the lime kiln resulted in additional aggregate costs, primarily related to purchases from third parties, of approximately C$3.2 million being reflected in cost of sales through to September 2004.

The Celgar mill's financial performance for any reporting period is also impacted by changes in the U.S. dollar to Canadian dollar exchange rate. Changes in currency rates affect the mill's operating results because the price for NBSK pulp is generally based on a global industry benchmark that is priced in U.S. dollars. Therefore, a weakening of the U.S. dollar against the Canadian dollar will generally reduce the amount of Canadian dollar revenues of Celgar's operations. This will adversely affect the Celgar mill's operating margins as the vast majority of its costs are incurred in Canadian dollars. The Celgar mill has not mitigated the effect of currency rate fluctuations, as it has elected not to enter into foreign exchange derivative transactions. As a result, Celgar's product sales, which are primarily invoiced in U.S. dollars, have been at risk to fluctuations in exchange rates from the time such products are sold to the time such products are paid for. Any gain or loss on foreign exchange has been included in Celgar's general and administrative expenses.

Improving pulp demand resulting from improving world economies and the weakening of the U.S. dollar has led to list prices for kraft pulp in the U.S. increasing from an average of approximately $545 in 2003 to an average of approximately $670 in the third quarter of 2004. However, such price increases have been largely offset as the U.S. dollar has weakened against the Canadian dollar by approximately 20% during the same period.

Nine Months Ended September 30, 2004 Compared to Nine Months Ended September 30, 2003 (Unaudited)

In the nine months ended September 30, 2004, net sales increased to C$214.9 million from C$207.6 million in the comparative period of 2003, primarily as a result of higher NBSK prices which were partially offset by the continuing decline in the U.S. dollar.

Cost of sales in the period ended September 30, 2004 decreased to C$167.6 million from C$182.9 million in the period ended September 30, 2003, primarily as a result of lower sales volume. The reduction in cost of sales was partially offset by an increase in average production costs which was primarily the result of increased fiber costs. Included in cost of sales are costs relating to the burner misalignment in the lime kiln of C$96,000 for the nine months ended September 30, 2004 and C$2.0 million for the nine months ended September 30, 2003.

U.S. dollar denominated list pulp price increases were offset by the weakness of the U.S. dollar against the Canadian dollar in the nine months ended September 30, 2004. Average list prices for NBSK pulp in the U.S. were approximately $600 per ADMT in the first quarter of 2004, approximately $660 per ADMT in the second quarter of 2004 and approximately $670 per ADMT in the third quarter of 2004. Pulp sales realizations were C$735 per ADMT on average in the current period, compared to C$630 per ADMT in the comparative period of 2003. Pulp sales by volume decreased to 292,233 ADMTs in the current period from 329,253 ADMTs in the comparative period of 2003 primarily as a result of lower shipment volumes to southeast Asia and Europe.

General and administrative expenses decreased to C$22.8 million in the period ended September 30, 2004 from C$28.2 million in the period ended September 30, 2003, primarily as a result of a decrease in foreign exchange losses on current receivables and payables. Foreign exchange losses were C$0.9 million for the nine months ended September 30, 2004, compared to C$5.0 million for the comparative period in 2003. General and administrative expenses also included C$0.8 million and C$1.7 million for the costs of KPMG Inc., as receiver and trustee in bankruptcy for the respective periods.

For the nine months ended September 30, 2004, Celgar reported a loss from operations of C$127.6 million compared to a loss from operations of C$32.9 million in the comparative period of 2003. This increase was attributable to a C$129.2 million write down on property, plant and equipment in connection with the Acquisition.

Depreciation and amortization was C$22.8 million in the nine months ended September 30, 2004, compared to C$29.3 million in the comparative period of 2003.

Year Ended December 31, 2003 Compared to Year Ended December 31, 2002

In the year ended December 31, 2003, net sales increased to C$271.6 million from C$249.4 million in the year ended December 31, 2002, primarily as a result of higher sales volumes.

Cost of sales in the year ended December 31, 2003 increased to C$230.5 million from C$213.6 million in the year ended December 31, 2002, primarily as a result of higher sales volumes. Included in cost of sales are costs relating to the burner misalignment in the lime kiln of C$3.1 million in the year ended December 31, 2003 with no corresponding charge in the comparative period in 2002.

U.S. dollar denominated list pulp price increases were mostly offset by an 18% decline in the U.S. dollar against the Canadian dollar in 2003. Average list prices for NBSK pulp in the U.S. were approximately $490 per ADMT in 2002 and increased to an average of approximately $550 per ADMT in 2003. Pulp sales realizations were C$635 per ADMT on average in the current period, compared to C$623 per ADMT in 2002. Pulp sales by volume increased to 427,860 ADMTs in the current period from 400,101 ADMTs in 2002.

General and administrative expenses increased to C$38.1 million in the year ended December 31, 2003 from C$30.6 million in the year ended December 31, 2002, primarily as a result of a required increase in a non-union salary pension plan accrual after an actuarial valuation and an increase in foreign exchange losses on current receivables and payables. Foreign exchange losses were C$6.0 million for the year ended December 31, 2003, compared to C$0.8 million for the comparative period. General and administrative expenses also included C$1.9 million and C$1.8 million for the costs of KPMG Inc., as receiver and trustee in bankruptcy for the respective periods.

For the year ended December 31, 2003, Celgar reported a loss from operations of C$36.3 million, compared to a loss from operations of C$33.8 million in 2002.

Depreciation and amortization was C$39.2 million in 2003, compared to C$38.9 million in 2002.

Year Ended December 31, 2002 Compared to the Year Ended December 31, 2001

In the year ended December 31, 2002, net sales increased to C$249.3 million from C$246.1 million in the year ended December 31, 2001, primarily as a result of higher sales volumes. In 2001, the Celgar mill was shut down for approximately 50 days for market related reasons.

Cost of sales in the year ended December 31, 2002 decreased to C$213.6 million from C$240.0 million in the year ended December 31, 2001, primarily as a result of lower production costs including a decrease in the cost of fiber and lower energy costs.

Average list prices for NBSK pulp in the U.S. were approximately $525 per ADMT in 2001 and approximately $490 per ADMT in 2002. Pulp sales realizations were C$623 per ADMT on average in the current period, compared to C$674 per ADMT in 2001. Pulp sales by volume increased to 400,101 ADMTs in the current period from 365,132 ADMTs in 2001.

General and administrative expenses increased to C$30.6 million in the year ended December 31, 2002 from C$25.9 million in the year ended December 31, 2001, primarily as a result of an increase in insurance premiums, a required increase in a non-union salary pension plan accrual after an actuarial valuation and foreign exchange losses from current receivables and payables. Foreign exchange losses were C$0.8 million for the year ended December 31, 2002, compared to a foreign exchange gain of C$1.8 million for the comparative period. General and administrative expenses also included C$1.8 million and C$2.0 million for the costs of KPMG Inc., as receiver and trustee in bankruptcy for the respective periods.

For the year ended December 31, 2002, Celgar reported a loss from operations of C$33.8 million, compared to a loss from operations of C$58.6 million in 2001.

Depreciation and amortization was C$38.9 million in 2002, compared to C$39.0 million in 2001.

BUSINESS

The Company

General

Mercer Inc. is a business trust organized under the laws of the State of Washington in 1968. Under Washington law, shareholders of a business trust have the same limited liability as shareholders of a corporation.

We operate in the pulp and paper business. Our operations are currently located primarily in eastern Germany and, upon completion of the Acquisition, will include western Canada. We currently employ approximately 1,647 people at our German operations and there are currently approximately 420 people employed at the Celgar mill. We believe we will be one of the largest market NBSK pulp producers in the world and will operate three pulp mills with an aggregate annual production capacity of approximately 1.3 million ADMTs:

Rosenthal mill. Our Rosenthal mill is a modern, efficient ISO 9002 certified pulp mill that has an annual production capacity of approximately 310,000 ADMTs and is located near the town of Blankenstein, Germany. The Rosenthal mill is currently the only producer of market NBSK pulp in Germany.

Stendal mill. Our Stendal mill is a new, state-of-the-art, single-line NBSK pulp mill which is designed to have an annual production capacity of approximately 552,000 ADMTs and is situated near the town of Stendal, Germany, approximately 300 kilometers north of the Rosenthal mill.

Celgar mill. The Celgar mill is a modern, efficient ISO 9001 certified pulp mill that has an annual production capacity of approximately 430,000 ADMTs of NBSK pulp and is located near the city of Castlegar, British Columbia, Canada, approximately 600 kilometers east of the port city of Vancouver, British Columbia.

We also own and operate two paper mills located at Heidenau and Fährbrücke, Germany that produce specialty papers and printing and writing papers and, based upon their current product mix, have an aggregate annual production capacity of approximately 70,000 ADMTs.

History and Development of Business

We originally invested in various real estate assets with the intention of becoming a real estate investment trust, but in 1985 changed its operational direction to acquiring controlling interests in operating companies. We acquired our current pulp and paper operations beginning in 1993.

Over the last five years to December 31, 2003, we have expended an aggregate of approximately €337.0 million on capital investments at our pulp and paper mills, not including the Stendal project or the Celgar mill, to increase production capacities, improve efficiencies, reduce effluent discharges and emissions and modernize the mills. Such capital investments were financed in large part through government guaranteed term financing and government grants of approximately €94.2 million. For more information about these grants, see "Business Government Financing".

In late 1999, we completed a major capital project which converted the Rosenthal mill to the production of kraft pulp from sulphite pulp, increased its annual production capacity from approximately 160,000 ADMTs to approximately 280,000 ADMTs and, through subsequent minor capital investments and efficiency improvements, increased its annual production capacity to approximately 310,000 ADMTs, and reduced emissions and energy costs. The aggregate cost of the project was approximately €361.0 million.

We completed financing arrangements and commenced construction of the Stendal mill in August 2002. The aggregate cost of the Stendal project is approximately €1.0 billion. Construction of

the Stendal mill was completed substantially on its planned schedule and budget in the third quarter of 2004 and the mill is currently in the start-up phase. For more information about the Stendal project, see "   Stendal Pulp Mill Project and Financing".

Commencing in 1998, we implemented a strategy to focus on our core operations and rationalize assets that either were not part of our core operations or did not provide the desired level of return. As a result, between 1998 and 2000, we took a charge of €17.9 million relating to our paper operations and sold four paper mills that produced packaging, carton and printing papers located at Greiz, Raschau, Trebsen and Hainsberg, Germany.

The sale of these paper mills was the result of a strategic decision to withdraw from commodity paper grades produced principally from waste paper where we had little market share and, we believed, limited potential for long-term profitability. We continue to operate and upgrade the Heidenau and Fährbrücke paper mills as they principally produce niche products.

We reorganized our interest in Landqart, which owns a specialty paper mill in Switzerland, at the end of 2002 by transferring a 20% interest to a Swiss bank and exchanging the other 80% interest for an indirect 39% minority interest through a limited partnership on a non-cash basis. See "Business   Our Products   Paper".

Organizational Chart

The following chart sets out our directly and indirectly owned principal operating subsidiaries, their jurisdictions of organization and their principal activities:

(1) Certain wholly owned intermediate holding companies are not shown.

Competitive Strengths

Our competitive strengths include the following:

Modern Low Cost NBSK Pulp Mills. Upon completion of the Acquisition, we will operate three large, modern NBSK pulp mills and are a low cost NBSK pulp producer. The significant capital investments at the Rosenthal mill have resulted in a facility which ranks in the lowest cost quartile for NBSK pulp delivered to Europe. We expect our overall cost structure to improve because the Stendal mill is designed to have even lower production costs than the Rosenthal mill. Based on an industry survey, we believe that the Celgar mill ranks in the second quartile in North America on a manufactured cost basis for NBSK pulp. The relative age and production capacity of our NBSK pulp mills provide us with certain cost advantages over many of our competitors including lower maintenance capital expenditures.

High Quality NBSK Pulp Products. Our pulp mills produce high quality NBSK pulp which is a premium grade of kraft pulp. Our Rosenthal mill continues to increase the proportion of its sales of reinforcement NBSK pulp, which is used to produce stronger papers and generally obtains the highest price. The Stendal mill is similarly expected to produce a high quality NBSK pulp product, although from a slightly different species mix, resulting in a complementary product more suitable for different end uses. We believe that the pulp produced at the Celgar mill is known for its excellent product characteristics and the mill is a long-established supplier to paper producers in Asia.

Close Proximity to Customers. We are the sole kraft pulp producer and the only producer of market pulp in Germany, which is the largest pulp import market in Europe. Due to the proximity of the Rosenthal and Stendal mills to most of our European customers and the new member countries of the European Union, we benefit from lower transportation costs relative to our major competitors. As the Celgar mill is located in western Canada, it is well situated to serve Asian and North American customers. We believe our ability to deliver pulp on a timely basis enhances customer satisfaction and has made us a preferred supplier for many customers.

Stable and Abundant Fiber Supply. There is a significant amount of high-quality fiber within a close radius of each of our pulp mills. This fiber supply, combined with our purchasing power, provides us with an ability to enter into contracts which have relatively stable prices and volumes.

Strategy

Our corporate strategy is to create shareholder value by focusing on the expansion of our asset and earnings base through organic growth and acquisitions primarily in Europe and North America. We pursue organic growth through active management and targeted capital expenditures designed to produce a high return by increasing production, reducing costs and improving quality. We seek to acquire interests in companies and assets in the pulp and paper industry and related businesses where we can leverage our experience and expertise in adding value through a focused management approach. Key features of our strategy include:

Focusing on NBSK Market Pulp. We focus on NBSK pulp because it is a premium grade kraft pulp known for its strength which obtains the highest price relative to other kraft pulps. Although demand is cyclical, worldwide demand for kraft market pulp has grown at an average of approximately 3% per annum over the last ten years with higher growth rates in certain markets such as eastern Europe and Asia. We do not believe there are any significant new NBSK pulp production capacity increases coming online in the next several years due in part to fiber supply constraints and high capital costs.

Operating Modern, World-Class NBSK Pulp Production Facilities. In order to keep our operating costs as low as possible, with a goal of operating profitably in all market conditions, we only plan to operate large, modern NBSK pulp production facilities. We believe such production facilities provide the best platform to be an efficient, low cost producer of high quality NBSK pulp without the need for significant sustaining capital.

Improving Efficiency and Reducing Operating Costs. We focus on increasing the productivity and operating efficiency of our production facilities through cost reduction initiatives, including targeted capital investments. We seek to make high return capital investments that increase production and operating efficiency at our production facilities, reduce costs and improve product quality. We also seek to reduce operating costs by better managing certain operating activities at our facilities such as fiber procurement, sales and marketing activities, and we intend to further coordinate these activities at our pulp facilities to realize on potential synergies among them. In particular, we believe there are a number of opportunities to reduce the operating costs, increase production and improve the financial results of the Celgar mill.

Enhancing Customer Relationships. We focus on continually improving our marketing and distribution capabilities to enhance our customer relationships and capitalize on our geographic diversification. We seek to differentiate ourselves from our competitors by consistently delivering high quality products to our customers on a global basis. We intend to coordinate the marketing and distribution activities at our pulp mills to better service our customers.

The Pulp Industry

General

Pulp is used in the production of paper, tissues and paper related products. Pulp is generally classified according to fiber type, the process used in its production and the degree to which it is bleached. Kraft pulp is produced through a sulphate chemical process in which lignin, the component of wood which binds individual fibers, is dissolved in a chemical reaction. Chemically treated pulp allows the wood's fiber to retain its length and flexibility, resulting in stronger paper products. Kraft pulp can be bleached to increase its brightness. Kraft pulp is noted for its strength, brightness and absorption properties and is used to produce a variety of products, including lightweight publication grades of paper, tissues and paper related products.

The market value of kraft pulp depends in part on the fiber used in the production process. There are two primary species of wood used as fiber: softwood and hardwood. Softwood species generally have long, flexible fibers which add strength to paper while fibers from species of hardwood contain shorter fibers which lend bulk and opacity. Prices for softwood pulp are generally much higher than for hardwood pulp. As at September 30, 2004, there was an approximately $110 per ADMT difference in their list prices in Europe. Currently, the kraft pulp market is roughly evenly split between softwood and hardwood grades. Most uses of market kraft pulp, including fine printing papers, coated and uncoated magazine papers and various tissue products, utilize a mix of softwood and hardwood grades to optimize production and product qualities. In recent years, production of hardwood pulp, based on fast growing plantation fiber primarily from Asia and South America, has increased much more rapidly than that of softwood grades that have longer growth cycles. As a result of the growth in supply and lower costs, kraft pulp customers in recent years have substituted some of the pulp content in their products to hardwood pulp. Counteracting customers' increased proportionate usage of hardwood pulp has been the requirement for strength characteristics in finished goods and paper and tissue makers focus on higher machine speeds and lower basis weights for publishing papers which also require the strength characteristics of softwood pulp. We believe that the ability of kraft pulp users to further substitute hardwood for softwood pulp is limited by such requirements.

NBSK pulp, which is a bleached kraft pulp manufactured using species of northern softwood, is considered a premium grade because of its strength. It generally obtains the highest price relative to other kraft pulps. Southern bleached softwood kraft pulp is kraft pulp manufactured using southern softwood species and does not possess the strength found in NBSK pulp. NBSK pulp is the sole product of the Rosenthal, Stendal and Celgar mills.

Kraft pulp can be made in different grades, with varying technical specifications, for different end uses. High quality kraft pulp is valued for its reinforcing role in mechanical printing papers, while other grades of kraft pulp are used to produce lower priced grades of paper, including tissues and paper related products.

Pulp Markets

Producers ranging from small independent manufacturers to large integrated companies produce pulp worldwide. In 2003, more than 130 million ADMTs of kraft pulp were converted into printing and writing papers, tissues, cartonboards and other white grades of paper and paperboard around the world. Approximately 65% of this pulp was produced for internal purposes by integrated paper and paperboard manufacturers, and approximately 35% was produced for sale on the open market.

In 2003, total worldwide consumption of market pulp was approximately 50 million ADMTs, comprised of various types of market pulp as illustrated below:

Global Market Pulp Shipments

Source: Pulp and Paper Products Council

Although demand is cyclical, worldwide demand for kraft market pulp has grown at an average rate of approximately 3% annually over the last ten years. Over the last ten years, hardwood kraft pulp production has increased at a faster rate than softwood kraft pulp production, at 5% and 2%, respectively. As such, hardwood pulp now comprises approximately 42% of total market pulp shipments, only slightly less than softwood, an increase from 35% in the early 1990s. This higher growth rate is the result of significant capital investment in new capacity in tropical regions where forest plantations exhibit higher growth rates, such as Indonesia and South America. The rapid growth rates result in shorter fibers, with resulting pulp qualities of softness, bulk and opacity. NBSK pulp, which provides paper makers with strength, allows for increased use of inert fillers, clays and coatings as well as reducing breakage on new high speed paper and printing machines. We believe that the substitution of softwood by hardwood pulp is limited, and that NBSK pulp will continue to act as the benchmark grade within the pulp markets. The growth rate for NBSK pulp reflects this continuing demand, with growth rates higher than the general softwood kraft group. The following chart illustrates the worldwide NBSK market pulp demand for the specified periods:

Worldwide NBSK Market Pulp Demand

Source: Pulp and Paper Products Council

Western Europe accounts for approximately 40% of global market pulp demand with a growth rate of approximately 2% annually over the past ten years. Approximately 18 million ADMTs of market pulp were consumed in western Europe in 2003, of which approximately six million ADMTs were comprised of NBSK pulp. The following map provides an overview of the estimated European trade flows of market pulp in 2003, with Europe importing substantial quantities of pulp from the Americas:

2003 Trade Flows in Pulp for Europe (CEPI) [(1)]
(thousands of ADMTs)

Source: Confederation of European Paper Industries ("CEPI")

(1) Europe (CEPI) means the European Union countries, Norway and Switzerland.

(2) Europe (non-CEPI) means all European countries other than Europe as defined above.

Within Europe, Germany, with its large economy and sizable paper industry, is the largest pulp market and consumed approximately six million ADMTs of market pulp in 2003 relying largely on imports from North America and Scandinavia. Approximately 61% of the market pulp consumed in Germany in 2003 was kraft pulp. In 2003, the top five importing countries in continental Europe were as follows:

Market	Imports of Kraft Pulp From	
	Europe[(1)]	Outside Europe
	(thousands of ADMTs)	
Germany	2,346	1,469
Italy	926	1,976
France	823	1,078
United Kingdom	435	737
Netherlands	458	256

(1) Includes European Union countries, Norway and Switzerland.
Source: Council of European Paper Industries

Demand for market pulp in Asia (excluding Japan) has been growing at approximately 9% annually over the past ten years and currently accounts for approximately 30% of global demand. Approximately 13 million ADMTs of market pulp were consumed in Asia (excluding Japan) in 2003, of

which approximately 2.3 million ADMTs were comprised of NBSK pulp. This demand growth has been driven both by increasing per capita consumption combined with the mandated closure of numerous small, often non-wood based, pulp facilities in China. Canada is the largest exporter to this region, supplying approximately three million ADMTs of market pulp in 2003, approximately two million of which were comprised of NBSK pulp. Additionally, Japan consumed approximately three million ADMTs of market pulp in 2002, the latest year for which data is available, of which approximately 25% was comprised of NBSK pulp. The following chart illustrates the worldwide total market pulp demand for the specified periods:

Worldwide Total Market Pulp Demand

Source: Pulp and Paper Products Council

We expect Europe and Asia to continue to be significant net importers of pulp in the foreseeable future. The markets for kraft pulp are cyclical in nature and demand for kraft pulp is related to global and regional levels of economic activity. A measure of demand for kraft pulp is the ratio obtained by dividing the worldwide consumption of kraft pulp by the worldwide capacity for the production of kraft pulp, or the "consumption/capacity ratio". An increase in this ratio generally occurs when there is an increase in global and regional levels of economic activity and low inventories of kraft pulp. An increase in this ratio generally indicates greater demand as consumption increases, which generally results in rising kraft pulp prices and a build-up of inventories by buyers and a reduction by producers. As prices continue to rise, producers continue to run at higher operating rates. However, an adverse change in global and regional levels of economic activity generally negatively affects demand for kraft pulp, often leading to a high level of inventory build-up by buyers. As demand falls, buyers generally reduce their purchases and rely on inventories of kraft pulp and many producers will run at lower operating rates by taking downtime to limit the build-up of their own inventories.

The consumption/capacity ratio, excluding Indonesian and eastern European pulp producers, was approximately 89% in 2001, approximately 91% in 2002 and approximately 93% in 2003. We expect the long lead time and significant capital investment required to bring new pulp mills on stream to limit growth in industry capacity in the next few years.

Kraft Pulp Pricing

Global economic conditions, changes in production capacity, inventory levels, and currency exchange rates are the primary factors affecting NBSK pulp list prices. Canada and western Europe currently represent approximately 50% and 40%, respectively, of global NBSK pulp capacity while list prices are denominated in U.S. dollars. The following chart illustrates the average annual European NBSK list pulp prices since 1990:

Average Annual European NBSK List Pulp Prices

Source: Pulp and Paper Week

The average annual European list prices for NBSK pulp between 1990 and 2003 ranged from a low of approximately $444 per ADMT in 1993 to a high of approximately $875 per ADMT in 1995.

The 1995 price peak was followed by a steep decline as inventory levels for North American and Scandinavian, or "Norscan", producers grew to over 2.5 million ADMTs by early 1996. Norscan producers currently produce a majority of the market NBSK pulp sold in North America and Europe and inventory levels held by Norscan producers are considered an industry benchmark in determining industry inventory levels. Between 1996 and 1999, list pulp prices remained relatively low due in part to the Asian financial crisis which began in late 1997.

Prices started to recover in 1999 due to a combination of factors including a recovery in the Asian economy, the shutdown of unprofitable mills or older mills in need of environmental upgrades and a decline in capacity expansion. This contributed to tightening inventory levels among Norscan producers, which fell to approximately 1.1 million ADMTs in June 2000, resulting in list prices increasing to an average of approximately $710 per ADMT in the fourth quarter of 2000. However, the decline of the American and major European economies in 2001 caused a sharp reduction in paper demand. As a result, Norscan pulp inventories rose to a high of approximately two million ADMTs in early 2001 and list price levels eroded to an average of approximately $460 per ADMT in late 2001. Inventory levels ranged between approximately 1.3 million and 1.9 million ADMTs in 2002, and list prices averaged approximately $463 per ADMT in 2002. The weakening of the U.S. dollar against the Euro and other major currencies and an increase in demand resulting from improving American and major European

economies in 2003 resulted in list prices for kraft pulp in Europe increasing to approximately $560 per ADMT in December 2003 despite relatively high inventory levels. List prices for kraft pulp in Europe continued to strengthen in the first half of 2004 due to the relatively weak U.S. dollar and improving world economies. List prices increased to approximately $660 per ADMT in July 2004, before falling to approximately $585 per ADMT in October 2004 and subsequently recovering to approximately $625 per ADMT in December 2004. A producer's sales realizations will reflect customer discounts, commissions and other items and it is likely that prices will continue to fluctuate in the future.

The Manufacturing Process

The following diagram provides a simplified description of the kraft pulp manufacturing process at the Rosenthal, Stendal and Celgar mills:

In order to transform wood chips into kraft pulp, wood chips undergo a multi-step process involving the following principal stages: chip screening, digesting, pulp washing, and screening, bleaching and drying.

In the initial processing stage, wood chips are screened to remove oversized chips and sawdust and are conveyed to a pressurized digester where they are heated and cooked with chemicals. This occurs in a continuous process at the Celgar and Rosenthal mills and in a batch process at the Stendal mill. This process softens and eventually dissolves the phenolic material called lignin that binds the fibers to each other in the wood.

Cooked pulp flows out of the digester and is washed and screened to remove most of the residual spent chemicals, called black liquor, and partially cooked wood chips. The pulp then undergoes a series of bleaching stages where the brightness of the pulp is gradually increased. Finally, the bleached pulp is

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sent to the pulp machine where it is dried to achieve a dryness level of more than 90%. The pulp is then ready to be baled for shipment to customers.

A significant feature of kraft pulping technology is the recovery system, whereby chemicals used in the cooking process are captured and extracted for re-use, which reduces chemical costs and improves environmental performance. During the cooking stage, dissolved organic wood materials and black liquor are extracted from the digester. After undergoing an evaporation process, black liquor is burned in a recovery boiler. The chemical compounds of the black liquor are collected from the recovery boiler and are reconstituted into cooking chemicals used in the digesting stage through additional processing in the recausticizing plant.

The heat produced by the recovery boiler is used to generate high-pressure steam. Additional steam is generated by a power boiler through the combustion of biomass consisting of bark and other wood residues from sawmills, residue generated by the effluent treatment system and natural gas. The steam produced by the recovery and power boilers is used to power a turbogenerator to generate electricity, as well as to provide heat for the digesting and pulp drying processes.

The Paper Industry

The paper industry is global in nature with many international, national and regional producers competing over many different product lines. Prices and profitability in the paper industry are driven primarily by global supply and demand. Demand is strongly influenced by global and regional levels of economic activity. Supply is determined by industry capacity and operating rates. In general, the paper industry has experienced periods of supply and demand imbalance. When demand increases, prices rise, which leads producers to increase their capacity and operating rates. As supply increases in response, price competition increases, driving prices lower.

We produce principally specialty papers and printing and writing papers. The specialty papers that we produce are comprised of coated and uncoated wallpaper base, non-woven wallpaper base and greaseproof paper.

Wallpaper can be coated with an agent to enhance its appearance and printing capability. In addition, non-woven wallpaper contains a certain proportion of synthetic fibers so that it does not expand when wet, paste can be applied to the wall instead of the wallpaper and it can be easily torn from the wall, or drystripped. Demand for wallpaper is related to activity in the construction and refurbishing industries, which have been relatively strong due to low interest rates in most industrialized countries. Non-woven wallpapers are the fastest growing category of wallpaper.

Greaseproof paper is a consumer oriented product that can be used for, among other things, baking and the packaging of food products such as fast foods.

Printing and writing papers which we produce consist of only uncoated woodfree papers. Woodfree papers generally contain less than 10% mechanical pulp. Uncoated woodfree papers can be finished to enhance their surface and are often used to print less costly products.

Raw Materials

Our mills are situated in regions which offer an ample and stable supply of fiber. The fiber consumed by our pulp mills consists of wood chips produced by sawmills and pulp logs, which are cyclical in both price and supply. Wood chips are small pieces of wood used to make pulp and are a product of either wood waste from sawmills or pulp logs processed, or chipped, especially for this purpose. Pulp logs consist of lower quality logs not used in the production of lumber. The costs of wood chips and pulp logs are primarily affected by the supply and demand for lumber.

Rosenthal mill

The wood chips for the Rosenthal mill are sourced from approximately 60 sawmills located in the States of Bavaria and Thuringia within a 150 kilometer radius of the Rosenthal mill. Within this radius, the Rosenthal mill is the largest consumer of wood chips. Given its location and size, the Rosenthal mill is the best economic outlet for the sale of wood chips in the area. In 2003, the Rosenthal mill consumed approximately 1.7 million cubic meters of fiber. Approximately 66%, or approximately 1.1 million cubic meters, of such consumption was in the form of sawmill wood chips. The balance of approximately 34%, or approximately 0.6 million cubic meters, was in the form of pulp logs. Approximately 85% to 90% of the fiber consumed by the Rosenthal mill is spruce and the remainder is pine. We believe the Rosenthal mill's fiber costs have historically been among the lowest for European pulp producers. The Rosenthal mill's transportation division, which operates approximately 50 trucks, handled approximately 50% of our wood chip deliveries to the mill in 2003. While fiber costs and supply are subject to cyclical changes largely in the sawmill industry, we expect that we will be able to continue to obtain an adequate supply of fiber on reasonably satisfactory terms for the Rosenthal mill due to its location and our long-term relationships with suppliers. We have not historically experienced any fiber supply interruptions at the Rosenthal mill.

Wood chips for the Rosenthal mill are normally sourced from sawmills under one year or quarterly supply contracts with fixed volumes, which provide for price adjustments. In 2003, we entered into a three-year agreement with one of our existing wood chip suppliers for the supply for the Rosenthal mill of approximately 500,000 cubic meters of wood chips annually until 2006. Pulp logs are partly sourced from the state forest agency in Thuringia on a contract basis and partly from private holders, on the same basis as wood chips. We organize the harvesting of pulp logs sourced from the state forest agency in Thuringia after discussions with the agency regarding the quantities of pulp logs that we require.

The Rosenthal mill's fiber requirements were historically procured principally by SCA Holz, a large wood supply company. Our agreement with SCA Holz expired in April 2003 and has not been renewed. We have organized our own internal wood procurement department to handle and source the fiber requirements for the Rosenthal mill. Five people are employed in the department currently. The department will continue to procure fiber for the Rosenthal mill from many of the same sources and under similar terms as under our agreement with SCA Holz. The department also assisted in sourcing fiber for the start-up of the Stendal mill. We expect to coordinate the fiber procurement for the Rosenthal and Stendal mills. We believe that handling our own fiber procurement will reduce our operating costs over the long-term due to the elimination of third party fees paid for sourcing fiber.

Stendal mill

The fiber consumed by the Stendal mill consists of wood chips and pulp logs. When fully operational, the Stendal mill is expected to consume approximately 2.8 to 3.0 million cubic meters of fiber annually. The core wood supply region for the Stendal mill includes most of the northern part of Germany within an approximately 240 kilometer radius of the mill. The wood supply potential in this core region is not yet fully utilized and we expect that it should be able to supply 80% of all of the fiber needed by the mill. We expect to obtain the balance primarily from southwestern and southern Germany. The fiber base in the planned wood supply area for the Stendal mill consists of approximately 80% pine and 20% spruce and fir. We expect approximately 20% of the fiber consumed by the Stendal mill to be in the form of sawmill wood chips and approximately 80% in the form of pulp logs. The Stendal mill has sufficient chipping capacity to fully operate using solely pulp logs, if required. We expect to source wood chips from sawmills within an approximately 360 kilometer radius of the Stendal mill. We expect to source pulp logs partly from private forest holders and partly from state forest agencies in Thuringia, Sachsen-Anhalt and Brandenburg. In 2003, Stendal commenced putting into place definitive supply arrangements similar to those of the Rosenthal mill. We have currently arranged for approximately 45% of the fiber requirements for the Stendal mill for 2005.

When fully operational, the Stendal mill is expected to be the largest consumer of wood chips in Germany and, together with the Rosenthal mill, provide the best economic outlet for the sale of wood chips in eastern Germany.

Stendal has established its own wood procurement organization to handle the fiber requirements for the Stendal mill. Currently, there are approximately 87 people employed in this division. This division focuses on three principal activities, being wood procurement and sales, harvesting, and transportation. The procurement and sales main activity is to procure the required wood chip and pulp log assortments for the mill's annual production. In conjunction with this activity, it may also procure higher quality sawlogs, either through harvesting or through purchases that it can sell or trade with others for wood chips in order to optimize the fiber mix. When fully operational, we expect these activities to employ up to 15 people. The harvesting activities focus on acquiring up to approximately 800,000 cubic meters per annum of harvestable timber, of which approximately 75% is expected to be pulp logs and the balance likely to be higher quality logs that could be sold or traded to third parties for wood chips. We expect that approximately half of this volume may be harvested directly by us and the other half would be contracted out to third parties. When fully operational, we expect to engage up to 55 people in this division. Transportation activities focus on managing, controlling and optimizing shipping and flows of pulp logs to the mill. When fully operational, we expect that the transportation activities may employ up to 40 people.

When the Stendal mill is fully operational, we expect to be the largest consumer of wood chips and pulp logs in Germany. We intend to coordinate and integrate the wood procurement activities for the Rosenthal mill and the Stendal mill to realize on a number of potential synergies between them. These include reduced overall personnel and administrative costs, greater purchasing power and coordinated buying and trading activities. We also believe such coordination and integration of fiber flows will allow us to optimize transportation costs, and the species and fiber mix for both mills.

Celgar mill

The Celgar mill has a secure supply of high quality fiber that it purchases from a number of Canadian and U.S. suppliers. When operating at full capacity, the Celgar mill's annual fiber requirements are approximately 2.4 million cubic meters. Two sources of fiber are used to meet this demand: chips purchased from nearby sawmills and chipping facilities, and roundwood pulp logs purchased from local logging contractors. All of the Celgar mill's fiber is sourced externally with approximately 90% covered under chip contracts and the remaining 10% coming from the roundwood pulp logs processed through its woodroom.

Celgar has entered into long and short-term chip supply agreements with approximately 30 different suppliers from British Columbia, Canada and the U.S. for a total of approximately 2.2 million cubic meters (excluding chips from its own woodroom). This represents approximately 90% of total annual fiber requirements at the mill. Celgar's woodroom supplies the remaining chips to meet the Celgar mill's requirements. The Canadian chip supply agreements contain terms that index the price of the chips to NBSK pulp pricing and therefore the chip costs are correlated with Celgar's net sales. The majority of the agreements are for periods ranging between two and six years. Several of the longer-term contracts are so-called "evergreen" agreements, where the contract remains in effect until one of the parties elects to terminate. Termination requires a minimum of two, and in some cases, five years written notice. Certain non-evergreen long-term agreements provide for renewal negotiations prior to expiry. We expect substantially all of the chip supply agreements which have been entered into by Celgar to be assigned to us or to renegotiate new agreements on substantially the same terms. Celgar has contracts with three sawmills, which are all owned by the same parent. These sawmills comprise approximately 25% of the Celgar mill's total fiber supply. Two of these chip agreements each remain in effect until December 31, 2008 and thereafter, if not extended, continue, subject to volume reductions, indefinitely, subject to termination by either party upon two years' prior notice. The third agreement is an evergreen agreement that remains in effect until terminated upon five years' prior notice. The chip agreements each contain provisions that may vary chip volume delivery commitments upon the happening of certain events.

Except for occasional minor purchases from smaller suppliers, the balance of Celgar's fiber requirements is met by the production of chips from its own woodroom. Currently the woodroom is effectively operating a 40 hour/week schedule to supply chips to the Celgar mill. To secure the volume of pulp logs required to meet its requirements, Celgar has entered into annual pulp log supply agreements with 20 to 30 different suppliers, many of whom are also Celgar's contract chip suppliers. The woodroom is capable of running additional shifts and has historically operated in this fashion. Additional volumes of pulp logs are available to ramp up woodroom operations by up to 50%. All of the pulp log agreements can be terminated by either party for any reason, upon seven days' written notice.

In addition to existing agreements, opportunities exist for the Celgar mill to secure additional fiber from mills in both Canada and the U.S. In the recent past, Celgar has purchased fiber from other suppliers. Celgar has flexibility in the selection and choice of suppliers, thus assuring continuity of supply as well as the ability to mix species when needed.

Paper mills

The fiber used by the paper mills consists of pulp and waste paper (recycled paper), which are cyclical in both price and supply. The cost of this fiber is primarily affected by the supply and demand for paper and pulp. In 2003, approximately 85%, or approximately 64,036 ADMTs, of the fiber consumed by our paper mills was in the form of market pulp and chemical additives. Market pulp and chemical additives are available at market prices from various suppliers throughout Europe. The balance of approximately 15%, or approximately 11,621 ADMTs, of the fiber consumed by our paper mills was in the form of waste paper. Germany has extensive waste paper recycling and collection laws which result in a readily available supply. The cost of lower grade waste paper is currently relatively low in comparison to virgin pulp. We have not historically experienced any fiber supply interruptions at our paper mills.

Pulp Cash Production Costs

The Rosenthal mill commenced kraft pulp operations in late 1999. As production and sales ramped-up and increased, efficiencies were achieved within the mill operations, resulting in lower per unit costs. Cash production costs for the Rosenthal mill for the periods indicated below are as follows:

	Year Ended December 31,			Nine Months Ended September 30,	
Costs	**2001**	**2002**	**2003**	**2003[1]**	**2004[1]**
			(per ADMT)	(unaudited)	
Fiber	€ 184	€ 178	€ 178	€ 178	€ 171
Labor	57	54	51	53	54
Chemicals	48	38	46	46	43
Energy[2]	18	9	4	5	
Other	35	33	28	28	32
Total cash production costs[3]	€ 342	€ 312	€ 307	€ 310	€ 300

(1) We normally report our cash production costs for pulp on an annual basis only and intend to continue to do so in our Annual Report on Form 10-K for future periods. Total cash production costs for the nine months ended September 30, 2003 and 2004 may not be comparable on an annualized basis due to the timing of maintenance expenditures.

(2) Net of energy revenues.

(3) Cost of production per ADMT produced excluding depreciation.

Construction of the Stendal mill was completed in the third quarter of 2004. Although the Stendal mill had approximately 13 days of operations in September 2004, it is currently in the start-up phase. As a result, we believe that cash production costs for pulp produced at the Stendal mill in the third quarter of 2004 are not meaningful as they do not provide an accurate representation of the mill's future operating performance. Accordingly, they are not included herein. The Stendal mill is designed to have even lower production costs than the Rosenthal mill.

The Celgar mill is a low-cost producer of NBSK pulp and, based on an industry survey, we believe it ranks in the second quartile in North America on a manufactured cost basis. Cash production costs for the Celgar mill for the periods indicated below are as follows:

	Year Ended December 31,			Nine Months Ended September 30,	
	2001[1]	2002	2003	2003[2]	2004[2]
			(per ADMT)	(unaudited)	
Fiber	C$257	C$204	C$208	C$205	C$233
Labor	99	89	96	101	98
Chemicals	79	72	75	74	76
Energy[3]	54	43	38	42	35
Other	82	83	82	91	91
Total cash production costs[4]	C$571	C$491	C$499	C$513	C$533

(1) The Celgar mill was shut down for approximately 50 days in 2001 for market related reasons.

(2) We normally report our cash production costs for pulp on an annual basis only and intend to continue to do so in our Annual Report on Form 10-K for future periods. Total cash production costs for the nine months ended September 30, 2003 and 2004 may not be comparable on an annualized basis due to the timing of maintenance expenditures.

(3) Net of energy revenues.

(4) Cost of production per ADMT produced excluding depreciation.

Our Products

We manufacture and sell NBSK pulp and two primary classes of paper products. Our products are produced from both virgin fiber, being wood chips, pulp logs and chemical woodfree pulp, and recycled fiber, being waste paper.

Pulp

In early 2000, we completed the conversion of the Rosenthal mill to the production of kraft pulp. The kraft pulp produced at the Rosenthal mill is a long-fibered softwood pulp produced by a sulphate cooking process and manufactured primarily from wood chips and pulp logs. A number of factors beyond economic supply and demand have an impact on the market for chemical pulp, including requirements for pulp bleached without any chlorine compounds or without the use of chlorine gas. The Rosenthal mill has the capability of producing both "totally chlorine free" and "elemental chlorine free" pulp. Totally chlorine free pulp is bleached to a high brightness using oxygen, ozone and hydrogen peroxide as bleaching agents, whereas elemental chlorine free pulp is produced by substituting chlorine dioxide for chlorine gas in the bleaching process. This substitution virtually eliminates complex chloro-organic compounds from mill effluent.

Kraft pulp is valued for its reinforcing role in mechanical printing papers and is sought after by producers of paper for the publishing industry, primarily for magazines and advertising materials. Kraft pulp produced for reinforcement fibers is considered the highest grade of kraft pulp and generally obtains the highest price. Through a focused technical and marketing effort, we have changed the mix of the kraft pulp that we produce at the Rosenthal mill to substantially increase our relative amount of

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reinforcement fibers from approximately 16% at the beginning of 2000 to approximately 41% at the end of 2003.

The Rosenthal mill produces pulp for reinforcement fibers to the specifications of certain of our customers. We believe that a number of our customers consider us their supplier of choice. For more information about the facilities at the Rosenthal mill, see " Rosenthal Conversion Project and Financing" and " Properties".

The kraft pulp produced at the Stendal mill will be of a slightly different grade than the kraft pulp produced at the Rosenthal mill as the mix of softwood fiber used will be slightly different. This will result in a complementary product more suitable for different end uses. The Stendal mill is capable of producing both totally chlorine free and elemental chlorine free pulp. For more information about the facilities at the Stendal mill, see " Stendal Pulp Mill Project and Financing" and " Properties".

The Celgar mill produces high quality kraft pulp that is made from a unique blend of slow growing/long-fiber western Canadian tree species. It is used in the manufacture of high quality paper products. The Celgar mill currently produces the following two grades of elemental chlorine free pulp:

Celstar approximately 55% of the pulp produced by the Celgar mill is a high quality bleached softwood kraft pulp made from Hemlock, Balsam Fir, Spruce, Pine and Western Red Cedar.

Celect the remaining 45% of the pulp produced by the Celgar mill is a unique softwood pulp made from a specifically segregated mixture of long-fiber wood species (Douglas Fir and Western Larch). Celect is preferred by papermakers looking for high tear and lower air resistance.

We believe the Celgar mill's pulp is known for its excellent product characteristics, including tensile strength, wet strength and brightness. We also believe that the pulp produced at the Celgar mill is known for its excellent product characteristics and the mill is a long-established supplier to paper producers in Asia. For more information about the facilities at the Celgar mill, see " Properties".

Paper

Our paper manufacturing strategy has focused on utilizing our existing machines, with certain modifications, in combination with our skilled workforce, to principally produce niche products. As a result, we have divested certain paper mills which focused on packaging, carton and recycled printing and writing papers, and shifted our production away from woodfree printing and writing papers.

The following table sets out the primary classes of paper products that we produce and the mills at which they are produced:

Paper Product Class	**Mill**	**Product Description**
Specialty Paper	Heidenau	Coated and uncoated wallpaper and non-woven wallpaper base
	Fährbrücke	Greaseproof paper
Printing Paper	Fährbrücke	Printing and writing paper

We sell our wallpaper and non-woven wallpaper base primarily to specialty paper converters and printers. It is used primarily in new construction and in the renovation industry in residential housing and commercial buildings. We sell our greaseproof paper to paper converters supplying the food industry. It is used primarily for wrapping and baking food. We sell our printing and writing papers primarily to traders, converter suppliers and paper wholesalers.

We currently manufacture specialty and printing paper at two facilities located in Germany. For more information about the facilities at the paper mills, see " Properties".

We reorganized our interest in Landqart at the end of 2002 by selling a 20% interest to a Swiss bank and exchanging the other 80% interest for a 49% interest in a limited partnership on a non-cash basis. This resulted in our having a 39% indirect interest in Landqart. We reduced our Landqart stake to prioritize our available capital and resources on Stendal because of our obligation to repay or refinance the two bridge loans obtained in connection with the financing arrangements for Stendal, and poor capital market conditions. The reorganization has allowed the management of Landqart to focus on its operations and financial requirements without regard to our other operations. The Swiss bank had agreed to reduce and refinance a portion of Landqart's debt in consideration of the equity stake, and was in a better position to assist Landqart in securing the funds necessary to make the required capital investment in the Landqart mill.

Sales, Marketing and Distribution

The distribution of Mercer's pulp and paper sales volume and revenues by product class, and revenues by geographic area is set out in the following table for the periods indicated:

	Year Ended December 31,			Nine Months Ended September 30,	
	2001	**2002**	**2003**	**2003**	**2004**
			(ADMTs)	**(unaudited)**	
Sales Volume by Product Class					
Pulp[1]	285,654	293,607	303,655	221,926	229,462
Papers					
Specialty Papers	40,437[2]	61,727[2]	40,621	30,420	28,144
Printing Papers	26,815	23,195	21,397	16,568	19,357
Total Papers	67,252	84,922	62,018	46,988	47,501
Total[1]	352,906	378,529	365,673	268,914	276,963
			(in thousands)		
Revenues by Product Class					
Pulp[1]	€ 146,245	€ 130,173	€ 126,594	€ 92,418	€ 103,743
Papers					
Specialty Papers	35,959[2]	79,358[2]	40,082	30,185	28,039
Printing Papers	22,797	18,352	15,780	12,332	13,302
Total Papers	58,756	97,710	55,862	42,517	41,341
Total[1]	€ 205,001	€ 227,883	€ 182,456	€ 134,935	€ 145,084
Revenues by Geographic Area					
Germany	€ 94,486	€ 88,809	€ 80,306	€ 60,596	€ 64,339
Italy	50,016	46,027	46,609	34,581	36,524
European Union[3]	21,938	31,631	29,936	21,974	35,441
Eastern Europe and Other	38,561	61,416	25,605	17,784	8,780
Total[1]	€ 205,001	€ 227,883	€ 182,456	€ 134,935	€ 145,084

(1)

Excluding intercompany sales volumes of 10,447, 10,768 and 5,527 ADMTs of pulp and intercompany net sales revenues of approximately €5.8 million, €4.9 million and €2.3 million in 2001, 2002 and 2003, respectively, and intercompany sales volumes of 5,166 and 3,897 ADMTs of pulp and intercompany net sales revenues of approximately €2.2 million and €1.8 million in the nine months ended September 30, 2003 and 2004, respectively.

(2)

We acquired Landqart, which operates a specialty paper mill, in December 2001 for approximately $2.7 million. As of December 31, 2002, our interest in Landqart is no longer consolidated and is included in our financial results on an equity basis. Accordingly, sales from the Landqart specialty paper mill are not included in our results for 2001, but are included for 2002. The Landqart mill sold approximately 18,222 ADMTs for approximately €39.7 million in 2002.

(3)

Not including Germany or Italy; includes new entrant countries to the European Union from their time of admission.

A large proportion of our kraft pulp sales from the Rosenthal mill in western Europe were historically handled through a sales agency agreement with Oy Metsä Botnia Ab, or "Metsä", a member of the M-real Corporation of Finland which operates a number of different paper mills. These sales comprised approximately 41% and 37% of the mill's total pulp sales in 2002 and 2001. Sales and marketing in other countries were conducted by Rosenthal's own sales staff and through independent agents. We chose not to renew our sales agency agreement with Metsä when it expired in December 2002. In 2003, we successfully placed with other customers all of the volumes formerly sold to the M-real Corporation. We are now conducting all sales and marketing of the kraft pulp from the Rosenthal mill internally through sales staff and through agents. We believe that this allows us to better coordinate our pulp sales and results in reduced sales and marketing costs due to reduced third party fees in the distribution of our products. In addition, the Stendal mill has established a sales and marketing division that is responsible for conducting all sales and marketing of the kraft pulp produced at the mill. When fully operational, we expect approximately 8 people to be employed in this division. We intend to co-ordinate and integrate the sales and marketing activities at the Rosenthal mill and Stendal mill to realize on a number of synergies between them. These include reduced overall administrative and personnel costs and co-ordinated selling, marketing and transportation activities. When the Stendal mill is fully operational, we expect to sell substantially all of its kraft pulp production in continental Europe.

The Rosenthal and Stendal mills are currently the only market kraft pulp producers in Germany, which is one of the leading import markets for kraft pulp in western Europe. We therefore have a material competitive transportation cost advantage compared to Norscan pulp producers when shipping to customers in Europe. Due to the Rosenthal mill's central location, it delivers pulp to customers primarily by truck. Most trucks that deliver goods into eastern Germany generally do not also haul goods out of the region as eastern Germany is primarily an importer of goods. We are therefore able to obtain relatively low freight rates for the delivery of our products to many of our customers. Further, the Rosenthal mill's transportation division handled approximately 9% of the Rosenthal mill's pulp deliveries in 2003. Approximately 37% of pulp sales from the Rosenthal mill in 2003 were to customers or destinations located within a 500 kilometer radius of the Rosenthal mill. As a result, we can generally supply pulp to customers of Rosenthal faster than our competitors because of the short distances between the Rosenthal mill and our customers. For our customers in western Europe, we can, if requested, often supply them with pulp within one day of it being ordered. This permits us to be a "just in time" supplier to these customers. When fully operational, the Stendal mill should also have similar advantages over Norscan producers based upon its location.

Mercer's pulp sales are on customary industry terms. At December 31, 2003 and September 30, 2004, Mercer had no material payment delinquencies. In the nine months ended September 30, 2004, two customers accounted for 23% of Mercer's pulp sales. In 2003, one customer, which operates a number of paper mills, accounted for approximately 11% of Mercer pulp sales. In 2002 one customer accounted for approximately 12% and in 2001 two customers accounted for approximately 22% of Mercer's pulp sales. Mercer's pulp sales are not dependent upon the activities of any single customer or upon a concentrated group of major customers.

The distribution of Celgar's pulp sales volume and revenues by pulp product, and revenues by geographic area is set out in the following table for the periods indicated:

	Year Ended December 31,			Nine Months Ended September 30,	
	2001[1]	2002	2003	2003	2004
			(ADMTs)	(unaudited)	
Sales Volume	365,132	400,101	427,860	329,253	292,233
			(in thousands)		
Revenues	C$ 246,139	C$ 249,366	C$ 271,566	C$ 207,593	C$ 214,886
Revenues by Geographic Area					
North America	C$ 39,247	C$ 25,087	C$ 31,169	C$ 24,506	C$ 22,767
China	43,022	66,184	76,932	55,803	67,511
Japan	26,781	26,667	20,917	18,360	17,294
Asia Other	68,976	75,905	88,329	64,864	66,713
Europe	52,606	42,123	38,949	32,826	27,653
Other	15,507	13,400	15,270	11,234	12,948
Total	C$ 246,139	C$ 249,366	C$ 271,566	C$ 207,593	C$ 214,886

(1) The Celgar mill was shut down for approximately 50 days in 2001 for market related reasons.

KPMG Inc., in its capacity as trustee in bankruptcy for Celgar, has retained sales agents for the purposes of pulp sales and distribution. As Celgar had no sales department or transportation/logistics manager, agency relationships are required in order to effectively market Celgar's pulp. The agency relationships also provide KPMG Inc. with payment guarantees for sales to creditworthy but offshore customers.

Our sales force will take over responsibility for supervising and managing all Celgar's sales agents and will perform some of its sales functions directly over time. We believe such changes will result in reduced agents' commissions and fees, increased contract sales and improved pulp price realizations. In addition, we expect to coordinate sales from the Celgar mill with our Rosenthal and Stendal mills on a global basis, thereby providing our larger customers with seamless service across all major geographies.

In 2003, one customer accounted for approximately 18%, in 2002 one customer accounted for approximately 19% and in 2001 one customer accounted for approximately 12% of Celgar's annual gross sales.

Recently, the Celgar mill's price realizations have been adversely affected by the amount of pulp that was considered and sold as "off-grade" caused primarily by a combination of technical production issues relating to variations in brightness and high quantities of pitch and talc deposits in the pulp and the mill's sales structure. We expect to address the amount of off-grade production and sales by adding a new EOP washer to the mill at a cost of approximately C$8.5 million and making other capital improvements as well as supervising and coordinating its sales with our Rosenthal and Stendal mills.

The Celgar mill's pulp production is transported to customers by rail, truck and ocean carrier using strategically located third party warehouses to ensure timely delivery. All overseas exports are shipped through warehouse facilities in the Vancouver, British Columbia area. The majority of Celgar's pulp for overseas markets is initially delivered primarily by rail to the port of Vancouver for shipment overseas by ocean carrier. As a western Canada based pulp mill, the Celgar mill enjoys a transportation advantage in sales to Asian customers, in comparison to certain of our competitors.

The majority of the Celgar mill's pulp for domestic markets is shipped by rail to third party warehouses in the U.S. midwest or directly to the customer.

Our paper sales operations focus primarily on Europe and are responsible for the majority of our paper sales. Our paper sales conducted through agents were approximately 26% of total paper sales in the nine months ended September 30, 2004. Our paper sales conducted through agents were approximately 26% of total paper sales in 2003, compared to approximately 27% in 2002 and 30% in 2001. We sell the majority of our paper products to paper converters, printers and wallpaper manufacturers.

Our paper sales are also on customary industry terms. At December 31, 2003 and September 30, 2004, we had no material payment delinquencies. No single customer accounted for more than 10% of our paper sales in 2003, 2002 or 2001. Our paper sales are not dependent upon a single customer or upon a concentrated group of major customers.

Capital Expenditures

In 2003, we continued with our capital investment programs designed to increase production capacity, improve efficiency and reduce effluent discharges and emissions at our manufacturing facilities. The improvements made at our mills over the past five years have reduced operating costs and increased the competitive position of our facilities.

Capital investments at the Rosenthal mill were approximately €6.9 million, €8.4 million and €7.4 million in 2003, 2002 and 2001, respectively, and approximately €2.9 million and €3.5 million in the nine months ended September 30, 2004 and 2003, respectively. We estimate capital expenditures at the Rosenthal mill to be approximately €5.2 million for 2004 relating primarily to maintaining the quality and efficiency of the mill and the reconstruction of the wastewater reservoirs at the mill. In addition, in 2003, we completed a strategic capital project to reconstruct the landfill related to the Rosenthal mill so that it will be useable for an additional 15 years. The total cost of this reconstruction was approximately €7.6 million, which Rosenthal is fully funding through a bank loan. Of this amount, we incurred €2.6 million in 2003 and €5.0 million in 2002. We estimate this project to have an approximately three-year payback period and the project required no equity investment on our part. A reboiler was installed at the Rosenthal mill in 2003 at a cost of approximately €1.9 million which we expect will reduce energy costs at the mill.

Construction of the Stendal mill commenced in August 2002. Total capital costs incurred in respect of the project in 2003 were approximately €399.4 million. For more information about the Stendal project, see " Stendal Pulp Mill Project and Financing".

In June 1993, an extensive modernization and expansion of the Celgar mill was completed at a cost of approximately C$850 million, which resulted in the Celgar mill becoming a low cost producer of high quality NBSK pulp with a significantly increased production capacity. Since the modernization of the Celgar mill in 1993, Celgar has made other capital expenditures to improve the efficiency of the mill and reduce operating costs. Over the last three years, Celgar has invested an aggregate of approximately C$15.4 million in gross capital improvements at the Celgar mill. In addition, we expect to invest approximately C$25 million in high return strategic capital projects at the Celgar mill over the next three years to reduce operating costs and increase production capacity and enhance operating efficiency and reliability at the mill. See "The Acquisition Acquisition Opportunities" for more information.

Capital investments at our paper operations were approximately €7.8 million, €5.4 million and €2.7 million in 2003, 2002 and 2001, respectively. As a result of flooding in parts of Germany and other eastern European countries during the third quarter of 2002, our paper mills had to replace certain damaged equipment at an aggregate cost of approximately €3.3 million. We have applied for reimbursement for these costs under German government grants and for assistance under special credit

programs instituted by the German government for flooding victims. In 2004, we estimate capital investments to be approximately €4.0 million relating primarily to quality and productivity upgrades of the paper machines at the paper mills and the completion of a wastewater treatment plant at the Fährbrücke mill. Capital investments at the Heidenau mill in 2003 included a new waste paper storage building, replacement of a gas turbine and the installation of a head box top wire on the paper machine at the mill at an aggregate cost of approximately €3.8 million. Capital expenditures at the Fährbrücke mill in 2003 included the addition of a reel packing machine to the paper machine and the continued construction of a wastewater treatment plant at the mill at an aggregate cost of approximately €1.1 million. We also continued with the adjustment to the paper machine at the Heidenau mill to produce non-woven wallpaper base in 2003 at a cost of approximately €0.3 million. We continue to review strategic initiatives designed to upgrade the product mix at our paper mills and enhance returns.

Capital investments at our facilities in Germany to reduce effluent discharges have offset wastewater fees that would otherwise be required to be paid. We estimate the aggregate wastewater fees we saved over the last five fiscal years as a result of these environmental capital expenditures at our facilities in Germany to be approximately €18.7 million. For more information about our environmental capital expenditures, see " Environmental".

Government Financing

Grants

Our capital investment programs in Germany are partially financed through government grants made available by German federal and state governments. Under legislation adopted by the federal and certain state governments of Germany, government grants are provided to qualifying businesses operating in eastern Germany to finance capital investments. The grants are made to encourage investment and job creation. Pursuant to the current terms of these grants, federal and state governments will provide funding for up to 35% of the cost of qualified investments. The terms of such government grants also require that at least one permanent job be created for each €500,000 of capital investment eligible for such grants and that such jobs be maintained for a period of five years from the completion of the capital investment project. Such government grants are not repayable by a recipient unless it fails to complete the proposed capital investment or fails to create or maintain the requisite amount of jobs. In the case of such failure, the government is entitled to revoke the grants and seek repayment unless such failure resulted from material unforeseen market developments beyond the control of the recipient, wherein the government may refrain from reclaiming previous grants. Pursuant to such grants provided in respect of our Rosenthal mill and being provided in respect of the Stendal project, we have agreed to maintain stipulated job levels at each operation for the specified five-year period. For more information, see " Human Resources". We believe that we are in compliance with all of the terms and conditions governing the government grants we have received in Germany.

Such government grants are not reported in our income. These grants reduce the cost basis of the assets purchased when the grants are received.

The following table sets out the capital expenditures and government grants recorded by Mercer for the periods indicated:

	Year Ended December 31,						Nine Months Ended September 30,	
	1999	2000	2001	2002	2003	Total	2003	2004
	(in thousands)						(unaudited)	
Capital expenditures, gross[1]	€ 271,382	€ 27,028	€ 10,097	€ 13,800	€ 14,647	€ 336,954[2]	€ 9,485	€ 6,611
Government grants[1]	€ 31,847	€ 55,355	€ 2,450	€ 1,176	€ 3,323	€ 94,151	€ 1,199	€ 451

(1) Not including the Stendal project.

(2) The total cost of the conversion of the Rosenthal mill to produce kraft pulp was approximately €361.0 million. We also received government grants totaling approximately €101.7 million in connection with such capital investments. For more information about the Rosenthal mill, see " Rosenthal Conversion Project and Financing".

In addition, the Stendal project qualifies for approximately €274.5 million of government grants, of which we have received €185.7 million as at September 30, 2004. For more information about the Stendal project, see " Stendal Pulp Mill Project and Financing".

The following table sets out for the periods indicated the effect of these government grants on the recorded value of such assets in our consolidated balance sheets:

	As at December 31, 2004		As at September 30, 2004
	2002	2003	
		(in thousands)	(unaudited)
Properties, net (as shown on consolidated balance sheets)	€ 441,990	€ 745,178	€ 942,249
Add back: government grants less amortization, deducted from properties	85,358	163,988	262,748
Properties, gross amount including government grants less amortization	€ 527,348	€ 909,166	€ 1,204,997

Loan Guarantees

Loan guarantees are available from German federal and state governments for up to an aggregate of 80% of the borrowed amount for qualifying capital investments made in certain parts of Germany. The federal and state governments are each severally committed to a portion of the guaranteed amount. These guarantees are provided by German federal and state governments to assist any qualifying businesses with financing capital investments. The guarantees permit qualifying businesses to obtain term loans for such capital investments on terms and at interest rates that are more favorable than available in the general market. In addition, subsidized interest rate loans are available from public financial institutions in Germany, which provide loans at below market interest rates for qualified investments.

These loan guarantees have permitted us to obtain a significantly greater amount of financing for the project to convert the Rosenthal mill to the production of kraft pulp, as well as the construction of the Stendal mill, at substantially more favorable rates and upon substantially more favorable terms than would otherwise have been available.

Rosenthal Conversion Project and Financing

In late 1999, we completed a major capital project to convert the Rosenthal mill to the production of kraft pulp and increase its annual production capacity to approximately 280,000 ADMTs. Through subsequent minor capital investments and efficiency improvements, the annual production capacity at the Rosenthal mill has been increased to approximately 310,000 ADMTs. The project has also substantially reduced effluent and sulphur dioxide emissions and has reduced energy costs, with natural gas consumption decreasing by approximately 45% during the period from the beginning of 2000 to the end of 2003 as a result of operating efficiencies.

The aggregate cost of the project, including project financing, capitalized interest of approximately €14.1 million and related costs and an amount for contingencies, was approximately €361.0 million. The project was financed through a combination of a project loan supported by government guarantees, government grants and an equity investment made by us.

In 1998, Rosenthal entered into the Rosenthal Loan Facility to finance the project. The Rosenthal Loan Facility is secured by liens on all of the assets of Rosenthal and the German federal government and the state government of Thuringia severally guaranteed an aggregate of 80% of the facility. The Rosenthal Loan Facility will be repaid and discharged upon closing of the Acquisition.

In addition to the government guarantee, the state government of Thuringia also provided government grants of €73.6 million in respect of the project. The German federal government also provided, under existing programs, government grants totaling €27.1 million in respect of the project. As of December 31, 2003, Rosenthal had received government grants totaling approximately €101.7 million for the Rosenthal mill conversion.

The sulphite pulp production at the Rosenthal mill was shut-down in July 1999 to implement the conversion to kraft pulp. The mill was successfully started-up to produce kraft pulp in December 1999. The Rosenthal mill was producing at approximately 89% of its planned production capacity in the first year and was producing at full capacity by the end of 2000.

Stendal Pulp Mill Project and Financing

The Project

Our 63.6% owned subsidiary, Stendal, is the project company formed to develop, construct and operate the Stendal mill. The other shareholders of Stendal are RWE, as to a 29.4% interest, and AIG Altmark-Industrie AG, or "AIG", as to a 7.0% interest. RWE is a subsidiary of the second largest utility company in Germany and is experienced in the construction of pulp mills. AIG is a German real estate company which owns 1,050 acres of a 1,250 acre industrial park on which the Stendal mill is situated.

The Stendal mill is a "greenfield" softwood kraft pulp mill that was constructed at an aggregate cost of approximately €1.0 billion near the town of Stendal, in the German State of Sachsen-Anhalt. The mill is a modern, state-of-the-art single line mill with a designed annual production capacity of approximately 552,000 ADMTs. The overall mill design is based on proven or existing processes and technologies. The process and mill operations are highly automated to ensure stable operation and pulp quality. The mill process is a modern but ordinary kraft pulping process that emphasizes environmentally sound operational principles. The Stendal mill uses a batch pulp cooking process. Batch cooking allows for different grades to be batch produced for different end uses.

Construction of the Stendal mill commenced on August 26, 2002 and was completed in the third quarter of 2004. The Stendal mill is located approximately 300 kilometers north of the Rosenthal mill. As a result of the proximity of the Stendal mill to the Rosenthal mill and the use of similar equipment at both mills, we believe we will be able to realize operating synergies between the two operations,

particularly in the areas of raw materials and supplies procurement, production engineering, maintenance and marketing.

The Stendal mill is situated on an approximately 200 acre site owned by Stendal that is part of a larger 1,250 acre industrial park. The balance of the industrial park is owned by AIG, which is seeking to develop the park. Although no assurances can be provided that any development will occur and we are not directly a party to these discussions, we are aware of third party proposals to build manufacturing facilities on the balance of the industrial park that would be complementary to our pulp operations.

The Stendal mill is the largest market kraft pulp mill in Germany, the only other being our Rosenthal mill. We anticipate that the addition of production from the Stendal mill will allow us to expand our customer base, as our two pulp mills will produce slightly different grades of softwood kraft pulp suitable for different end uses.

The summaries of certain material provisions of agreements entered into in connection with the Stendal project set forth herein are not complete and such summaries, including definitions of certain terms, are qualified in their entirety by reference to such agreements on file with the SEC.

Control and Management

We, Stendal and its other shareholders, RWE and AIG, entered into a shareholders' agreement dated August 26, 2002 to govern our respective interests in Stendal. The agreement contains terms and conditions customary for these types of agreements, including restrictions on transfers of share capital and shareholder loans other than to affiliates, rights of first refusal on share and shareholder loan transfers, pre-emptive rights and piggyback rights on dispositions of our interest. The shareholders are not obligated to fund any further equity capital contributions to the project. Pursuant to the shareholders' agreement, we are entitled to transfer up to 12.5% of our interest in Stendal without the prior consent of the other shareholders. The shareholders' agreement provides that Stendal's managing directors may be appointed by holders of a simple majority of its share capital. Further, shareholder decisions, other than those mandated by law or for the provision of financial assistance to a shareholder, are determined by a simple majority of Stendal's share capital. If a shareholder is in default under the shareholders' agreement or commits certain acts of insolvency or bankruptcy, it shall be considered to be a defaulting shareholder and must offer to sell its share capital and shareholder loans to the remaining shareholders on a pro rata basis, to a third party nominated by the other shareholders or permit them to be redeemed by Stendal. Other than in circumstances where a shareholder is considered to be a defaulting shareholder, the shareholders' agreement does not provide for any mandatory or forced purchases and sales of a shareholder's interest in Stendal.

In addition to integrating the wood procurement activities at the Rosenthal and Stendal mills, we plan to coordinate other activities and operations between the two mills to realize efficiencies and optimize the cost structure of each mill. Such activities include establishing a unified sales organization to conduct the sales and marketing of the pulp produced by both mills. We currently coordinate the pulp sales of the Rosenthal mill pursuant to a sales agency agreement with Rosenthal whereby we receive a commission on overall sales. We intend to establish a similar arrangement for the Stendal mill. Other activities that we intend to coordinate between the two mills include purchases of supplies and stores, maintenance activities, workforce and management training and transportation.

EPC Contract

The Stendal mill was constructed under a €716.0 million fixed-price turn-key EPC contract between Stendal and RWE. RWE's obligations under the EPC contract are guaranteed by its parent company.

The contract price for the completion of the project is fixed, taking into account all risks associated with the project and is subject only to certain changes that we cause or agree to, changes that arise due to changes in the law and specified events of force majeure. Payments under the EPC contract are made periodically against milestones as and when achieved by RWE.

Under the EPC contract, RWE is responsible for all planning, design, engineering, procurement, construction and testing in connection with the build-out and start-up of the mill. We are responsible for obtaining legal title and possession of the site and providing the site and certain equipment, materials and services, as well as personnel, raw materials and other items in connection with the start-up of the mill. RWE is also primarily responsible for obtaining construction and operating permits. We constructed approximately €23.5 million of the site infrastructure and additional general site infrastructure connections were constructed by the local government. The costs of such infrastructure construction are 90% subsidized and co-financed by us, among others. Our co-financing obligations amounted to approximately €3.0 million and were funded out of the project loan facility.

Construction of the Stendal mill was completed in the third quarter of 2004 and the mill is currently in the start-up phase. The mill underwent extensive testing and evaluation in December 2004 to determine whether certain performance requirements have been met, referred to as the "Acceptance Test". The Acceptance Test required that the mill continuously produce pulp at stated volumes, and within certain product specifications, for a 72-hour period. Samples of the pulp produced during such test have been sent to laboratories for qualitative testing. The results are expected to be received by mid-January 2005. The mill substantially passed all of the quantitative tests, although the test was extended for approximately four hours due to an operating error relating to the recovery boiler which caused it to shut down for a short period. We intend to meet with RWE in January 2005 to review all of the results of the Acceptance Test to determine whether the results of the Acceptance Test are acceptable to us. Even if further modifications are required, we do not expect any such modifications to affect our start-up schedule or the mill's capacity. The mill is currently operating well and product sales continue to be for the benefit of Mercer.

If it is determined that the mill has not satisfied the Acceptance Test, RWE would be required to pay liquidated damages equal to 0.4% of the contract price per week of delay up to the maximum of 12% of the contract price. If certain performance requirements are not met within the terms of the agreement, subject to certain conditions, RWE has agreed to pay liquidated damages totaling up to a maximum of 10% of the contract price. The combined amounts that may become payable to us by RWE as a result of delays in completion and failure to meet performance requirements are capped at 17% of the contract price. Payment of such amounts will not relieve RWE of its obligations to complete the project, attain minimum performance requirements or cure deficiencies.

When acceptance of the mill has occurred, we are required to provide RWE with an acceptance certificate. Once we deliver the acceptance certificate to RWE, we assume responsibility for the operation of the mill, subject to RWE's warranty obligations. Furthermore, each department of the mill will be tested on a stand-alone basis for compliance with its design specifications after the acceptance of the mill has occurred. Such testing is scheduled to be completed within the six-month period after acceptance of the mill has occurred. Under the EPC contract, RWE warrants conformity to specifications, compliance with permits and laws, suitability for intended use, compliance with performance requirements and warrants against defects in construction, in each case for a period of 18 months after acceptance, subject to extension in certain circumstances. RWE is required under the EPC contract to provide irrevocable bank guarantees in our favor, in agreed upon amounts, as security for an initial advance payment and for any deficiencies arising during the warranty period. In July 2006, RWE is required to provide an additional guarantee in the same form, in respect of the same matters, in an amount not less than 5% of the contract price which shall remain in effect until January 1, 2009.

Subject to certain conditions, we have the right to terminate the EPC contract if, among other things, RWE becomes insolvent, assigns or transfers its interest in the agreement in violation of the provisions of the agreement or fails, without valid reason, to perform any of its material obligations.

The EPC contract also contains reciprocal indemnities between us and RWE pursuant to which we each agree to indemnify the other in respect of losses or claims arising from negligent, illegal or other wrongful acts in connection with the agreement or arising out of any violation of applicable laws or permits.

Project Financing

In August 2002, we completed financing arrangements for the Stendal project. Total investment costs in connection with the project are approximately €1.0 billion, the majority of which was provided under the Stendal Loan Facility arranged by HVB, pursuant to a project finance loan agreement, referred to as the "Project Finance Loan Agreement", entered into between Stendal and HVB. We also contributed financing to Stendal of approximately €63.5 million from cash on hand and through bridge loans from a U.S. investment partnership and a bank. For a brief summary of the Stendal Loan Facility, see "Description of Certain Indebtedness Stendal Pulp Mill Project Financing".

As the site of the Stendal project is located in eastern Germany, it qualifies for approximately €274.5 million of government grants, which are applied to reduce the cost basis of the assets acquired with such grants. As of September 30, 2004, we had outstanding claim expenditures of €65.2 million of such grants in connection with the Stendal project, which we expect to receive in 2005. In accordance with our accounting policies, these grants are not recorded by us until they are received.

Under European Union rules, the Commission of the European Communities, referred to as the "Commission", was formally notified in March 2002 by Germany of plans to provide support to the Stendal project through grants and guarantees. The Commission considered these plans and, on June 19, 2002, decided not to raise any objection against such support being provided by the German federal and state governments in respect of the Stendal project. In its decision, the Commission was not called upon to determine whether the governmental aid schemes, on which the support is based, were acceptable, but was limited to a determination as to whether a reduction of the pre-approved aid level for investment in the German State of Sachsen-Anhalt under the previously approved schemes was required under European Union law in the case of the Stendal project. In coming to its decision, the Commission generally has a wide margin of discretion in its assessment of facts and data. Under European Union law, member states, competitors or trade associations directly affected by a decision of the Commission may appeal such decision within a period of two months and twenty-four days after publication of the Commission decision. Generally to be successful, an appeal must show that the Commission failed to comply with procedural requirements or committed a manifest error in assessing facts and data in adopting its decision. On December 23, 2002, Kronoply and Kronotex, two related manufacturers of, among other things, OSB and MDF boards that do not compete with the Stendal project by selling pulp or paper, filed an appeal with the Court of First Instance of the European Communities (Luxembourg) against the Commission decision of June 19, 2002. Although no assurance can be provided, we believe that the complainants are unlikely to have standing under the applicable rules to proceed with the appeal and that their appeal is without merit.

Project Development

Beginning in February 2002, approximately three months of pre-construction activity was carried out in respect of the Stendal project. This was comprised of, among other things, pre-engineering, planning and reviewing and sourcing procurement requirements. Construction activity commenced on the Stendal project upon the effectiveness of the EPC contract.

The Stendal mill was completed substantially on its planned schedule and budget in the third quarter of 2004. The mill is currently in the start-up phase and underwent extensive testing and

evaluation in December 2004. The mill has all of its requisite permits in place to commence operations and has currently arranged for approximately 45% of its fiber requirements for 2005. At September 30, 2004, the mill had filled in excess of 77% of its overall staffing requirements. The balance of the hiring will occur in affiliated activities such as harvesting and transportation and will be completed through 2005 as the mill ramps up operations.

The Stendal mill is currently being supervised by the contractor using Stendal's personnel to operate the mill. Stendal commenced the initial production of pulp in the third quarter of 2004. The initial pulp produced was off-grade pulp which was primarily sold into the recycled fiber, corrugated board and similar markets. The prices realized on the sale of off-grade pulp are lower than the selling price for on-grade NBSK pulp. Pursuant to our current start-up plan, we have been ramping up pulp production and quality at the Stendal mill and the mill is now producing a significant proportion of saleable kraft pulp.

In conjunction with the start-up of the Stendal mill, we built up the fiber and finished goods inventory at the mill. We expect that the inventory levels at the Stendal mill will decrease to more normalized levels as the mill ramps up operations.

The mill underwent extensive testing and evaluation in December 2004 in connection with its mechanical completion and the Acceptance Test. The Acceptance Test required that the mill continuously produce pulp for a 72-hour period in compliance with specified operational, quality and environmental requirements. When acceptance of the mill has occurred, we are required to provide the contractor with an acceptance certificate. Once we deliver the acceptance certificate, we assume responsibility for the operation of the mill, subject to the contractor's warranty obligations.

Pursuant to the current start-up plan, the contractor shut down the mill for approximately one week in the fourth quarter of 2004 for the completion of adjustments, installations and the replacement of equipment that was required in order to fulfill its obligations under the construction contract, as well as for a few days in December 2004 for fine tuning and cleaning so that the contractor could commence trials for the Acceptance Test.

As at September 30, 2004, Stendal qualified for investment grants and had outstanding claim expenditures totaling €65.2 million with respect to the project, which we expect to receive in 2005. In accordance with our accounting policies, these grants are not recorded by us until they are received.

Start-Up

Pursuant to the EPC contract, construction of the Stendal mill was completed in the third quarter of 2004. Such completion means that the construction and installation of all equipment and works were essentially finished and the final checks are occurring so that continuous production from the mill can commence. The mill is being supervised by RWE using Stendal's personnel to operate the mill. The mill must pass the Acceptance Test prior to being accepted by Stendal. During the period that RWE has been commissioning the mill and supervising its operations, the mill has had a low capacity utilization. Upon passing the Acceptance Test, the mill will be operated by Stendal. Production at the Stendal mill is expected to reach approximately 80% of the rated capacity of the mill during the first year and in excess of 90% of rated capacity in the following year.

Project Risks

Our planned start-up of the Stendal mill is subject to risks commonly associated with the start-up of large greenfield industrial projects which could result in the Stendal mill experiencing operating difficulties or delays in the start-up period and the Stendal mill may not achieve our planned production, timing, quality or cost projections. These risks include, without limitation, equipment failures or damage, errors or miscalculations in engineering, design specifications or equipment manufacturing, faulty construction or workmanship, defective equipment or installation, human error, industrial accidents, weather conditions, failure to comply with environmental and other permits, and complex integration of processes and equipment. See "Risk Factors".

Environmental

Our operations are subject to a wide range of environmental laws and regulations, dealing primarily with water, air and land pollution control. In recent years, we have devoted significant financial and management resources to comply with all applicable environmental laws and regulations. Our total capital expenditures on environmental projects at our facilities in Germany were approximately €3.7 million in 2003 and are expected to be approximately €3.2 million in 2004.

We believe we have obtained all required environmental permits, authorizations and approvals for our operations. We believe our operations are currently in substantial compliance with the requirements of all applicable environmental laws and regulations and our respective operating permits.

The Rosenthal mill has a relatively modern biological wastewater treatment and oxygen bleaching facility. We have significantly reduced our levels of Adsorbable Organic Halogen, or "AOX", discharge at the Rosenthal mill and we believe the Rosenthal mill's AOX discharges are substantially below those currently mandated by the German government. Effective January 1, 2001, the Rosenthal mill is required to maintain levels of Chemical Oxygen Demand, or "COD" discharge at the Rosenthal mill below 25 kilograms per ADMT of pulp. The Rosenthal mill is currently in compliance with these levels of COD discharge. We will continue to modify our wastewater and bleaching facilities at the Rosenthal mill, which have been further enhanced as a result of the conversion of the mill to the production of kraft pulp, to meet or exceed prescribed regulations. In addition, in 2003 we commenced a strategic capital project to reconstruct the landfill at the Rosenthal mill so that it will be useable for an additional 15 years. The aggregate cost of the project is approximately €7.6 million.

Under German state environmental rules relating to effluent discharges, industrial users are required to pay wastewater fees based upon the amount of their effluent discharge. These rules also provide that an industrial user which undertakes environmental capital expenditures and lowers certain effluent discharges to prescribed levels may offset the amount of these expenditures against the wastewater fees that they would otherwise be required to pay. As a result, we estimate that the aggregate wastewater fees we saved in 2003 as a result of environmental capital expenditures made at our manufacturing plants in Germany were approximately €3.0 million. We expect that capital investment programs for our manufacturing plants in Germany will fully offset the wastewater fees that may be payable for 2004 and 2005 and will ensure that our operations continue in substantial compliance with prescribed standards.

Environmental compliance is a priority for our operations. To ensure compliance with environmental laws and regulations, we regularly monitor emissions at our mills and periodically perform environmental audits of operational sites and procedures both with our internal personnel and outside consultants. These audits identify opportunities for improvement and allow us to take proactive measures at the mills as considered appropriate.

Although the Rosenthal mill's overall emission levels for nitric oxide and nitrogen oxide, collectively referred to as "NOx", are substantially below prescribed levels, NOx emissions from one gas burner have recently exceeded its permitted emission level. We made a claim on the warranty from the supplier of the gas burner who installed an ammonia scrubber to reduce NOx emissions. Due to a technical issue, emission levels from the gas burner were not reduced to permitted levels. Pursuant to our agreement with the gas burner supplier, the supplier is responsible for installing a new burner that reduces NOx emission levels to prescribed standards. The supplier completed the installation of a new gas burner at the Rosenthal mill in the third quarter of 2004 at an aggregate cost of €0.9 million, of which €0.5 million was borne by the supplier and the remainder by us.

We have until the end of 2005 to begin biologically treating the wastewater at the Fährbrücke mill. We are in the process of constructing a wastewater treatment plant at the Fährbrücke mill, the first stage of which was completed in 2002 and brought into operation at the beginning of 2003. The cost of

the treatment plant is expected to be approximately €2.0 million, of which €0.2 million was incurred in 2003. The project is being funded by government grants as to 28%, a bank loan as to 45% and the remainder from our funds, and we expect construction of the plant to be completed in early 2005.

In September 2003, during a shut down, the Celgar mill inadvertently discharged approximately 1,500 m^3 of diluted process chemicals through its effluent treatment system and, as a result, released semi-treated effluent into a nearby river. An independent report concluded that there were no measurable adverse effects from the spill. Upon investigation, the British Columbia Ministry of Water, Lands and Air Protection, referred to as "MWLAP", issued a pollution prevention order that required the Celgar mill to adopt certain requirements including operator training, reporting requirements, development of contingency plans and the dredging of spill ponds. The mill has complied with all of the requirements of the order. The MWLAP has not imposed any fines or sanctions as a result of the spill.

The Celgar mill has a number of permits regulating air emissions, including those with respect to sulphur dioxide, referred to as "SO_2". While the mill's overall SO_2 emissions are generally below one-third of the total SO_2 emissions permitted to be discharged under its air permits, the mill's lime kiln SO_2 emissions periodically exceed emissions allowed under its individual SO_2 air permit. The mill is investigating the level of SO_2 emissions from the lime kiln and the ability to amend its air permits to lower overall SO_2 emissions for the mill while increasing the SO_2 emission discharge limit on its lime kiln permit. In the event that such permit amendments are not available, our consulting engineers have preliminarily estimated the capital cost to correct the SO_2 emissions at the lime kiln to be in the range of C$1.5 million to C$2 million. MWLAP has been advised of the level of SO_2 emissions at the lime kiln and apprised of the mill's efforts to correct the same. Although the MWLAP has not taken actions or imposed any fines to date, there can be no assurance that any permit amendment will be successful, that MWLAP may not take action in the future or that the capital requirements to address the same will not exceed the preliminary estimates.

The Celgar mill operates two landfills, a newly commissioned site and an older site. The Celgar mill intends to decommission the old landfill and is developing a closure plan and reviewing such plan with the MWLAP. The Celgar mill currently believes it may receive regulatory approval for such closure plan in 2005 and would commence closure activities in 2006. Our consulting engineers have estimated that the closure program is to cost up to C$3 million, which would incorporate a clay or synthetic hydraulic cap. Potential savings may accrue should effluent treatment sludge be approved for use as a cap. As the closure program for the old landfill has not been finalized or approved, there can be no assurance that the decommissioning of the old landfill will not exceed such cost estimate.

Future regulations or permits may place lower limits on allowable types of emissions, including air, water, waste and hazardous materials, and may increase the financial consequences of maintaining compliance with environmental laws and regulations or conducting remediation. Our ongoing monitoring and policies have enabled us to develop and implement effective measures to maintain emissions in material compliance with environmental laws and regulations to date in a cost-effective manner. However, there can be no assurances that this will be the case in the future.

Human Resources

We currently employ or hold positions for approximately 1,647 people. Our German operations have approximately 1,004 employees working in our pulp operations, including our transportation subsidiary, and approximately 223 employees working in our paper operations. The Celgar mill currently employs 420 people in its operations, the vast majority of which are unionized.

Pursuant to the government grants and financing arranged in connection with the conversion of the Rosenthal mill to the production of kraft pulp, we have agreed with state government authorities in Germany to maintain at least 504 jobs at our Rosenthal pulp operations until June 30, 2005. This

includes the employees of the Rosenthal mill's transportation operations which deliver raw materials to the mill and pulp to our customers.

When the Stendal mill is fully operational, Stendal and its subsidiaries are expected to employ approximately 580 people. Pursuant to the government grants and financing arranged in connection with the Stendal project, we have agreed with German state authorities to maintain this number of jobs until 2010.

Rosenthal and Dresden are bound by collective agreements negotiated with Bergbau-Chemie Energie, or "IG-BCE", a national union that represents pulp and paper workers. In February 2003, we entered into a new labor agreement with IG-BCE for our pulp workers which, among other things, had a one-year term and provided for a 2% wage increase effective March 1, 2003 and that the parties would negotiate in respect of a further wage increase for August 2003 depending upon general economic conditions. Our pulp workers agreed to defer negotiations in respect of a further wage increase for 2003 as a result of current general economic conditions. In February 2004, a new agreement was reached which provides for a 2% wage increase. The agreement expires at the end of February 2005 and a new agreement is expected to be negotiated in the first half of 2005.

A labor agreement was reached with the workers at our paper mills in 1999 upon terms which provided for wage increases of 1.5% in July 2000 and January 2001. A further agreement was reached in May 2001 upon terms which provided for wage increases of 2.0% in each of July 2001 and January 2002. In December 2002, a new agreement was reached for 2003 which provided for a wage increase of 2.5%. In February 2004, a new agreement was reached which provides for a 1.5% wage increase on each of February 1, 2004, July 1, 2004, January 1, 2005 and July 1, 2005. This agreement cannot be terminated prior to August 31, 2005 and a new agreement is expected to be negotiated in the fourth quarter of 2005.

Over 90% of the employees at our German pulp and paper operations have post-secondary education or are trained tradespersons. We consider the relationships with these employees to be good. We have implemented profit sharing plans, training programs and early retirement schemes for the benefit of our German employees. Although no assurances can be provided, we have not had any significant work stoppages at any of our German operations and we would therefore expect to enter into labor agreements with our pulp and paper workers in Germany without any significant work stoppages at our German mills.

A collective agreement was reached with the union hourly workers at the Celgar mill in January 2003 which has a term of five years. The agreement provides for wage increases effective May 2003 of 2.5% in each of 2003 and 2004, and 2% in each of the following three years. Management at the Celgar mill considers relations with its workers to be good.

Properties

We lease offices in Seattle, Washington, Vancouver, British Columbia, and in Germany. We own the Rosenthal mill, the Celgar mill and the paper mills and the underlying property. The Stendal mill is situated on property owned by Stendal, our 63.6% owned subsidiary.

The Rosenthal mill is situated on a 220 acre site near the town of Blankenstein in the State of Thuringia, approximately 300 kilometers south of the Stendal mill. The Saale river flows through the site of the mill. In late 1999, we completed a major capital project which converted the Rosenthal mill to the production of kraft pulp. It is a single line mill with an annual production capacity of approximately 310,000 ADMTs of kraft pulp. The mill is self-sufficient in steam and electrical power. Some excess electrical power which is constantly generated is sold to the regional power grid. The facilities at the mill include:

- an approximately 723,000 square feet fiber storage area;

barking and chipping facilities for pulp logs;

a fiber line, which includes a Kamyr continuous digester and bleaching facilities;

a pulp machine, which includes a dryer and a cutter;

an approximately 63,000 square foot finished goods storage area;

a chemical recovery system, which includes a recovery boiler, evaporation plant and recausticizing plant;

a fresh water plant;

a wastewater treatment plant; and

a power station with a turbine capable of producing 45 megawatts of electric power from steam produced by the recovery boiler and a power boiler.

The Stendal mill is situated on a 200 acre site near the town of Stendal in the State of Sachsen-Anhalt, approximately 300 kilometers north of the Rosenthal mill and 130 kilometers from the city of Berlin. The mill is adjacent to the Elbe river and has access to harbor facilities for water transportation. Construction of the Stendal mill was completed in the third quarter of 2004. The mill is a single line mill with a designed annual production capacity of approximately 552,000 ADMTs of kraft pulp. The Stendal mill is designed to be self-sufficient in steam and electrical power. Some excess electrical power which is constantly being generated will be sold to the regional power grid. The facilities at the mill are designed to include:

an approximately 920,000 square feet fiber storage area;

barking and chipping facilities for pulp logs;

a fiber line, which includes eight Superbatch digester and bleaching facilities;

a pulp machine, which includes a dryer and a cutter;

an approximately 108,000 square foot finished goods storage area;

a recovery line, which includes a recovery boiler, evaporation plant, recausticizing plant and lime kiln;

a fresh water plant;

a wastewater treatment plant; and

a power station with a turbine capable of producing approximately 100 megawatts of electric power from steam produced by the recovery boiler and a power boiler.

The Celgar mill is situated on a 400 acre site near the city of Castlegar, British Columbia in Canada. The mill is located on the south bank of the Columbia River, approximately 600 kilometers east of the port city of Vancouver, British Columbia, and approximately 32 kilometers north of the Canada-United States border. The city of Seattle, Washington is approximately 650 kilometers southwest of Castlegar. It is a single line mill with a current annual production capacity of approximately 430,000 ADMTs of NBSK pulp. Internal power generating capacity could, with certain capital improvements, enable the Celgar mill to be self-sufficient in electrical power and at times to sell surplus electricity. The facilities at the Celgar mill include:

fiber storage facilities consisting of four vertical silos and an asphalt surfaced yard with a capacity of 200,000 m^3 of chips;

a woodroom containing debarking and chipping equipment for pulp logs;

a fiber line, which includes a dual vessel hydraulic digester, pressure knotting and screening, single stage oxygen delignification and bleaching facilities;

two pulp machines;

a chemical recovery system, which includes a recovery boiler, recausticizing area and effluent treatment system; and

a turbine generator capable of producing approximately 48 megawatts of electric power from steam produced by a recovery boiler and power boiler.

The Heidenau mill is situated on a 26 acre site in the town of Heidenau in the State of Saxony at the Elbe river, approximately 120 kilometers east of the Fährbrücke mill and 12 kilometers south of the city of Dresden. The mill was constructed in 1956 and has been continually upgraded. The mill has a rated annual production capacity of approximately 45,000 ADMTs of specialty papers. The facilities at the mill include:

an approximately 34,200 square feet fiber storage area;

an approximately 57,600 square foot paper machine building, which houses a PAMA paper machine with a 339 centimeter trim width, processing speed of 300 meters per minute and including, among other things, a stock preparation unit, approach system, press section and dryer section;

a fresh water plant, which consists of 15 wells;

a wastewater treatment plant; and

a power plant, which includes a gas turbine capable of producing approximately 4,250 kilowatts of electric power, a waste heat boiler capable of producing 17 tonnes per hour of steam generated power and an auxiliary boiler capable of producing five tonnes per hour of steam generated power.

The Fährbrücke mill is situated on a 27 acre site near the town of Fährbrücke in the State of Saxony, in the western part of the Erzgebirge mountains at the Zwickauer Mulde river. The mill is approximately 100 kilometers east of the Rosenthal mill and approximately 120 kilometers west of the Heidenau mill. The mill was constructed between 1972 and 1973 and has been continually upgraded. The mill has a rated annual production capacity for approximately 40,000 ADMTs of printing and writing papers and specialty papers. The mill uses virgin fiber in producing various grades of printing and writing papers and specialty papers. The facilities at the mill include:

an approximately 69,300 square feet fiber storage area;

an approximately 60,300 square foot paper machine building, which houses a Voith paper machine with a 276 centimeter trim width, processing speed of 540 meters per minute and including, among other things, a pulper unit, paper chemical preparation unit, refiner system, stock blending system, approach system, press section and dryer section;

a fresh water plant;

a power plant, which consists of, among other things, a waste heat boiler which can produce 22 tonnes per hour of steam generated power and a heavy duty boiler which can produce 3.2 tonnes per hour of steam and a gas turbine which can produce approximately 4,250 kilowatts of electric power; and

a wastewater treatment plant is currently being constructed, the first stage of which was completed at the end of 2002 and brought on line at the beginning of 2003.

The following table sets out, by primary product class, our production capacity and actual production for the periods indicated:

Product Class	Annual Production Capacity[2]	Production[1] Year Ended December 31, 2001[3]	2002	2003
		(ADMTs)		
Pulp	1,292,000[4]	642,395[5]	707,315[5]	732,749[5]
Papers				
Specialty Papers	55,000[6][7]	40,275[6]	62,172[6]	40,424
Printing Papers	30,000[7]	26,852	23,195	21,488
Total Papers	70,000[7]	67,127	85,367	61,912
Total	1,362,000	709,522	792,682	794,661

(1) The Stendal mill is currently in the start-up phase and, as a result, the actual production amounts do not include production at the Stendal mill.

(2) Capacity is the rated capacity of the plants as at September 30, 2004, which is based upon production for 365 days a year. Targeted production is generally based upon 353 days per year for the Rosenthal mill, 350 days per year for the Celgar mill and 340 days per year for the paper mills.

(3) The Celgar mill was shut down for approximately 50 days in 2001 for market related reasons.

(4) After giving effect to the Acquisition, comprised of 310,000 ADMTs for our Rosenthal mill, 552,000 ADMTs for our Stendal mill and 430,000 ADMTs for the Celgar mill.

(5) After giving effect to the Acquisition.

(6) As we reorganized our interest in Landqart at the end of 2002, we no longer have a direct interest in the Landqart mill. The Landqart mill had an annual production capacity of approximately 20,500 ADMTs, which is not included in the calculation of our annual production capacity for specialty papers. Actual production of specialty papers at the Landqart mill is not included for 2001, but is included for 2002. The Landqart mill produced approximately 20,422 ADMTs in the year ended December 31, 2002. As of December 31, 2002, our interest in the Landqart mill is no longer consolidated and is included in our financial results on an equity basis.

(7) Based upon the current product mix at the paper mills, the aggregate annual production capacity of the paper mills is approximately 70,000 ADMTs. The rated aggregate annual production capacity of the paper mills is approximately 85,000 ADMTs.

We own a substantial amount of real estate adjacent to the paper mills, which is in excess of our production requirements and may be divested. Substantially all of our German pulp related assets, including our German pulp facilities, are currently pledged to secure the Rosenthal Loan Facility and the Stendal Loan Facility. The Rosenthal Loan Facility will be repaid and discharged upon closing of the Acquisition.

MANAGEMENT

As a business trust, we are managed by "trustees", who have comparable duties and responsibilities as directors of corporations. Trustees are elected by shareholders at annual meetings for staggered three-year terms. Each issued and outstanding share of beneficial interest is entitled to one vote at such meeting. Our trustees and executive officers are as follows:

Jimmy S.H. Lee, age 47, has been a trustee since May 1985 and President and Chief Executive Officer since 1992. Previously, Mr. Lee served with MFC Bancorp Ltd. as a director from 1986, Chairman from 1987 and President from 1988 to December 1996, respectively. During Mr. Lee's tenure with the Company, the Company acquired the Rosenthal mill, converted the Rosenthal mill to the production of kraft pulp, constructed and started up the Stendal mill and has entered into an agreement to acquire the Celgar mill.

William D. McCartney, age 49, has been a trustee since January 2003. Mr. McCartney has been President and Chief Executive Officer of Pemcorp Management Inc., a management services company, since 1990. Mr. McCartney is a director of Southwestern Resources Corp., where he has served since March 2004. Mr. McCartney is also a member of the Institute of Chartered Accountants in Canada.

Kenneth A. Shields, age 56, has been a trustee since August 2003. Mr. Shields was a founder of the institutional firm of Goepel Shields & Partners Inc., where he held the position of President and Chief Executive Officer. In April of 1998, the firm merged with McDermid St. Lawrence Securities Ltd. to become the investment firm of Goepel McDermid Inc. which was subsequently acquired, in January of 2001, by Florida-based Raymond James Financial, Inc. Mr. Shields currently serves as a member of the board of directors of Raymond James Financial, Inc. and serves as the Chairman, Chief Executive Officer and a member of the board of directors of the Canadian subsidiary, Raymond James Ltd. Mr. Shields is also a director of TimberWest Forest Corp., a member of the Accounting Standards Oversight Council, and a Director of the Council for Business and the Arts in Canada. Additionally, Mr. Shields has served as past Chairman of the Investment Dealers Association of Canada and Pacifica Papers Inc., and is a former director of each of Slocan Forest Products Ltd. and the Investment Dealers Association of Canada.

Guy W. Adams, age 53, has been a trustee since August 2003. Mr. Adams is the managing member of GWA Advisors, LLC, GWA Investments, LLC, referred to as "GWA", and GWA Capital Partners, LLC, where he has served since 2002, and is the managing member of GWA Master Fund, LP since October 2004. GWA Advisors, LLC is a private equity investment firm and a holding company for Mr. Adams' private equity investments. GWA is an investment fund investing in publicly traded securities managed by GWA Capital Partners, LLC, a registered investment advisor. Prior to 2002, Mr. Adams was the President of GWA Capital, which he founded in 1996 to invest his own capital in public and private equity transactions, and a business consultant to entities seeking refinancing or recapitalization.

Eric Lauritzen, age 66, has been a trustee since June 2004. Mr. Lauritzen was President and Chief Executive Officer of Harmac Pacific, Inc., a North American producer of softwood kraft pulp previously listed on the Toronto Stock Exchange and acquired by Pope & Talbot Inc. in 1998, from May 1994 to July 1998, when he retired. Mr. Lauritzen was Vice President, Pulp and Paper Marketing of MacMillan Bloedel Limited, a North American pulp and paper company previously listed on the Toronto Stock Exchange and acquired by Weyerhaeuser Company Limited in 1999, from July 1981 to April 1994.

Graeme A. Witts, age 66, has been a trustee since January 2003. Mr. Witts organized Sanne Trust Company Limited, a trust company located in the Channel Islands, in 1988 and was managing director from 1988 to 2000, when he retired. Mr. Witts is also a fellow of the Institute of Chartered Accountants of England and Wales.

David M. Gandossi, age 47, has been Secretary, Executive Vice-President and Chief Financial Officer since August 15, 2003. Mr. Gandossi was formerly the Chief Financial Officer and Executive Vice-President of Formation Forest Products (a closely held corporation) from June 2002 to August 2003. Mr. Gandossi previously served as Chief Financial Officer, Vice-President, Finance and Secretary of Pacifica Papers Inc., a North American specialty pulp and paper manufacturing company previously listed on the Toronto Stock Exchange, from December 1999 to August 2001 and Controller and Treasurer from June 1998 to December 1999. From June 1998 to August 31, 1998, he also served as Secretary to Pacifica Papers Inc. From March 1998 to June 1998, Mr. Gandossi served as Controller, Treasurer and Secretary of MB Paper Ltd. From April 1994 to March 1998, Mr. Gandossi held the position of Controller and Treasurer with Harmac Pacific Inc., a Canadian pulp manufacturing company previously listed on the Toronto Stock Exchange. Mr. Gandossi is a member of the Institute of Chartered Accountants in Canada.

Wolfram Ridder, age 41, was appointed a managing director of Stendal, our 63.6% owned project subsidiary that has completed construction a new state-of-the-art NBSK kraft pulp mill near the town of Stendal, Germany, in July 2002. Mr. Ridder was the principal assistant to our Chief Executive Officer from November 1995 until September 2002. Mr. Ridder has also been a Vice-President of pulp operations since August 1999.

We also have experienced mill managers at our Rosenthal and Stendal mills who have operated through multiple business cycles in the pulp and paper industry. These managers have on average 18 years of industry experience.

Mr. Adams was nominated for election as a trustee at the 2003 annual meeting pursuant to a settlement agreement entered into between us and Greenlight Capital, Inc. and Greenlight Capital, LLC.

The terms of Mr. Lee and Mr. McCartney as trustees expire at the annual meeting of shareholders to be held in 2005. The terms of Mr. Shields and Mr. Adams as trustees expire at the annual meeting of shareholders to be held in 2006. The terms of Mr. Lauritzen and Mr. Witts as trustees expire at the annual meeting of shareholders to be held in 2007.

Our board of trustees, referred to as the "Board", met five times during 2003 and each member of the Board attended 75% or more of the total number of such meetings and meetings of the committees of the Board on which they serve, other than C.S. Moon who was replaced as a trustee at the annual meeting of shareholders held in June 2004. In addition, our independent trustees regularly meet in separate executive sessions without any member of our management present. The Lead Trustee presides over these meetings. Although we do not have a formal policy with respect to attendance of trustees at our annual meetings, all trustees are encouraged and expected to attend such meetings if possible. Six trustees attended our 2003 annual meeting.

Our Board has developed corporate governance guidelines in respect of: (i) the duties and responsibilities of the Board, its committees and the officers of the Company; and (ii) practices with respect to the holding of regular quarterly and strategic meetings of the Board including separate meetings of non-management trustees. The Board is also developing additional disclosure controls and procedures in connection with periodic reports and certifications we are required to file with the SEC pursuant to the Sarbanes-Oxley Act of 2002. Our Board has established three standing committees, the Audit Committee, the Compensation Committee and the Governance and Nominating Committee.

Audit Committee

The Audit Committee functions pursuant to a charter adopted by the trustees. A copy of the current charter is attached as Appendix "A" to the definitive proxy statement on Schedule 14A relating to our annual meeting of shareholders held in June 2004. The function of the Audit Committee generally is to meet with and review the results of the audit of our financial statements performed by

the independent public accountants and to recommend the selection of independent public accountants. The members of the Audit Committee are Mr. McCartney, Mr. Witts and Mr. Lauritzen, each of whom is independent under applicable laws and regulations and the listing requirements of the Nasdaq National Market. Both Mr. McCartney and Mr. Witts are chartered accountants and Mr. McCartney is a "financial expert" within the meaning of such term under the Sarbanes-Oxley Act of 2002. The Audit Committee met five times during 2003.

The Audit Committee has established procedures for: (i) the receipt, retention and treatment of complaints received by the Company regarding accounting, internal accounting controls or auditing matters; and (ii) the confidential and anonymous submission by the Company's employees and others of concerns regarding questionable accounting or auditing matters. A person wishing to notify the Company of such a complaint or concern should send a written notice thereof, marked "Private & Confidential", to the Chairman of the Audit Committee, Mercer International Inc., c/o Suite 2840, P.O. Box 11576, 650 West Georgia Street, Vancouver, B.C.,V6B 4N8 Canada.

Compensation Committee

The Board has established a Compensation Committee. The Compensation Committee is responsible for reviewing and approving the strategy and design of the Company's compensation, equity-based and benefits programs. The Compensation Committee is also responsible for approving all compensation actions relating to executive officers. The members of the Compensation Committee are Mr. Shields, Mr. McCartney and Mr. Adams, each of whom is independent under applicable laws and regulations and the listing requirements of the Nasdaq National Market. The Compensation Committee met once during 2003.

Governance and Nominating Committee

Our Board has established a Governance and Nominating Committee comprised of Mr. Shields, Mr. McCartney and Mr. Witts, each of whom is independent under applicable laws and regulations and the listing requirements of the Nasdaq National Market. The Governance and Nominating Committee functions pursuant to a charter adopted by the trustees, a copy of which is attached as Appendix "B" to the definitive proxy statement on Schedule 14A relating to our annual meeting of shareholders held in June 2004. The purpose of the committee is to: (i) manage the corporate governance system of the Board; (ii) assist the Board in fulfilling its duties to meet applicable legal and regulatory and self-regulatory business principles and codes of best practice; (iii) assist in the creation of a corporate culture and environment of integrity and accountability; (iv) in conjunction with the Lead Trustee, monitor the quality of the relationship between the Board and management; (v) review management succession plans; (vi) recommend to the Board nominees for appointment to the Board; (vii) lead the Board's annual review of the Chief Executive Officer's performance; and (viii) set the Board's forward meeting agenda. The Governance and Nominating Committee was established in September 2003 and met once in 2003.

Lead Trustee

Our Board appointed Mr. Shields as its Lead Trustee in September 2003. The role of the Lead Trustee is to provide leadership to the non-management trustees on the Board and to ensure that the Board can operate independently of management and that trustees have an independent leadership contact. The duties of the Lead Trustee include, among other things: (i) ensuring that the Board has adequate resources to support its decision-making process and ensuring that the Board is appropriately approving strategy and supervising management's progress against that strategy; (ii) ensuring that the independent trustees have adequate opportunity to meet to discuss issues without management being present; (iii) chairing meetings of trustees in the absence of the Chairman and Chief Executive Officer; (iv) ensuring that delegated committee functions are carried out and reported to the Board; and (v) communicating to management, as appropriate, the results of private discussions among outside trustees and acting as a liaison between the Board and the Chief Executive Officer.

PRINCIPAL SHAREHOLDERS

The following table sets forth information regarding the beneficial ownership of our shares as of February 8, 2005 by each shareholder who is known by us to own more than five percent of our outstanding shares. The following is based solely on statements made in filings with the SEC or other information we believe to be reliable.

Name and Address of Owner	Number of Shares Owned	Percentage of Outstanding Shares
Peter R. Kellogg[1] 120 Broadway, 6th Floor New York, NY 10271	4,196,783	14.6%
Greenlight Capital, L.L.C.[2]. 420 Lexington Avenue Suite 875 New York, NY 10170	3,985,183	13.9%
Coghill Capital Management, LLC[3] One North Wacker Drive Suite 4725 Chicago, IL 60606	1,582,679	8.8%
FMR Corp.[4] 82 Devonshire Street Boston, MA 02109	2,200,001	7.7%
Cramer Rosenthal McGlynn 707 Westchester Avenue White Plains, NY 10604	1,018,500	5.6%
Franklin Resources, Inc.[5] One Franklin Parkway San Mateo, CA 94403	1,448,610	5.1%

(1) Filed jointly with IAT Reinsurance Company Ltd., or IAT. The number of shares owned includes 1,645,161 shares issuable upon conversion of convertible senior subordinated notes. The percentage of outstanding shares owned gives pro forma effect to the 10,645,155 shares issuable upon conversion of the convertible senior subordinated notes.

(2) Filed jointly with Greenlight Capital, L.L.C., Greenlight Capital, Inc. and David Einhorn. The number of shares owned includes 1,419,353 shares issuable upon conversion of convertible senior subordinated notes. The percentage of outstanding shares owned gives pro forma effect to the 10,645,155 shares issuable upon conversion of the convertible senior subordinated notes.

(3) Filed jointly with CCM Master Qualified Fund, Ltd., Coghill Capital Management, LLC and Clint D. Coghill.

(4) Filed jointly with Edward C. Johnson 3d, Abigail P. Johnson and Fidelity Management & Research Company. The number of shares owned represents shares issuable upon conversion of convertible senior subordinated notes. The percentage of outstanding shares owned gives pro forma effect to the 10,645,155 shares issuable upon conversion of the convertible senior subordinated notes.

(5) Filed jointly with Charles B. Johnson, Rupert H. Johnson, Jr. and Franklin Advisory Services, LLC. The number of shares owned includes 903,210 shares issuable upon conversion of convertible senior subordinated notes. The percentage of outstanding shares owned gives pro forma effect to the 10,645,155 shares issuable upon conversion of the convertible senior subordinated notes.

Pursuant to the terms of the Acquisition, we will issue $40 million of our shares of beneficial interest to either KPMG Inc. and/or the two senior secured lenders of Celgar, being Royal Bank of Canada and National Westminster Bank PLC.

The following table sets forth information regarding ownership of our shares as of February 8, 2005 by each of our trustees and executive officers and all of our trustees and executive officers as a group. Unless otherwise indicated, each trustee has sole voting and disposition power with respect to the shares set forth opposite his name.

Name of Owner	Number of Shares Owned	Percentage of Outstanding Shares
Jimmy S.H. Lee[(1)]	1,619,800	8.6%
Kenneth A. Shields[(2)]	25,000	*
Guy W. Adams[(3)]	255,000	1.5%
William D. McCartney[(4)]	5,000	*
Graeme A. Witts[(5)]	5,000	*
Eric Lauritzen		
David M. Gandossi[(6)]	100,000	*
Wolfram Ridder[(7)]	60,000	*
Trustees and Officers as a Group (8 persons)[(8)]	2,069,800	10.9%

* Less than 1%.

(1) Includes 784,800 shares of beneficial interest and presently exercisable stock options to acquire up to 835,000 shares. Mr. Lee exercised options and acquired an aggregate of 750,000 of our shares of beneficial interest in October 2004. In addition, Mr. Lee will be purchasing 350,000 of our shares pursuant to the Share Offering.

(2) In January 2004, Mr. Shields was granted 25,000 restricted shares of beneficial interest in connection with his role as the Lead Trustee of our Board. These shares vest in three equal installments on January 20, 2004, November 11, 2004 and November 11, 2005.

(3) In August 2003, we issued options to purchase up to 225,000 shares to GWA, of which Mr. Adams is the managing member, and up to 100,000 shares to Mr. Adams, each at an exercise price of $4.53 per share. GWA exercised its options in September 2003 and Mr. Adams exercised his options in March 2004. In addition, in June 2004, Mr. Adams was granted 5,000 restricted shares in connection with his role as an independent trustee of Mercer. The shares vest and become non-forfeitable in June 2005.

(4) In June 2004, Mr. McCartney was granted 5,000 restricted shares in connection with his role as an independent trustee of Mercer. These shares vest and become non-forfeitable in June 2005.

(5) In June 2004, Mr. Witts was granted 5,000 restricted shares in connection with his role as an independent trustee of Mercer. These shares vest and become non-forfeitable in June 2005.

(6) In September 2003, Mr. Gandossi was granted options to acquire up to 100,000 of our shares at a price of $5.65 per share exercisable as of September 10, 2003 as to one-third of the options granted and one-third on each of September 10, 2004 and September 10, 2005. These options have a ten-year term.

(7) Represents presently exercisable stock options.

(8) Includes presently exercisable stock options to acquire up to 995,000 shares.

The following table sets forth information as at December 31, 2004 regarding: (i) our 1992 amended and restated stock option plan under which options to acquire an aggregate of 3,600,000 of our shares may be granted; and (ii) our 2004 Stock Incentive Plan pursuant to which 1,000,000 of our shares may be issued pursuant to options, stock appreciation rights and restricted shares:

	Number of Shares to be Issued Upon Exercise of Outstanding Options	Weighted-average Exercise Price of Outstanding Options	Number of Shares Available for Future Issuance Under Plan

1992 Amended Stock Option Plan	1,055,000	$ 6.58	230,500
2004 Stock Incentive Plan			960,000[(1)]

(1) An aggregate of 40,000 restricted shares have been issued under the plan.

CERTAIN RELATIONSHIPS

MFC Bancorp Ltd., referred to as "MFC", was an approximately 92% owned subsidiary until June 1996, when we spun-off approximately 83% of the issued shares of MFC to our shareholders by way of a special dividend-in-kind. MFC is primarily engaged in merchant banking and financial services including through a wholly owned licensed Swiss bank.

As part of the financing for the Stendal project, in August 2002, we obtained a €15 million bridge loan from Babcock & Brown Investment Management Partners LP, referred to as "Babcock & Brown", and a €30 million bridge loan arranged by the Swiss banking affiliate of MFC with variable interest rates and specified fees. Babcock & Brown was our advisor in connection with the overall financing arrangements for the Stendal project. Both loans were on substantially the same terms. In October 2003, we fully repaid the two bridge loans from Babcock & Brown and MFC, which, with fees and accrued interest, aggregated $66.9 million, from the proceeds of our convertible note offering.

In addition to the bridge loan, at December 31, 2002, Mercer had other indebtedness to MFC in the amount of approximately €8.6 million. Approximately €6.4 million of this indebtedness was repaid in December 2003 from the proceeds of the sale of MFC shares to an affiliate of MFC and the balance was fully repaid in early 2004. We previously held, directly and indirectly, approximately 575,683 common shares of MFC, being approximately 4% of its outstanding shares. We sold 538,683 MFC shares to an affiliate of MFC in December 2003 at a price of $15.84 per share (being the 20-day weighted average trading price of the shares on the Nasdaq National Market at the time of the agreement to sell the shares) for total proceeds of $8.5 million, referred to as the "MFC Share Sale". The proceeds were used to repay part of the €8.6 million indebtedness to MFC described above. The MFC Share Sale was approved by a special committee of Mercer's trustees and Mercer's board, with Mr. Lee abstaining. Subsequently, Mercer sold its remaining shares of MFC.

Mr. Lee, Mercer's Chairman, chief executive officer and a trustee was formerly a non-executive director of the Swiss banking affiliate of MFC until he resigned from such position in April 2004.

Ian Rigg, a former trustee and our former chief financial officer, became a Vice President of MFC in August 2003. Mr. Rigg resigned as our chief financial officer in August 2003 and as a trustee in December 2003.

We have in the course of our business entered into transactions and other arrangements with MFC and its affiliates. From time to time, our Rosenthal pulp mill sells pulp to a commodities trading subsidiary of MFC, both for its own account and as an agent for sales to certain parts of eastern Europe. All such transactions are conducted on market terms on an arm's length basis as provided for in the Rosenthal project loan agreements. As at December 31, 2003, we had trade receivables for pulp sales of approximately €1.4 million from MFC affiliates, which were all collected in the ordinary course.

In December 2002, we contributed our 80% interest in Landqart to a limited partnership in exchange for a 49% interest therein. The other limited partner of the limited partnership is MFC and the general partner is wholly-owned by Cade Struktur Corporation, referred to as "CSC". CSC is a Canadian public company in which we own an approximate 26% interest and MFC owns 25% of its issued and outstanding shares. Mr. Lee, our Chief Executive Officer, previously served as an officer and director of CSC from July 2001 to December 2002. During such time, Mr. Lee received no remuneration from CSC and did not have any ownership interest therein. At the time of the Landqart reorganization, Mr. Lee was neither an officer nor a director of CSC. Previously, an affiliate of MFC arranged receivables financing for Landqart. This receivables financing from an MFC affiliate was terminated by Landqart in the first half of 2004.

MFC has also acquired an indirect majority interest in AIG Altmark-Industrie AG, a German real estate company, which is an indirect 7% shareholder of Stendal.

As at December 31, 2004, we had an approximately €1.5 million investment in shares and loans of a venture company, which is an affiliate of both us and MFC. This is a legacy investment which Mercer has been seeking to divest.

Stendal (our 63.6% subsidiary) informally subleases furnished office space and receptionist services from an MFC affiliate in Berlin. The sublease rate is approximately €80,000 per quarter.

A director of MFC is indebted to a subsidiary of Mercer in the approximate principal amount of €245,000.

Mercer previously utilised administrative services from a private company that also provided similar services to MFC related companies. Mercer terminated using such administrative services at the end of the second quarter of 2004. Mercer used to pay C$125,000 per quarter for such services and has agreed to pay such amounts until March 31, 2005.

Mercer's board has developed corporate governance guidelines which, among other things, provides that its audit committee or other special committee of trustees review and approve transactions with related and affiliated parties, including those with MFC. Mercer's board is comprised of six trustees, only one of which (the Chief Executive Officer) is part of management. There are no cross-directorships or officerships between Mercer (and its subsidiaries) and MFC (and its subsidiaries).

DESCRIPTION OF CERTAIN INDEBTEDNESS

Rosenthal Project Financing

The following summary of certain material provisions of the Rosenthal project loan agreement is not complete and these provisions, including definitions of certain terms, are qualified by reference to the Rosenthal project loan agreement and the applicable amendment agreements on file with the SEC.

In 1998, Rosenthal entered into the Rosenthal Loan Facility, as amended, having a 15 year term with a German bank and other syndicated lenders in the aggregate amount of €259.7 million to finance the conversion project. The Rosenthal Loan Facility is secured by liens on all of the assets of Rosenthal and the German federal government and the state government of Thuringia severally guaranteed an aggregate of 80% of the facility. We have agreed with the lenders under the Rosenthal Loan Facility that, so long as Rosenthal has liability thereunder, to retain control over at least 51% of the voting shares of Rosenthal.

As part of the Rosenthal Loan Facility, there is a credit line which allows for derivative transactions, subject to certain controls, including certain maximum notional and at-risk amounts, to manage risk. Rosenthal has entered into derivatives with the lead bank under the Rosenthal Loan Facility to manage its risk exposure with respect to certain amounts outstanding thereunder.

Repayment of the Rosenthal Loan Facility commenced on March 31, 2001. During the first nine months of 2004, €20.1 million of the Rosenthal Loan Facility was repaid and, net of cash in a restricted account, €143.1 million remained outstanding as at September 30, 2004. The outstanding amount under the Rosenthal Loan Facility and €7.6 million under a bank facility of Rosenthal in connection with the reconstruction of the landfill at the Rosenthal mill will be repaid with a portion of the proceeds of the Financings. See "Use of Proceeds" and "The Financings".

Stendal Pulp Mill Project Financing

The following summary of certain material provisions of the Stendal loan facility agreement is not complete and these provisions, including definitions of certain terms, are qualified by reference to the Stendal loan facility agreement on file with the SEC.

In August 2002, referred to as the "Stendal Financing Closing Date", we completed financing arrangements for the Stendal project. Total investment costs in connection with the project are approximately €1.0 billion, the majority of which was provided under the Stendal Loan Facility pursuant to the Project Finance Loan Agreement entered into between Stendal and HVB. We also contributed financing to Stendal of approximately €63.5 million from cash on hand and through bridge loans from a U.S. investment partnership and a bank.

The Stendal Loan Facility is in the aggregate amount of €828.0 million and is divided into tranches which cover, among other things, project construction and development costs, financing and start-up costs and working capital, as well as the financing of a debt service reserve account, approved cost overruns and a revolving loan facility to cover any time lag for receipt of grant funding and value-added tax refunds in the amount of €160 million, referred to as "Tranche E". The Stendal Loan Facility is available for disbursement from August 2002 until the earlier of the issuance by us of a final acceptance certificate for the project and December 2005, except that financing under the Stendal Loan Facility for approved cost overruns will be available for up to one month prior to the first repayment.

Pursuant to the Project Finance Loan Agreement, interest on the credit facilities was to accrue at variable rates between Euribor plus 0.60% and Euribor plus 1.55% per year. The Project Finance Loan Agreement provides for facilities to allow us to manage our risk exposure to interest rate risk, currency risk and pulp price risk by way of interest rate swaps, Euro and U.S. dollar swaps and pulp hedging transactions, subject to certain controls, including certain maximum notional and at-risk amounts.

Pursuant to the terms of the Project Finance Loan Agreement, in 2002 Stendal entered into interest rate swap agreements in respect of borrowings under the Stendal Loan Facility to fix most of the interest costs under the Stendal Loan Facility at a rate of 3.795% per year until April 2004 and at a rate of 5.28% commencing May 2004, plus margin, until final payment in October 2017. For more information, see "Business Quantitative and Qualitative Disclosures about Market Risk". In March 2003, as part of its loan syndication, HVB exercised its right under the Stendal Loan Facility to increase its up-front arrangement fee by 20 basis points and the rate of interest under the facility by 30 basis points.

Stendal has agreed to initially reduce the aggregate advances outstanding under the Stendal Loan Facility, other than in respect of Tranche E, to a maximum of €599.0 million, from a maximum original amount of €638.0 million (assuming no draws for approved cost overruns), on or before the first March 31 or September 30 following the fourth anniversary of the first advance under the Stendal Loan Facility for project construction and development costs. The tranches are generally repayable in installments and mature between the fifth and 15th anniversary of the first advance under the Stendal Loan Facility for project construction and development costs. Subject to various conditions, including a minimum debt service coverage test, Stendal may make distributions, in the form of interest and capital payments on shareholder debt or dividends on equity invested, to its shareholders, including us.

The tranches under the Stendal Loan Facility for project construction and development costs, financing costs, start-up costs and working capital are severally guaranteed by German federal and state governments in respect of an aggregate of 80% of the principal amount of these tranches, but the tranche under the Stendal Loan Facility for financing and start-up costs, working capital and certain of the project construction and development costs benefiting from these guarantees will be reduced semi-annually by 12.5% per year beginning on the first repayment date following the fourth anniversary of the first advance under the Stendal Loan Facility for each of these costs. Under the guarantees, the German federal and state governments that provide the guarantees are responsible for the performance of our payment obligations for the guaranteed amounts. Approximately €394.4 million was drawn under the Stendal Loan Facility as of December 31, 2003.

On December 12, 2003, Stendal entered into agreements with Nord Deutsche Landesbank, referred to as "Nord LB", and the European Investment Bank, referred to as "EIB". Pursuant to the agreements, EIB will provide a refinancing credit facility to Nord LB at preferred interest rates for up to €495.0 million. Such refinancing loan is made to Nord LB for the benefit of the Stendal project. Instead of actually refinancing the Stendal Loan Facility through Nord LB, and Stendal benefiting from lower interest rates over time, the agreements provide for the disbursement to Stendal of the net present value of the interest rate differential offered to Nord LB by EIB (less a portion retained by Nord LB).

A first draw down refinancing of €250.0 million was completed in December 2003 which resulted in a net present value of the interest rate differential of approximately €2.1 million being disbursed to Stendal. A second draw down refinancing in the amount of up to €245.0 million was completed in the first quarter of 2004 which resulted in a net present value interest rate differential credit of approximately €2.0 million being disbursed to Stendal.

The proceeds received from the interest rate differential arrangement with EIB were transferred to the Stendal project's disbursement account. These EIB proceeds are considered additional cash flow in the period between the Stendal mill's start-up and acceptance.

The Stendal Loan Facility is secured by all of the assets of Stendal. In addition, the Project Finance Loan Agreement provides for the establishment of an equity reserve account into which excess start-up cash flows may be deposited. The account will be used to secure claims and amounts owing to the lenders in priority to the funding of the debt service reserve account under the Stendal Loan

Facility. The Project Finance Loan Agreement also provides that revenues held by Stendal after certain payments may be paid to a shareholders' account.

In connection with the Stendal Loan Facility, we entered into a shareholders' undertaking agreement, referred to as the "Undertaking", dated August 26, 2002 with RWE, AIG and HVB in order to finance the shareholders' contribution to the Stendal project. Pursuant to the terms of the Undertaking, on the Stendal Financing Closing Date the shareholders of Stendal, on a pro rata basis, subscribed for €15 million of share capital of Stendal and advanced to it €55 million in subordinated loans. In addition, on a pro rata basis, the shareholders of Stendal agreed to advance to it €30 million of stand-by equity to, among other things, cover approved cost overruns, fund the equity reserve account and partially fund the debt service reserve account under the Stendal Loan Facility. On the Stendal Financing Closing Date, we provided HVB with a cash deposit for our pro rata portion of such equity reserve account. Our total funding commitment under the Undertaking was €63.5 million, all of which was effected in August 2002. Pursuant to the Undertaking, we have agreed, for as long as Stendal has any liability under the Stendal Loan Facility to HVB, to retain control over at least 51% of the voting shares of Stendal. We have no further capital commitments with relation to the Stendal project.

On the Stendal Financing Closing Date, we entered into and completed funding under two bridge financing loan agreements and used the net proceeds from the two bridge loans, referred to as the "Bridge Loans", in the principal amounts of €15.0 million and €30.0 million to fund, in part, our contribution to the Stendal project and commitment pursuant to the Undertaking. The Bridge Loans were negotiated at the same time and the agreements in respect of the Bridge Loans were entered into upon substantially the same terms. The Bridge Loans accrued interest at rates equal to Euribor plus 6.5% per year until April 2003 and Euribor plus 9.0% per year thereafter until October 2003.

In October 2003, we completed the sale of $82.5 million in aggregate principal amount of convertible senior subordinated notes due 2010. The notes bear interest at a rate of 8.5% per annum and are convertible into our shares of beneficial interest at a conversion price of $7.75 per share. The net proceeds from the offering of approximately $78.4 million were used to repay in full our indebtedness, including fees and accrued interest, under the Bridge Loans aggregating approximately $66.9 million and the balance was used for general corporate purposes, including working capital.

Convertible Notes

In October 2003, we issued $82.5 million in aggregate principal amount of 8.5% convertible senior subordinated notes due 2010, referred to as the "convertible notes". The following summary of certain provisions of the convertible notes and the indenture governing the convertible notes is not complete and is qualified in its entirety by reference to the indenture, a copy of which is attached as an exhibit to the Form 8-K filed with the SEC on October 16, 2003.

We pay interest semi-annually on the convertible notes on April 15 and October 15 of each year, beginning on April 15, 2004. The convertible notes mature on October 15, 2010. The convertible notes are redeemable on and after October 15, 2008, at any time in whole or in part, at our option on not less than 20 and not more than 60 days' prior notice at a redemption price equal to 100% of the principal amount thereof plus accrued and unpaid interest, if any, to, but not including, the date of redemption, subject to the restrictions in the indenture governing the notes to be issued hereunder. See "Description of the Notes Certain Covenants Restricted Payments".

The convertible notes are convertible, at the option of the holder, unless previously redeemed, at any time on or prior to maturity into our shares of beneficial interest. The convertible notes are convertible at a conversion price of $7.75 per share, which is equal to a conversion rate of approximately 129 shares per $1,000 principal amount of convertible notes, subject to adjustment.

Holders of the convertible notes have the right to require us to purchase all or any part of the convertible notes 30 business days after the occurrence of a change of control with respect to us at a purchase price equal to the principal amount thereof plus accrued and unpaid interest, if any, to the date of purchase.

The convertible notes are unsecured obligations of Mercer International Inc. and are subordinated in right of payment to existing and future senior indebtedness and are effectively subordinated to all of the indebtedness and liabilities of our subsidiaries. The indenture governing the convertible notes limits the incurrence by us, but not our subsidiaries, of senior indebtedness.

The convertible notes are eligible for trading in the Private Offerings, Resales and Trading through Automated Linkages (PORTAL) systems of the National Association of Securities Dealers, Inc. In addition, we have registered the convertible notes and underlying shares with the SEC for resale by the holders thereof.

Paper Mill Project Facilities

In 2003, our paper operations secured two long-term credit facilities aggregating approximately €2.5 million, which facilities along with certain government grants are being utilized to repair flooding damage suffered by the mills in 2002. One facility totaling approximately €1.0 million matures on June 30, 2009, bears interest at a rate of 2.65% per annum and is repayable in ten equal semi-annual installments. The other facility in the amount of approximately €1.5 million matures on June 30, 2013, bears interest at a rate of 2.65% per annum and is repayable in 16 equal semi-annual installments. Both facilities are guaranteed by Mercer Inc. as well as to 80% thereof by a German governmental agency.

In addition, in 2003, our Fährbrücke paper mill secured three credit facilities aggregating €5.5 million, which facilities along with certain government grants were utilized to finance equipment and construction costs associated with expanding and adapting the paper machine at the mill. In September 2004, we repaid the majority of the outstanding amounts under these credit facilities and permanently reduced the aggregate amount available thereunder to €2.2 million. Two of the facilities aggregating approximately €1.4 million mature on December 30, 2012 and bear interest at rates between 4.15% and 4.3% per annum and are repayable in 16 equal semi-annual installments. The other facility in the amount of approximately €0.8 million matures on March 31, 2009 and bears interest at a rate equal to the three-month Euribor rate plus 1.75% per annum and is repayable in 16 equal quarterly installments. All three facilities are guaranteed by Mercer Inc. as well as to 80% thereof by a German state government. As at September 30, 2004, we had utilized the entire €4.7 million available under the five credit facilities relating to the paper operations.

New Working Capital Facilities

In conjunction with the Acquisition, we intend to establish new working capital facilities for the Rosenthal and Celgar mills. We have received term sheets from two financial institutions relating to the provision of such working capital facilities upon terms and conditions customary for facilities of this nature.

The €40 million revolving working capital facility for the Rosenthal mill, arranged by HVB, consists of a revolving credit facility which may be utilized by way of cash advances or advances by way of letter of credit or bank guarantees. The facility will mature in February 2010. The interest payable on cash advances is LIBOR or EURIBOR plus 1.55%, plus certain other costs incurred by the lenders in connection with the facility. Each cash advance is to be repaid on the last day of the respective interest period and in full on the termination date and each advance by way of a letter of credit or bank guarantee shall be repaid on the applicable expiry date of such letter of credit or bank guarantee. An interest period for cash advances shall be three, six or 12 months or any other period as Rosenthal and

the lenders may determine. There is also a 0.375% per annum commitment fee on the unused and uncancelled amount of the revolving facility which is payable quarterly in arrears. This facility will be secured by a first fixed charge on the inventories, receivables and accounts of Rosenthal. In connection with this facility, Rosenthal will also enter into a hedging facility which will provide for a strategy to be agreed to between Rosenthal and HVB relating to the hedging of the interest, currency and pulp prices as they affect Rosenthal.

The $30 million revolving working capital facility for the Celgar mill, arranged by Royal Bank of Canada on a best efforts basis, consists of either a 364 day revolving credit facility and a one year non-revolving term loan upon the conversion of the revolving facility. The revolving facility has a term of 364 days and the term facility will mature on the first anniversary of the conversion date. The borrower will be our wholly owned acquisition subsidiary which will acquire the Celgar mill. The borrower can request a 364 day extension, not more than 90 days or less than 60 days prior to the maturity date of the revolving facility, and the lenders, in their sole discretion, shall decide whether or not to extend such facility not later than 30 days prior to the maturity date of the revolving facility. The revolving facility shall be available by way of: (i) Canadian and U.S. prime rate loans which bear interest at the designated rate plus between 1.5% and 2% depending upon which designated debt coverage ratio of the borrower is applicable at the time; (ii) banker's acceptances which bear interest at the applicable banker's acceptance discount rate plus between 2.5% and 3%, depending upon which designated debt coverage ratio of the borrower is applicable at the time; and/or (iii) LIBOR advances, which will accrue for periods of one, two, three or six months duration and which bear interest at LIBOR plus between 2.5% and 3%, depending upon which designated debt coverage ratio of the borrower is applicable at the time. Letters of credit and/or letters of guarantee will also be available under the facility up to a maximum of $10 million. There is also a commitment fee payable monthly in arrears on any unutilized and uncancelled amount of the revolving facility. The amount of the fee varies from 0.625% to 0.9% of such amount depending upon the amount drawn under the facility and which designated debt coverage ratio the borrower has achieved. This facility will be secured by a first charge on the current assets of the borrower, a guarantee and postponement of claims delivered by Mercer Inc. and a priority agreement executed by the borrower and Mercer Inc. which acknowledges the lender's priority claim on the accounts receivable and inventory of the borrower.

DESCRIPTION OF THE NOTES

You can find the definitions of certain terms used in this description under the subheading "Certain Definitions." In this description, the word "Mercer" refers only to Mercer International Inc. and not to any of its subsidiaries.

Mercer will issue the notes under a base indenture, as supplemented by a supplemental indenture to be dated the date of the issuance of the notes offered by this prospectus supplement (which together we refer to herein as the "indenture"), among itself and Wells Fargo, N.A., as trustee. The terms of the notes will include those stated in the indenture and those made part of the indenture by reference to the Trust Indenture Act of 1939, as amended.

The following description is a summary of the material provisions of the indenture. It does not restate that agreement in its entirety. We urge you to read the indenture because it, and not this description, defines your rights as holders of the notes. We have filed a copy of the base indenture as an exhibit to the registration statement which includes this prospectus, and we will file a copy of the supplemental indenture as an exhibit to a current report on Form 8-K for incorporation by reference into the registration statement. Certain defined terms used in this description but not defined below under " Certain Definitions" have the meanings assigned to them in the supplemental indenture.

The registered holder of a note will be treated as the owner of it for all purposes. Only registered holders will have rights under the indenture.

Brief Description of the Notes

The notes:

- will be general unsecured obligations of Mercer;
- will be *pari passu* in right of payment with all existing and future unsecured senior Indebtedness of Mercer; and
- will be senior in right of payment to our 8.5% Senior Subordinated Convertible Notes due 2010 and any future subordinated Indebtedness of Mercer.

However, the notes will be effectively subordinated to all borrowings under the Credit Agreements, which will be secured by substantially all of the assets of certain of our Restricted Subsidiaries. See "Risk Factors We are a holding company and we are substantially dependent on cash provided by our subsidiaries to meet our debt service obligations under the notes." and " The notes will be effectively subordinated to all liabilities of our subsidiaries and are unsecured. We may not have sufficient funds to pay our obligations under the notes if we encounter financial difficulties."

The operations of Mercer are conducted through its Subsidiaries and, therefore, Mercer depends on the cash flow of its Subsidiaries to meet its obligations, including its obligations under the notes. The notes will be effectively subordinated in right of payment to all Indebtedness and other liabilities and commitments (including trade payables and lease obligations) of Mercer's Subsidiaries. Any right of Mercer to receive assets of any of its Subsidiaries upon the Subsidiary's liquidation or reorganization (and the consequent right of the holders of the notes to participate in those assets) will be effectively subordinated to the claims of that Subsidiary's creditors, except to the extent that Mercer is itself recognized as a creditor of the Subsidiary by reason of intercompany loans or otherwise, in which case the claims of Mercer would still be effectively subordinate in right of payment to any secured Indebtedness of the Subsidiary or Indebtedness senior to that held by Mercer. As of September 30, 2004, pro forma for the Acquisition and the refinancing of the outstanding Indebtedness of Rosenthal, as described under "Use of Proceeds," Mercer's Restricted Subsidiaries would have had approximately €308.0 million of Indebtedness and €26.4 million of trade payables and other liabilities outstanding.

As of the date of the supplemental indenture, Rosenthal and our acquisition subsidiary which is acquiring the Celgar mill (and their respective Subsidiaries) will be "Restricted Subsidiaries", and Stendal and Dresden (and their respective Subsidiaries) will be "Unrestricted Subsidiaries." Under the circumstances described below under the caption " Certain Covenants Designation of Restricted and Unrestricted Subsidiaries," we will be permitted to designate certain additional Subsidiaries of Mercer as Unrestricted subsidiaries. Our Unrestricted Subsidiaries will not be subject to many of the restrictive covenants in the indenture. We have presented unaudited pro forma financial information of Mercer and the Restricted Subsidiaries, which we refer to as the restricted group, elsewhere in this prospectus supplement to show the effect of excluding the assets, liabilities and results of operations of the Unrestricted Subsidiaries from the restricted group. See Note 6 to the "Notes to the Unaudited Pro Forma Consolidated Financial Statements." Mercer, a member of the restricted group, has guaranteed certain credit facilities totaling approximately €4.7 million relating to paper mills operated by Unrestricted Subsidiaries. None of our Subsidiaries will guarantee the notes, except in the circumstances described below under the caption " Certain Covenants Note Guarantees".

Principal, Maturity and Interest

Mercer will issue $310.0 million in aggregate principal amount of notes in this offering. Mercer may issue additional notes under the indenture from time to time after this offering. Any issuance of additional notes is subject to all of the covenants in the indenture, including the covenant described below under the caption " Certain Covenants Incurrence of Indebtedness and Issuance of Preferred Stock." The notes and any additional notes subsequently issued under the indenture will be treated as a single class for all purposes under the indenture, including, without limitation, waivers, amendments, redemptions and offers to purchase. Mercer will issue notes in denominations of $1,000 and integral multiples of $1,000. The notes will mature on February 15, 2013.

Interest on the notes will accrue at the rate of 9.25% per annum and will be payable semi-annually in arrears on February 15 and August 15, commencing on August 15, 2005. Interest on overdue principal and interest will accrue at a rate that is 1% higher than the then applicable interest rate on the notes. Mercer will make each interest payment to the holders of record on the immediately preceding February 1 and August 1.

Interest on the notes will accrue from the date of original issuance or, if interest has already been paid, from the date it was most recently paid. Interest will be computed on the basis of a 360-day year comprised of twelve 30-day months.

Methods of Receiving Payments on the Notes

If a holder of notes has given wire transfer instructions to Mercer, Mercer will pay all principal, interest and premium, if any, on that holder's notes in accordance with those instructions. All other payments on the notes will be made at the office or agency of the paying agent and registrar within the City and State of New York unless Mercer elects to make interest payments by check mailed to the noteholders at their address set forth in the register of holders.

Paying Agent and Registrar for the Notes

The trustee will initially act as paying agent and registrar. Mercer may change the paying agent or registrar without prior notice to the holders of the notes, and Mercer or any of its Subsidiaries may act as paying agent or registrar.

Transfer and Exchange

A holder may transfer or exchange notes in accordance with the provisions of the indenture. The registrar and the trustee may require a holder, among other things, to furnish appropriate endorsements and transfer documents in connection with a transfer of notes. Holders will be required

to pay all taxes due on transfer. Mercer will not be required to transfer or exchange any note selected for redemption. Also, Mercer will not be required to transfer or exchange any note for a period of 15 days before a selection of notes to be redeemed.

Optional Redemption

At any time prior to February 15, 2008, Mercer may on any one or more occasions redeem up to 35% of the aggregate principal amount of notes issued under the indenture at a redemption price of 109.25% of the principal amount, plus accrued and unpaid interest to the redemption date, with the net cash proceeds of a sale of Equity Interests (other than Disqualified Stock) of Mercer; *provided* that:

(1) at least 65% of the aggregate principal amount of notes originally issued under the indenture (excluding notes held by Mercer and its Subsidiaries) remains outstanding immediately after the occurrence of such redemption; and

(2) the redemption occurs within 90 days of the date of the closing of such sale of Equity Interests.

Except pursuant to the preceding paragraph, the notes will not be redeemable at Mercer's option prior to February 15, 2009.

On or after February 15, 2009, Mercer may redeem all or a part of the notes upon not less than 30 nor more than 60 days' notice, at the redemption prices (expressed as percentages of principal amount) set forth below plus accrued and unpaid interest on the notes redeemed, to the applicable redemption date, if redeemed during the twelve-month period beginning on February 15 of the years indicated below, subject to the rights of holders of notes on the relevant record date to receive interest on the relevant interest payment date:

Year	Percentage
2009	104.6250%
2010	102.3125%
2011 and thereafter	100.0000%

Unless Mercer defaults in the payment of the redemption price, interest will cease to accrue on the notes or portions thereof called for redemption on the applicable redemption date.

Mandatory Redemption

Mercer is not required to make mandatory redemption or sinking fund payments with respect to the notes.

Repurchase at the Option of Holders

Change of Control

If a Change of Control occurs, each holder of notes will have the right to require Mercer to repurchase all or any part (equal to $1,000 or an integral multiple of $1,000) of that holder's notes pursuant to a Change of Control Offer on the terms set forth in the indenture. In the Change of Control Offer, Mercer will offer a Change of Control Payment in cash equal to 101% of the aggregate principal amount of notes repurchased plus accrued and unpaid interest, if any, on the notes repurchased to the date of purchase, subject to the rights of holders of notes on the relevant record date to receive interest due on the relevant interest payment date. Within ten days following any Change of Control, Mercer will mail a notice to each holder describing the transaction or transactions that constitute the Change of Control and offering to repurchase notes on the Change of Control Payment Date specified in the notice, which date will be no earlier than 30 days and no later than 60 days from the date such notice is mailed, pursuant to the procedures required by the indenture and described in such notice. Mercer will comply with the requirements of Rule 14e-1 under the Exchange

Act and any other securities laws and regulations thereunder to the extent those laws and regulations are applicable in connection with the repurchase of the notes as a result of a Change of Control. To the extent that the provisions of any securities laws or regulations conflict with the Change of Control provisions of the indenture, Mercer will comply with the applicable securities laws and regulations and will not be deemed to have breached its obligations under the Change of Control provisions of the indenture by virtue of such compliance.

On the Change of Control Payment Date, Mercer will, to the extent lawful:

(1) accept for payment all notes or portions of notes properly tendered pursuant to the Change of Control Offer;

(2) deposit with the paying agent an amount equal to the Change of Control Payment in respect of all notes or portions of notes properly tendered; and

(3) deliver or cause to be delivered to the trustee the notes properly accepted together with an officers' certificate stating the aggregate principal amount of notes or portions of notes being purchased by Mercer.

The paying agent will promptly mail to each holder of notes properly tendered the Change of Control Payment for such notes, and the trustee will promptly authenticate and mail (or cause to be transferred by book entry) to each holder a new note equal in principal amount to any unpurchased portion of the notes surrendered, if any. Mercer will publicly announce the results of the Change of Control Offer on or as soon as practicable after the Change of Control Payment Date. The provisions described above that require Mercer to make a Change of Control Offer following a Change of Control will be applicable whether or not any other provisions of the indenture are applicable. Except as described above with respect to a Change of Control, the indenture does not contain provisions that permit the holders of the notes to require that Mercer repurchase or redeem the notes in the event of a takeover, recapitalization or similar transaction.

Mercer will not be required to make a Change of Control Offer upon a Change of Control if (1) a third party makes the Change of Control Offer in the manner, at the times and otherwise in compliance with the requirements set forth in the indenture applicable to a Change of Control Offer made by Mercer and purchases all notes properly tendered and not withdrawn under the Change of Control Offer, or (2) notice of redemption has been given pursuant to the indenture as described above under the caption "   Optional Redemption," unless and until there is a default in payment of the applicable redemption price.

The definition of Change of Control includes a phrase relating to the direct or indirect sale, lease, transfer, conveyance or other disposition of "all or substantially all" of the properties or assets of Mercer and its Subsidiaries taken as a whole. Although there is a limited body of case law interpreting the phrase "substantially all," there is no precise established definition of the phrase under applicable law. Accordingly, the ability of a holder of notes to require Mercer to repurchase its notes as a result of a sale, lease, transfer, conveyance or other disposition of less than all of the assets of Mercer and its Subsidiaries taken as a whole to another Person or group may be uncertain.

Asset Sales

Mercer will not, and will not permit any of its Restricted Subsidiaries to, consummate an Asset Sale unless:

(1) Mercer (or the Restricted Subsidiary, as the case may be) receives consideration at the time of the Asset Sale at least equal to the Fair Market Value of the assets or Equity Interests issued or sold or otherwise disposed of (provided that Fair Market Value shall be determined on the date of contractually agreeing to such Asset Sale); and

(2) at least 75% of the consideration received in the Asset Sale by Mercer or such Restricted Subsidiary is in the form of cash. For purposes of this provision, each of the following will be deemed to be cash:

(a) Cash Equivalents;

(b) any liabilities, as shown on Mercer's most recent consolidated balance sheet, of Mercer or any Restricted Subsidiary (other than contingent liabilities and liabilities that are by their terms subordinated to the notes) that are assumed by the transferee of any such assets pursuant to an agreement that releases Mercer or such Restricted Subsidiary from, or indemnifies Mercer or such Restricted Subsidiary against, further liability;

(c) any securities, notes or other obligations received by Mercer or any such Restricted Subsidiary from such transferee that are converted within 60 days by Mercer or such Restricted Subsidiary into cash or Cash Equivalents, to the extent of the cash or Cash Equivalents received in that conversion; and

(d) any stock or assets of the kind referred to in clauses (2) or (4) of the next paragraph of this covenant.

Within 365 days after the receipt of any Net Proceeds from an Asset Sale, Mercer (or the applicable Restricted Subsidiary, as the case may be) may apply such Net Proceeds:

(1) to permanently repay or prepay Indebtedness and other Obligations under a Credit Facility and, if the Indebtedness repaid is revolving credit Indebtedness, to correspondingly reduce commitments with respect thereto;

(2) to acquire (including by way of a purchase of assets or stock, merger, consolidation or otherwise), or enter into a binding commitment to acquire within 120 days thereafter, all or substantially all of the assets of, or any Capital Stock of, another Permitted Business, if, after giving effect to any such acquisition of Capital Stock, the Permitted Business is or becomes a Restricted Subsidiary of Mercer;

(3) to make, or enter into a binding commitment to make within 60 days thereafter, a capital expenditure; or

(4) to acquire other assets that are not classified as current assets under GAAP and that are used or useful in a Permitted Business.

Pending the final application of any Net Proceeds, Mercer or a Restricted Subsidiary may temporarily reduce revolving credit borrowings (under the Credit Facilities or otherwise) or otherwise invest the Net Proceeds in any manner that is not prohibited by the indenture.

Any Net Proceeds from Asset Sales that are not applied or invested as provided in the second paragraph of this covenant will constitute "*Excess Proceeds*." When the aggregate amount of Excess Proceeds exceeds $15.0 million, within five days thereof, Mercer will make an Asset Sale Offer to all holders of notes and all holders of other Indebtedness that is *pari passu* with the notes containing provisions similar to those set forth in the indenture with respect to offers to purchase or redeem with the proceeds of sales of assets to purchase the maximum principal amount of notes and such other *pari passu* Indebtedness that may be purchased out of the Excess Proceeds. The offer price in any Asset Sale Offer will be equal to 100% of the principal amount plus accrued and unpaid interest to the date of purchase, and will be payable in cash. If any Excess Proceeds remain after consummation of an Asset Sale Offer, Mercer may use those Excess Proceeds for any purpose not otherwise prohibited by the indenture. If the aggregate principal amount of notes and other *pari passu* Indebtedness tendered into such Asset Sale Offer exceeds the amount of Excess Proceeds, the trustee will select the notes and such other *pari passu* Indebtedness to be purchased on a *pro rata* basis. Upon completion of each Asset Sale Offer, the amount of Excess Proceeds will be reset at zero.

Mercer will comply with the requirements of Rule 14e-1 under the Exchange Act and any other securities laws and regulations thereunder to the extent those laws and regulations are applicable in connection with each repurchase of notes pursuant to an Asset Sale Offer. To the extent that the provisions of any securities laws or regulations conflict with the Asset Sale provisions of the indenture, Mercer will comply with the applicable securities laws and regulations and will not be deemed to have breached its obligations under the Asset Sale provisions of the indenture by virtue of such compliance.

Selection and Notice

If less than all of the notes are to be redeemed at any time, the trustee will select notes for redemption on a pro rata basis unless otherwise required by law or applicable stock exchange requirements.

No notes of $1,000 or less can be redeemed in part. Notices of redemption will be mailed by first class mail at least 30 but not more than 60 days before the redemption date to each holder of notes to be redeemed at its registered address, except that redemption notices may be mailed more than 60 days prior to a redemption date if the notice is issued in connection with a defeasance of the notes or a satisfaction and discharge of the indenture. Notices of redemption may not be conditional.

If any note is to be redeemed in part only, the notice of redemption that relates to that note will state the portion of the principal amount of that note that is to be redeemed. A new note in principal amount equal to the unredeemed portion of the original note will be issued in the name of the holder of notes upon cancellation of the original note. Notes called for redemption become due on the date fixed for redemption. On and after the redemption date, interest ceases to accrue on notes or portions of notes called for redemption.

Certain Covenants

Restricted Payments

Mercer will not, and will not permit any of its Restricted Subsidiaries to, directly or indirectly:

(1) declare or pay any dividend or make any other payment or distribution on account of Mercer's or any of its Restricted Subsidiaries' Equity Interests (including, without limitation, any payment in connection with any merger or consolidation involving Mercer or any of its Restricted Subsidiaries) or to the direct or indirect holders of Mercer's or any of its Restricted Subsidiaries' Equity Interests in their capacity as such (other than dividends or distributions payable in Equity Interests (other than Disqualified Stock) of Mercer and other than dividends or distributions payable to Mercer or a Restricted Subsidiary of Mercer);

(2) purchase, redeem or otherwise acquire or retire for value (including, without limitation, in connection with any merger or consolidation involving Mercer) any Equity Interests of Mercer or any direct or indirect parent of Mercer;

(3) make any payment on or with respect to, or purchase, redeem, defease or otherwise acquire or retire for value any Indebtedness of Mercer that is contractually subordinated to the notes (excluding any intercompany Indebtedness between or among Mercer and any of its Restricted Subsidiaries), except a payment of interest or principal at the Stated Maturity thereof; or

(4) make any Restricted Investment;

(all such payments and other actions set forth in these clauses (1) through (4) above being collectively referred to as "*Restricted Payments*"),

unless, at the time of and after giving effect to such Restricted Payment:

(1) no Default or Event of Default has occurred and is continuing or would occur as a consequence of such Restricted Payment;

(2)

Mercer would, at the time of such Restricted Payment and after giving pro forma effect thereto as if such Restricted Payment had been made at the beginning of the applicable four-quarter period, have been permitted to incur at least $1.00 of additional Indebtedness pursuant to the Fixed Charge Coverage Ratio test set forth in the first paragraph of the covenant described below under the caption " Incurrence of Indebtedness and Issuance of Preferred Stock;" and

(3)

such Restricted Payment, together with the aggregate amount of all other Restricted Payments made by Mercer and its Restricted Subsidiaries since the date of the supplemental indenture (excluding Restricted Payments permitted by clauses (2), (3), (4), (5), (7), and (8) of the next succeeding paragraph), is less than the sum, without duplication, of:

(a)

50% of the Consolidated Net Income of Mercer for the period (taken as one accounting period) from the beginning of the first fiscal quarter commencing after the date of the supplemental indenture to the end of Mercer's most recently ended fiscal quarter for which internal financial statements are available at the time of such Restricted Payment (or, if such Consolidated Net Income for such period is a deficit, less 100% of such deficit); *plus*

(b)

100% of the aggregate net cash proceeds received by Mercer since the date of the supplemental indenture (i) as a contribution to its common equity capital or from the issue or sale of Equity Interests of Mercer including upon exercise of stock options whether issued before or after the date of the supplemental indenture (other than Disqualified Stock) (excluding the issue or sale of Mercer common stock being used to finance, in part, the Acquisition, other than any Mercer common stock issued pursuant to any over-allotment option granted to the underwriters in connection therewith) or (ii) from the issue or sale of convertible or exchangeable Disqualified Stock or convertible or exchangeable debt securities of Mercer that have been converted into or exchanged for such Equity Interests (other than Equity Interests (or Disqualified Stock or debt securities) sold to a Subsidiary of Mercer); *plus*

(c)

to the extent that any Restricted Investment that was made after the date of the supplemental indenture is sold for cash or otherwise liquidated or repaid for cash, the lesser of (i) the cash return of capital with respect to such Restricted Investment (less the cost of disposition, if any) and (ii) the initial amount of such Restricted Investment; *plus*

(d)

to the extent that any Unrestricted Subsidiary of Mercer designated as such after the date of the supplemental indenture is redesignated as a Restricted Subsidiary after the date of the supplemental indenture, the lesser of (i) the Fair Market Value of Mercer's Investment in such Subsidiary as of the date of such redesignation or (ii) such Fair Market Value as of the date on which such Subsidiary was originally designated as an Unrestricted Subsidiary after the date of the supplemental indenture; *plus*

(e)

50% of (i) any dividends, interest, intercompany loan payments or other distributions received in cash by Mercer or a Wholly-Owned Restricted Subsidiary of Mercer after the date of the supplemental indenture from an Unrestricted Subsidiary of Mercer; (ii) without duplication, any amounts received in cash by Mercer or a Wholly-Owned Restricted Subsidiary of Mercer after the date of the supplemental indenture representing the proceeds of any settlement of any Hedging Obligations, to the extent that such dividends or cash proceeds represent gains previously recognized under GAAP and were not otherwise included in calculating the Consolidated Net Income of Mercer; and (iii) the amount of any marketing administration or other fee received in cash by Mercer or a Wholly Owned Restricted Subsidiary from an Unrestricted Subsidiary to the extent such amounts were not included in the Consolidated Net Income of Mercer for such period; *less* 100% of any payment made in settlement of any Hedging Obligations of Mercer and its Restricted Subsidiaries to the extent such payment represents cumulative net losses previously recognized under GAAP and not previously deducted in calculating the Consolidated Net Income of Mercer.

So long as no Default has occurred and is continuing or would be caused thereby, the preceding provisions will not prohibit:

(1) the payment of any dividend or the consummation of any irrevocable redemption within 60 days after the date of declaration of the dividend or giving of the redemption notice, as the case may be, if at the date of declaration or notice, the dividend or redemption payment would have complied with the provisions of the indenture;

(2) the making of any Restricted Payment in exchange for, or out of the net cash proceeds of the substantially concurrent sale (other than to a Subsidiary of Mercer) of, Equity Interests of Mercer (other than Disqualified Stock) or from the substantially concurrent contribution of common equity capital to Mercer; *provided* that the amount of any such net cash proceeds that are utilized for any such Restricted Payment will be excluded from clause (3)(b) of the preceding paragraph;

(3) the repurchase, redemption, defeasance or other acquisition or retirement for value of Indebtedness of Mercer that is contractually subordinated to the notes with (a) the net cash proceeds from a substantially concurrent incurrence of Permitted Refinancing Indebtedness, or (b) after the completion of a Change in Control Offer pursuant to the terms of the covenant described above under the caption " Repurchase at the Option of Holders Change of Control," to the extent required pursuant to any similar change of control offer provision of the indenture or other agreement governing Subordinated Indebtedness (including the Subordinated Notes);

(4) the repurchase, redemption, defeasance or other acquisition or retirement for value of Mercer's Subordinated Notes in the event that the daily closing sale price per share of Mercer's common stock on the Nasdaq National Market (or, if Mercer's common stock is no longer traded on the Nasdaq National Market, the principal public trading market, including the Toronto Stock Exchange, for such common stock) for a period of at least ten (10) consecutive Trading Days exceeds 120% of the then-applicable conversion price of the Subordinated Notes, determined in accordance with the terms of the Subordinated Indenture as in effect on the date of the supplemental indenture;

(5) the payment of any dividend (or, in the case of any partnership or limited liability company, any similar distribution) by a Restricted Subsidiary of Mercer to the holders of its Equity Interests who are not Affiliates of Mercer, except Restricted Subsidiaries of Mercer, on a *pro rata* basis;

(6) the repurchase, redemption or other acquisition or retirement for value of any Equity Interests of Mercer or any Restricted Subsidiary of Mercer held by any current or former officer, trustee, director or employee of Mercer or any of its Restricted Subsidiaries pursuant to any equity subscription agreement, stock option agreement, shareholders' agreement or similar agreement; *provided* that the aggregate price paid for all such repurchased, redeemed, acquired or retired Equity Interests may not exceed $2.0 million in any twelve-month period;

(7) the repurchase of Equity Interests deemed to occur upon the exercise of stock options or stock appreciation rights to the extent such Equity Interests represent a portion of the exercise price of those stock options or stock appreciation rights;

(8) the declaration and payment of regularly scheduled or accrued dividends to holders of any class or series of Disqualified Stock of Mercer issued on or after the date of the supplemental indenture in accordance with the Fixed Charge Coverage Ratio test described below under the caption " Incurrence of Indebtedness and Issuance of Preferred Stock;"

(9) payments or distributions to shareholders exercising appraisal or discount rights pursuant to applicable law pursuant to or in connection with a merger, consolidation or transfer of all or substantially all of Mercer and its Restricted Subsidiary assets that complies with the provisions of the indenture;

(10) in the event of a Change of Control, and if no Default or Event of Default shall have occurred and be continuing, the payment, purchase, redemption, defeasance or other acquisition or retirement of Indebtedness of Mercer or any Guarantor that is subordinated or junior in right of payment to the Notes or the Guarantee of such Guarantor, in each case, at a purchase price not greater than 101% of the principal amount of such Indebtedness, plus any accrued and unpaid interest therein; *provided* that prior or contemporaneously with such payment, purchase, redemption or defeasance or other acquisition or retirement, Mercer (or a third party to the extent permitted by the indenture) has made the Change of Control Offer with respect to the Notes and has repurchased all Notes validly tendered and not withdrawn in connection with such Change of Control Offer;

(11) in the event of an Asset Sale which requires Mercer to make an Asset Sale Offer, and if no Default or Event of Default shall have occurred and be continuing, the payment, purchase, redemption, defeasance or other acquisition or retirement of Indebtedness of Mercer or any Guarantor that is subordinated or junior in right of payment to the Notes or the Guarantee of such Guarantor, in each case, at a purchase price not greater than 100% of the principal amount of such Indebtedness, plus any accrued and unpaid interest therein; *provided* that prior or contemporaneously with such payment, purchase, redemption or defeasance or other acquisition or retirement, the Company has made an Asset Sale Offer with respect to the Notes and has repurchased all Notes validly tendered and not withdrawn in connection with such Asset Sale Offer;

(12) the purchase, redemption, acquisition, cancellation or other retirement for a nominal value per right of any rights granted to all the holders of Common Stock of Mercer pursuant to any shareholders' rights plan adopted for the purpose of protecting shareholders from unfair takeover practices; *provided* that any such purchase, redemption, acquisition, cancellation or other retirement of such rights shall not be for the purpose of evading the limitations of this covenant (as determined in good faith by the Board of Directors of Mercer); and

(13) other Restricted Payments in an aggregate amount not to exceed $15.0 million since the date of the supplemental indenture.

The amount of all Restricted Payments (other than cash) will be the Fair Market Value on the date of the Restricted Payment of the asset(s) or securities proposed to be transferred or issued by Mercer or such Restricted Subsidiary, as the case may be, pursuant to the Restricted Payment. The Fair Market Value of any assets or securities that are required to be valued by this covenant will be determined in good faith (a) in the case of assets or securities of $5.0 million or less by the Chief Financial Officer, Controller or Treasurer of Mercer set forth in a certificate delivered to the trustee, and (b) in the case of assets or securities valued at more than $5.0 million by the Board of Directors of Mercer, and set forth in an officers certificate delivered to the trustee. The Board of Directors' determination must be based upon an opinion or appraisal issued by an accounting, appraisal or investment banking firm of national standing in the United States or Canada if the Fair Market Value exceeds $20.0 million.

Incurrence of Indebtedness and Issuance of Preferred Stock

Mercer will not, and will not permit any of its Restricted Subsidiaries to, directly or indirectly, create, incur, issue, assume, guarantee or otherwise become directly or indirectly liable, contingently or otherwise, with respect to (collectively, "*incur*") any Indebtedness (including Acquired Debt), and Mercer will not issue any Disqualified Stock and will not permit any of its Restricted Subsidiaries to issue any shares of preferred stock; *provided, however*, that Mercer may incur Indebtedness (including Acquired Debt) or issue Disqualified Stock and any Restricted Subsidiary that is a Guarantor may incur Indebtedness (including Acquired Debt) or issue preferred stock if the Fixed Charge Coverage Ratio for Mercer's most recently ended four full fiscal quarters for which internal financial statements

are available immediately preceding the date on which such additional Indebtedness is incurred or such Disqualified Stock or such preferred stock is issued, as the case may be, would have been at least 2.0 to 1, determined on a pro forma basis (including a pro forma application of the net proceeds therefrom), as if the additional Indebtedness had been incurred or the Disqualified Stock or the preferred stock had been issued, as the case may be, at the beginning of such four-quarter period.

The first paragraph of this covenant will not prohibit the incurrence of any of the following items of Indebtedness (collectively, "*Permitted Debt*"):

(1)
the incurrence by Mercer and its Restricted Subsidiaries of additional Indebtedness and letters of credit under Credit Facilities in an aggregate principal amount at any one time outstanding under this clause (1) (with letters of credit being deemed to have a principal amount equal to the maximum potential liability of Mercer and its Restricted Subsidiaries thereunder) not to exceed the greater of (x) $85.0 million *less* the aggregate amount of all Net Proceeds of Asset Sales applied by Mercer or any of its Restricted Subsidiaries since the date of the supplemental indenture to repay any term Indebtedness under a Credit Facility or to repay any revolving credit Indebtedness under a Credit Facility and effect a corresponding commitment reduction thereunder pursuant to the covenant described above under the caption " Repurchase at the Option of Holders Asset Sales", or (y) the amount of the Borrowing Base on the date of incurrence.

(2)
the incurrence by Mercer and its Restricted Subsidiaries of the Existing Indebtedness;

(3)
the incurrence by Mercer of Indebtedness represented by the notes to be issued on the date of the supplemental indenture;

(4)
the incurrence by Mercer or any of its Restricted Subsidiaries of Indebtedness represented by Capital Lease Obligations, mortgage financings**,** project financing, or purchase money obligations, in each case, incurred for the purpose of financing all or any part of the purchase price or cost of design, construction, installation or improvement of property, plant or equipment used in the business of Mercer or any of its Restricted Subsidiaries, in an aggregate principal amount, including all Permitted Refinancing Indebtedness incurred to renew, refund, refinance, replace, defease or discharge any Indebtedness incurred pursuant to this clause (4), not to exceed at any time outstanding $20.0 million plus an amount not to exceed $10.0 million equal to all German federal and state grant receivables in connection therewith;

(5)
the incurrence by Mercer or any of its Restricted Subsidiaries of Permitted Refinancing Indebtedness in exchange for, or the net proceeds of which are used to renew, refund, refinance, replace, defease or discharge any Indebtedness that was permitted by the indenture to be incurred under the first paragraph of this covenant or clauses (2), (3), (4), (5) or (14) of this paragraph;

(6)
the incurrence by Mercer or any of its Restricted Subsidiaries of intercompany Indebtedness between or among Mercer and any of its Restricted Subsidiaries; *provided, however*, that:

(a)
if Mercer is the obligor on such Indebtedness, such Indebtedness must be expressly subordinated to the prior payment in full in cash of all Obligations then due with respect to the notes; and

(b)
(i) any subsequent issuance or transfer of Equity Interests that results in any such Indebtedness being held by a Person other than Mercer or a Restricted Subsidiary of Mercer and (ii) any sale or other transfer of any such Indebtedness to a Person that is not either Mercer or a Restricted Subsidiary of Mercer, will be deemed, in each case, to constitute an incurrence of such Indebtedness by Mercer or such Restricted Subsidiary, as the case may be, that was not permitted by this clause (6);

(7) the issuance by any of Mercer's Restricted Subsidiaries to Mercer or to any of its Restricted Subsidiaries of shares of preferred stock; *provided, however,* that:

(a) any subsequent issuance or transfer of Equity Interests that results in any such preferred stock being held by a Person other than Mercer or a Restricted Subsidiary of Mercer; and

(b) any sale or other transfer of any such preferred stock to a Person that is not either Mercer or a Restricted Subsidiary of Mercer,

will be deemed, in each case, to constitute an issuance of such preferred stock by such Restricted Subsidiary that was not permitted by this clause (7);

(8) the incurrence by Mercer or any of its Restricted Subsidiaries of Hedging Obligations (which may, but need not be, under Credit Facilities) in the ordinary course of business and not for speculation;

(9) the guarantee by Mercer or any of its Restricted Subsidiaries that executes a Note Guarantee of Indebtedness of Mercer or a Restricted Subsidiary of Mercer that was permitted to be incurred by another provision of this covenant; *provided* that if the Indebtedness being guaranteed is subordinated to or *pari passu* with the notes, then the Guarantee shall be subordinated or *pari passu*, as applicable, to the same extent as the Indebtedness guaranteed;

(10) the incurrence by Mercer or any of its Restricted Subsidiaries of Indebtedness in respect of workers' compensation claims, self-insurance obligations, bankers' acceptances, performance and surety bonds in the ordinary course of business;

(11) the incurrence by Mercer or any of its Restricted Subsidiaries of Indebtedness arising from the honoring by a bank or other financial institution of a check, draft or similar instrument inadvertently drawn against insufficient funds, so long as such Indebtedness is covered within five business days;

(12) Indebtedness of a Restricted Subsidiary incurred and outstanding on or prior to the date on which such Restricted Subsidiary was acquired by Mercer (other than Indebtedness incurred in contemplation of, or in connection with, the transaction or series of related transactions pursuant to which such Restricted Subsidiary became a Restricted Subsidiary of or was otherwise acquired by Mercer); provided, however, that for any such Indebtedness outstanding at any time under this clause (12), on the date that such Subsidiary is acquired by Mercer, Mercer would have been able to incur $1.00 of additional Indebtedness pursuant to the first paragraph of this covenant and Mercer's Fixed Charge Coverage Ratio would not be reduced after giving effect to the incurrence of such Indebtedness pursuant to this clause (12);

(13) Indebtedness arising from agreements of Mercer or a Restricted Subsidiary providing for indemnification, adjustment of purchase price or similar obligations, in each case incurred or assumed in connection with the disposition of any assets or property or Capital Stock of a Restricted Subsidiary; and

(14) the incurrence by Mercer or any of its Restricted Subsidiaries of additional Indebtedness (which may, but need not, be pursuant to Credit Facilities) in an aggregate principal amount (or accreted value, as applicable) at any time outstanding, including all Permitted Refinancing Indebtedness incurred to renew, refund, refinance, replace, defease or discharge any Indebtedness incurred pursuant to this clause (14), not to exceed $20.0 million.

Mercer will not incur any Indebtedness (including Permitted Debt) that is contractually subordinated in right of payment to any other Indebtedness of Mercer unless such Indebtedness is also contractually subordinated in right of payment to the notes on substantially identical terms; *provided, however*, that no Indebtedness will be deemed to be contractually subordinated in right of payment to

any other Indebtedness of Mercer solely by virtue of being unsecured or by virtue of being secured on a first or junior Lien basis.

For purposes of determining compliance with this "Incurrence of Indebtedness and Issuance of Preferred Stock" covenant, in the event that an item of proposed Indebtedness meets the criteria of more than one of the categories of Permitted Debt described in clauses (1) through (14) above, or is entitled to be incurred pursuant to the first paragraph of this covenant, Mercer will be permitted to classify such item of Indebtedness on the date of its incurrence, or later reclassify all or a portion of such item of Indebtedness, in any manner that complies with this covenant. Indebtedness under Credit Facilities outstanding on the date on which notes are first issued and authenticated under the indenture will initially be deemed to have been incurred on such date in reliance on the exception provided by clause (1) of the definition of Permitted Debt. Indebtedness permitted by this covenant need not be permitted solely by reference to one provision permitting such Indebtedness but may be permitted in part by one such provision and in part by one or more other provisions of this covenant permitting such Indebtedness. The accrual of interest, the accretion or amortization of original issue discount, the payment of interest on any Indebtedness in the form of additional Indebtedness with the same terms, the reclassification of preferred stock as Indebtedness due to a change in accounting principles, and the payment of dividends on Disqualified Stock or preferred stock in the form of additional shares of the same class of Disqualified Stock or preferred stock will not be deemed to be an incurrence of Indebtedness or an issuance of Disqualified Stock or preferred stock for purposes of this covenant; *provided*, in each such case, that the amount of any such accrual, accretion or payment is included in Fixed Charges of Mercer as accrued. For purposes of determining compliance with any U.S. dollar-denominated restriction on the incurrence of Indebtedness, the U.S. dollar-equivalent principal amount of Indebtedness denominated in a foreign currency shall be calculated based on the relevant currency exchange rate in effect on the date such Indebtedness was incurred, in the case of term Indebtedness, or first committed, in the case of revolving credit Indebtedness; provided that if such Indebtedness is incurred to refinance other Indebtedness denominated in a foreign currency, and such refinancing would cause the applicable U.S. dollar-denominated restriction to be exceeded if calculated at the relevant currency exchange rate in effect on the date of such refinancing, such U.S. dollar-denominated restriction shall be deemed not to have been exceeded so long as the principal amount of such refinancing Indebtedness does not exceed the principal amount of such Indebtedness being refinanced. Notwithstanding any other provision of this indenture, the maximum amount of Indebtedness that Mercer or any Restricted Subsidiary may incur pursuant to this covenant shall not be or be deemed to be exceeded as a result of fluctuations in exchange rates or currency values.

The amount of any Indebtedness outstanding as of any date will be:

(1) the accreted value of the Indebtedness, in the case of any Indebtedness issued with original issue discount;

(2) the principal amount of the Indebtedness, in the case of any other Indebtedness; and

(3) in respect of Indebtedness of another Person secured by a Lien on the assets of the specified Person, the lesser of:

 (a) the Fair Market Value of such assets at the date of determination; and

 (b) the amount of the Indebtedness of the other Person.

Liens

Mercer will not, and will not permit any of its Restricted Subsidiaries to, directly or indirectly, create, incur, assume or suffer to exist any Lien of any kind on any asset now owned or hereafter acquired, except Permitted Liens, unless all payments due under the indenture and the notes are secured on an equal and ratable basis with the obligations so secured until such time as such obligations are no longer secured by a Lien.

Limitation on Sale and Leaseback Transactions

Mercer will not, and will not permit any of its Restricted Subsidiaries to, enter into any sale and leaseback transaction; *provided* that Mercer or any Restricted Subsidiary may enter into a sale and leaseback transaction if:

(1) Mercer or that Restricted Subsidiary, as applicable, could have (a) incurred Indebtedness in an amount equal to the Attributable Debt relating to such sale and leaseback transaction under the Fixed Charge Coverage Ratio test in the first paragraph of the covenant described above under the caption " Incurrence of Indebtedness and Issuance of Preferred Stock" and (b) incurred a Lien to secure such Indebtedness pursuant to the covenant described above under the caption " Liens";

(2) the gross cash proceeds of that sale and leaseback transaction are at least equal to the Fair Market Value of the property that is the subject of that sale and leaseback transaction; and

(3) the transfer of assets in that sale and leaseback transaction is permitted by, and Mercer applies the proceeds of such transaction in compliance with, the covenant described above under the caption " Repurchase at the Option of Holders Asset Sales."

Dividend and Other Payment Restrictions Affecting Subsidiaries

Mercer will not, and will not permit any of its Restricted Subsidiaries to, directly or indirectly, create or permit to exist or become effective any consensual encumbrance or restriction on the ability of any Restricted Subsidiary to:

(1) pay dividends or make any other distributions on its Capital Stock to Mercer or any of its Restricted Subsidiaries, or with respect to any other interest or participation in, or measured by, its profits, or pay any indebtedness owed to Mercer or any of its Restricted Subsidiaries;

(2) make loans or advances to Mercer or any of its Restricted Subsidiaries; or

(3) sell, lease or transfer any of its properties or assets to Mercer or any of its Restricted Subsidiaries.

However, the preceding restrictions will not apply to encumbrances or restrictions existing under or by reason of:

(1) agreements governing Existing Indebtedness and Credit Facilities as in effect on the date of the supplemental indenture and any amendments, restatements, modifications, renewals, supplements, refundings, replacements or refinancings of those agreements; *provided* that the amendments, restatements, modifications, renewals, supplements, refundings, replacements or refinancings are not materially more restrictive, taken as a whole, with respect to such dividend and other payment restrictions than those contained in those agreements on the date of the supplemental indenture;

(2) the indenture and the notes;

(3) applicable law, rule, regulation or order;

(4) any instrument governing Indebtedness or Capital Stock of a Person acquired by Mercer or any of its Restricted Subsidiaries as in effect at the time of such acquisition (except to the extent such Indebtedness or Capital Stock was incurred in connection with or in contemplation of such acquisition), which encumbrance or restriction is not applicable to any Person, or the properties or assets of any Person, other than the Person, or the property or assets of the Person, so acquired; *provided* that, in the case of Indebtedness, such Indebtedness was permitted by the terms of the indenture to be incurred;

(5) customary non-assignment provisions in contracts and licenses entered into in the ordinary course of business;

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(6) purchase money obligations for property acquired in the ordinary course of business and Capital Lease Obligations that impose restrictions on the property purchased or leased of the nature described in clause (3) of the preceding paragraph;

(7) any agreement for the sale or other disposition of a Restricted Subsidiary or assets that restricts distributions by that Restricted Subsidiary or the transfer of the assets pending the sale or other disposition;

(8) Permitted Refinancing Indebtedness; *provided* that the restrictions contained in the agreements governing such Permitted Refinancing Indebtedness are not materially more restrictive, taken as a whole, than those contained in the agreements governing the Indebtedness being refinanced;

(9) Liens permitted to be incurred under the provisions of the covenant described above under the caption " Liens" that limit the right of the debtor to dispose of the assets subject to such Liens;

(10) provisions limiting the disposition or distribution of assets or property in joint venture agreements, asset sale agreements, sale-leaseback agreements, Capital Stock sale agreements and other similar agreements entered into with the approval of Mercer's Board of Directors, which limitation is applicable only to the assets, or (in the case of Capital Stock sales) entities, that are the subject of such agreements;

(11) restrictions on cash or other deposits or net worth imposed by customers under contracts entered into in the ordinary course of business; and

(12) agreements governing Indebtedness permitted to be incurred by Restricted Subsidiaries of Mercer under the provisions of the covenant described above under the caption " Incurrence of Indebtedness and Issuance of Preferred Stock;" *provided* that such agreements (except those agreements entered into pursuant to clause (14) of the definition of "Permitted Debt") are not materially more restrictive, taken as a whole, with respect to such dividend and other payment restrictions than those contained in the agreements governing Credit Facilities as in effect on the date of the supplemental indenture.

Merger, Consolidation or Sale of Assets

Mercer will not, directly or indirectly: (1) consolidate or merge with or into another Person (whether or not Mercer is the surviving corporation); or (2) sell, assign, transfer, convey or otherwise dispose of all or substantially all of the properties or assets of Mercer and its Restricted Subsidiaries taken as a whole, in one or more related transactions, to another Person, unless:

(1) either: (a) Mercer is the surviving corporation; or (b) the Person formed by or surviving any such consolidation or merger (if other than Mercer) or to which such sale, assignment, transfer, conveyance or other disposition has been made is a corporation organized or existing under the laws of the United States, any state of the United States or the District of Columbia, or the laws of Canada or any province or territory thereof;

(2) the Person formed by or surviving any such consolidation or merger (if other than Mercer) or the Person to which such sale, assignment, transfer, conveyance or other disposition has been made assumes all the obligations of Mercer under the notes, the indenture and pursuant to agreements reasonably satisfactory to the trustee;

(3) immediately after such transaction, no Default or Event of Default exists; and

(4) Mercer or the Person formed by or surviving any such consolidation or merger (if other than Mercer), or to which such sale, assignment, transfer, conveyance or other disposition has been made would, on the date of such transaction after giving pro forma effect thereto and any related financing transactions as if the same had occurred at the beginning of the applicable four-quarter period, be permitted to incur at least $1.00 of additional Indebtedness pursuant to the Fixed

Charge Coverage Ratio test set forth in the first paragraph of the covenant described above under the caption " Incurrence of Indebtedness and Issuance of Preferred Stock."

In addition, Mercer will not, directly or indirectly, lease all or substantially all of the properties and assets of it and its Restricted Subsidiaries taken as a whole, in one or more related transactions, to any other Person.

This "Merger, Consolidation or Sale of Assets" covenant will not apply to:

(1) a merger of Mercer with an Affiliate solely for the purpose of reincorporating Mercer in another jurisdiction;

(2) a conversion of Mercer from a business trust into a corporation organized or existing under the laws of the United States, any state of the United States or the District of Columbia including by way of a merger with an Affiliate; or

(3) any consolidation or merger, or any sale, assignment, transfer, conveyance, lease or other disposition of assets between or among Mercer and its Restricted Subsidiaries.

Transactions with Affiliates

Mercer will not, and will not permit any of its Restricted Subsidiaries to, make any payment to, or sell, lease, transfer or otherwise dispose of any of its properties or assets to, or purchase any property or assets from, or enter into or make or amend any transaction, contract, agreement, understanding, loan, advance or guarantee with, or for the benefit of, any Affiliate of Mercer (each, an "*Affiliate Transaction*"), unless:

(1) the Affiliate Transaction is on terms that are no less favorable to Mercer or the relevant Restricted Subsidiary than those that would have reasonably been obtained in a comparable transaction by Mercer or such Restricted Subsidiary with an unrelated Person; and

(2) Mercer delivers to the trustee:

(a) with respect to any Affiliate Transaction or series of related Affiliate Transactions involving aggregate consideration in excess of $5.0 million, a resolution of the Board of Directors of Mercer set forth in an officers' certificate certifying that such Affiliate Transaction complies with this covenant and that such Affiliate Transaction has been approved by a majority of the disinterested members of the Board of Directors of Mercer; and

(b) with respect to any Affiliate Transaction or series of related Affiliate Transactions involving aggregate consideration in excess of $20.0 million, an opinion as to the fairness to Mercer or such Restricted Subsidiary of such Affiliate Transaction from a financial point of view issued by an accounting, appraisal or investment banking firm of national standing in the United States or Canada.

The following items will not be deemed to be Affiliate Transactions and, therefore, will not be subject to the provisions of the prior paragraph:

(1) any employment agreement, employee benefit plan, officer, trustee or director indemnification agreement or any similar arrangement entered into by Mercer or any of its Restricted Subsidiaries in the ordinary course of business and payments pursuant thereto;

(2) transactions between or among Mercer and/or its Restricted Subsidiaries;

(3) transactions with a Person (other than an Unrestricted Subsidiary of Mercer) that is an Affiliate of Mercer solely because Mercer owns, directly or through a Restricted Subsidiary, an Equity Interest in, or controls, such Person;

(4) payment of reasonable compensation or fees to trustees, directors or officers of Mercer and its Restricted Subsidiaries;

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(5) any issuance of Equity Interests (other than Disqualified Stock) of Mercer to Affiliates of Mercer;

(6) Restricted Payments that do not violate the provisions of the indenture described above under the caption " Restricted Payments;"

(7) Permitted Investments that are permitted by the provisions of the supplemental indenture;

(8) provision of corporate-level administrative, marketing, tax, accounting, budgeting, treasury, finance, employee benefits, legal, risk management and other similar services for the benefit of Unrestricted Subsidiaries of Mercer on substantially the same terms provided to Restricted Subsidiaries of Mercer;

(9) payment of consolidated taxes on behalf of Restricted Subsidiaries and Unrestricted Subsidiaries;

(10) purchases, sales or other transfers of pulp , fibre, chemicals and other consumables between or among Mercer or any Restricted Subsidiary and any Unrestricted Subsidiary at market prices pursuant to arrangements approved by Mercer's Board of Directors as being fair, from a financial point of view, to Mercer or the applicable Restricted Subsidiary, as the case may be; purchases, sales or other transfers of spare parts or mill consumables between any Restricted Subsidiary and any Unrestricted Subsidiary at book value; and the provision of logistics, planning, and transportation services between and/or among any Restricted Subsidiary and Unrestricted Subsidiary at cost; and other transactions with customers, clients, suppliers or purchasers or sellers of goods or services, in each case in the ordinary course of business and otherwise in compliance with the terms of the indenture, that are fair to Mercer or the Restricted Subsidiary, as the case may be, in the reasonable determination of Mercer's Board of Directors;

(11) payment of sales agency, administration, management and other fees, payment of interest, principal, dividends or other distributions, in case from an Unrestricted Subsidiary to Mercer or a Restricted Subsidiary to Mercer; and

(12) loans or advances to employees in the ordinary course of business not to exceed $2.0 million in the aggregate at any one time outstanding.

Business Activities

Mercer will not, and will not permit any of its Restricted Subsidiaries to, engage in any business other than Permitted Businesses, except to such extent as would not be material to Mercer and its Restricted Subsidiaries taken as a whole.

Note Guarantees

If Mercer or any of its Restricted Subsidiaries acquires or creates a Domestic Subsidiary after the date of the supplemental indenture, then that newly acquired or created Domestic Subsidiary (other than a Domestic Subsidiary the sole business of which is the direct or indirect ownership of one or more Foreign Subsidiaries) will become a Guarantor and execute a supplemental indenture and deliver an opinion of counsel satisfactory to the trustee within 10 business days of the date on which it was acquired or created; *provided* that any Domestic Subsidiary that does not constitute a Significant Subsidiary need not become a Guarantor until such time as it is a Significant Subsidiary. Mercer may designate any Restricted Subsidiary as a Guarantor at any time.

Limitation on Issuances of Guarantees of Indebtedness

Mercer will not permit any of its Restricted Subsidiaries, directly or indirectly, to Guarantee or pledge any assets to secure the payment of any other Indebtedness of Mercer (except Permitted Liens) unless such Restricted Subsidiary simultaneously executes and delivers a supplemental indenture providing for the Guarantee of the payment of the notes by such Restricted Subsidiary, which Guarantee will be senior to or *pari passu* with such Restricted Subsidiary's Guarantee of or pledge to secure such other Indebtedness.

The Note Guarantee of a Guarantor will automatically and unconditionally be released:

(1) in connection with any sale or other disposition of all or substantially all of the assets of that Guarantor (including by way of merger or consolidation) to a Person that is not (either before or after giving effect to such transaction) Mercer or a Restricted Subsidiary of Mercer, if the sale or other disposition does not violate the "Asset Sale" provisions of the indenture;

(2) in connection with any sale or other disposition of all of the Capital Stock of that Guarantor to a Person that is not (either before or after giving effect to such transaction) Mercer or a Restricted Subsidiary of Mercer, if the sale or other disposition does not violate the "Asset Sale" provisions of the indenture;

(3) if Mercer designates any Restricted Subsidiary that is a Guarantor to be an Unrestricted Subsidiary in accordance with the applicable provisions of the indenture; or

(4) upon legal defeasance or satisfaction and discharge of the indenture as provided below under the captions " Legal Defeasance and Covenant Defeasance" and " Satisfaction and Discharge."

The form of the Note Guarantee will be attached as an exhibit to the supplemental indenture.

Designation of Restricted and Unrestricted Subsidiaries

The Board of Directors of Mercer may designate any Restricted Subsidiary to be an Unrestricted Subsidiary if that designation would not cause a Default. If a Restricted Subsidiary is designated as an Unrestricted Subsidiary, the aggregate Fair Market Value of all outstanding Investments owned by Mercer and its Restricted Subsidiaries in the Subsidiary designated as Unrestricted will be deemed to be an Investment made as of the time of the designation and will reduce the amount available for Restricted Payments under the covenant described above under the caption " Restricted Payments" or under one or more clauses of the definition of Permitted Investments, as determined by Mercer. That designation will only be permitted if the Investment would be permitted at that time and if the

Restricted Subsidiary otherwise meets the definition of an Unrestricted Subsidiary. The Board of Directors of Mercer may redesignate any Unrestricted Subsidiary to be a Restricted Subsidiary if that redesignation would not cause a Default.

Any designation of a Restricted Subsidiary of Mercer as an Unrestricted Subsidiary will be evidenced to the trustee by filing with the trustee a certified copy of a resolution of the Board of Directors giving effect to such designation and an officers' certificate certifying that such designation complied with the preceding conditions and was permitted by the covenant described above under the caption " Restricted Payments." If, at any time, any Unrestricted Subsidiary would fail to meet the preceding requirements as an Unrestricted Subsidiary, it will thereafter cease to be an Unrestricted Subsidiary for purposes of the indenture and any Indebtedness of such Subsidiary will be deemed to be incurred by a Restricted Subsidiary of Mercer as of such date and, if such Indebtedness is not permitted to be incurred as of such date under the covenant described under the caption " Incurrence of Indebtedness and Issuance of Preferred Stock," Mercer will be in default of such covenant. The Board of Directors of Mercer may at any time designate any Unrestricted Subsidiary to be a Restricted Subsidiary of Mercer; *provided* that such designation will be deemed to be an incurrence of Indebtedness by a Restricted Subsidiary of Mercer of any outstanding Indebtedness of such Unrestricted Subsidiary, and such designation will only be permitted if (1) such Indebtedness is permitted under the covenant described under the caption " Incurrence of Indebtedness and Issuance of Preferred Stock," calculated on a pro forma basis as if such designation had occurred at the beginning of the four-quarter reference period; and (2) no Default or Event of Default would be in existence following such designation.

No Amendment to Subordination Provisions

Without the consent of the holders of at least a majority in aggregate principal amount of the notes then outstanding, Mercer will not amend, modify or alter the Subordinated Note Indenture in any way to:

(1) increase the rate of or advance the time for payment of interest on any Subordinated Notes;

(2) increase the principal of, advance the final maturity date of or shorten the Weighted Average Life to Maturity of any Subordinated Notes;

(3) alter the redemption provisions, increase the price or otherwise alter terms at which Mercer is required to offer to purchase any Subordinated Notes; or

(4) amend the provisions of Article 5 of the Subordinated Note Indenture (which relate to subordination);

provided that none of the foregoing shall prohibit amendments to the Subordinated Note Indenture that provide for satisfaction of any obligation thereunder solely in common stock of Mercer.

Payments for Consent

Mercer will not, and will not permit any of its Restricted Subsidiaries to, directly or indirectly, pay or cause to be paid any consideration to or for the benefit of any holder of notes for or as an inducement to any consent, waiver or amendment of any of the terms or provisions of the indenture or the notes unless such consideration is offered to be paid and is paid to all holders of the notes that consent, waive or agree to amend in the time frame set forth in the solicitation documents relating to such consent, waiver or agreement.

Reports

Whether or not required by the rules and regulations of the SEC, so long as any notes are outstanding, Mercer will furnish to the holders of notes or cause the trustee to furnish to the holders of notes, within the time periods specified in the SEC's rules and regulations:

(1) all quarterly and annual reports that would be required to be filed with the SEC on Forms 10-Q and 10-K if Mercer were required to file such reports; and

(2) all current reports that would be required to be filed with the SEC on Form 8-K if Mercer were required to file such reports.

All such reports will be prepared in all material respects in accordance with all of the rules and regulations applicable to such reports. Each annual report on Form 10-K will include a report on Mercer's consolidated financial statements by Mercer's certified independent accountants. In addition, Mercer will file a copy of each of the reports referred to in clauses (1) and (2) above with the SEC for public availability within the time periods specified in the rules and regulations applicable to such reports (unless the SEC will not accept such a filing).

If, at any time, Mercer is no longer subject to the periodic reporting requirements of the Exchange Act for any reason, Mercer will nevertheless continue filing the reports specified in the preceding paragraphs of this covenant with the SEC within the time periods specified above unless the SEC will not accept such a filing. Mercer will not take any action for the purpose of causing the SEC not to accept any such filings. If, notwithstanding the foregoing, the SEC will not accept Mercer's filings for any reason, Mercer will post the reports referred to in the preceding paragraphs on its website within the time periods that would apply if Mercer were required to file those reports with the SEC.

The quarterly and annual financial information required by the preceding paragraphs will include a reasonably detailed presentation, either on the face of the financial statements or in the footnotes thereto, and in Management's Discussion and Analysis of Financial Condition and Results of Operations, of the financial condition and results of operations of Mercer and its Restricted Subsidiaries separate from the consolidated financial condition and results of operations of Mercer.

In addition, Mercer agrees that, for so long as any notes remain outstanding, if at any time it is not required to file with the SEC the reports required by the preceding paragraphs, it will furnish to the holders of notes and to securities analysts and prospective investors, upon their request, the information required to be delivered pursuant to Rule 144A(d)(4) under the Securities Act.

Events of Default and Remedies

Each of the following is an "*Event of Default*":

(1) default for 30 days in the payment when due of interest on the notes;

(2) default in the payment when due (at maturity, upon redemption or otherwise) of the principal of, or premium, if any, on, the notes;

(3) failure by Mercer or any of its Restricted Subsidiaries to comply with the provisions described under the captions " Repurchase at the Option of Holders Change of Control," " Repurchase at the Option of Holders Asset Sales," or " Certain Covenants Merger, Consolidation or Sale of Assets;"

(4) failure by Mercer or any of its Restricted Subsidiaries for 60 days after notice to Mercer by the trustee or the holders of at least 25% in aggregate principal amount of the notes then outstanding voting as a single class to comply with any of the other agreements in the indenture;

(5) default under any mortgage, indenture or instrument under which there may be issued or by which there may be secured or evidenced any Indebtedness for money borrowed by Mercer or any of its Restricted Subsidiaries (or the payment of which is guaranteed by Mercer or any of its Restricted Subsidiaries), whether such Indebtedness or Guarantee now exists, or is created after the date of the supplemental indenture, if that default:

(a) is caused by a failure to pay principal of, or interest or premium, if any, on, such Indebtedness prior to the expiration of the grace period provided in such Indebtedness on the date of such default (a "*Payment Default*"); or

(b) results in the acceleration of such Indebtedness prior to its express maturity,

and, in each case, the principal amount of any such Indebtedness, together with the principal amount of any other such Indebtedness under which there has been a Payment Default or the maturity of which has been so accelerated, aggregates $15.0 million or more;

(6) failure by Mercer or any of its Restricted Subsidiaries to pay final judgments entered by a court or courts of competent jurisdiction aggregating in excess of $15.0 million, which judgments are not paid, discharged or stayed for a period of 60 days; and

(7) certain events of bankruptcy or insolvency described in the indenture with respect to Mercer or any of its Restricted Subsidiaries that is a Significant Subsidiary or any group of Restricted Subsidiaries that, taken together, would constitute a Significant Subsidiary.

In the case of an Event of Default arising from certain events of bankruptcy or insolvency, with respect to Mercer, any Restricted Subsidiary of Mercer that is a Significant Subsidiary or any group of Restricted Subsidiaries of Mercer that, taken together, would constitute a Significant Subsidiary, all outstanding notes will become due and payable immediately without further action or notice. If any other Event of Default occurs and is continuing, the trustee or the holders of at least 25% in aggregate principal amount of the then outstanding notes may declare all the notes to be due and payable immediately.

Subject to certain limitations, holders of a majority in aggregate principal amount of the then outstanding notes may direct the trustee in its exercise of any trust or power. The trustee may withhold from holders of the notes notice of any continuing Default or Event of Default if it determines that withholding notice is in their interest, except a Default or Event of Default relating to the payment of principal, interest or premium, if any.

Subject to the provisions of the indenture relating to the duties of the trustee, in case an Event of Default occurs and is continuing, the trustee will be under no obligation to exercise any of the rights or powers under the indenture at the request or direction of any holders of notes unless such holders have offered to the trustee reasonable indemnity or security against any loss, liability or expense. Except to enforce the right to receive payment of principal, premium, if any, or interest when due, no holder of a note may pursue any remedy with respect to the indenture or the notes unless:

(1) such holder has previously given the trustee notice that an Event of Default is continuing;

(2) holders of at least 25% in aggregate principal amount of the then outstanding notes have requested the trustee to pursue the remedy;

(3) such holders have offered the trustee reasonable security or indemnity against any loss, liability or expense;

(4) the trustee has not complied with such request within 60 days after the receipt of the request and the offer of security or indemnity; and

(5) holders of a majority in aggregate principal amount of the then outstanding notes have not given the trustee a direction inconsistent with such request within such 60-day period.

The holders of a majority in aggregate principal amount of the then outstanding notes by notice to the trustee may, on behalf of the holders of all of the notes, rescind an acceleration or waive any existing Default or Event of Default and its consequences under the indenture except a continuing Default or Event of Default in the payment of interest or premium, if any, on, or the principal of, the notes.

In the case of any Event of Default occurring by reason of any willful action (or inaction) taken (or not taken) by or on behalf of Mercer with the intention of avoiding payment of the premium that Mercer would have had to pay if Mercer then had elected to redeem the notes pursuant to the optional redemption provisions of the indenture, an equivalent premium will also become and be immediately due and payable to the extent permitted by law upon the acceleration of the notes. If an Event of Default occurs prior to February 15, 2009, by reason of any willful action (or inaction) taken (or not taken) by or on behalf of Mercer with the intention of avoiding the prohibition on redemption of the notes prior to February 15, 2009, then an additional premium specified in the indenture will also become and be immediately due and payable to the extent permitted by law upon the acceleration of the notes.

Mercer is required to deliver to the trustee annually a statement regarding compliance with the indenture. Upon becoming aware of any Default or Event of Default, Mercer is required to deliver to the trustee a statement specifying such Default or Event of Default.

No Personal Liability of Directors, Trustees, Officers, Employees and Stockholders

No director, trustee, officer, employee, incorporator or stockholder of Mercer, as such, will have any liability for any obligations of Mercer under the notes, the indenture or for any claim based on, in respect of, or by reason of, such obligations or their creation. Each holder of notes by accepting a note waives and releases all such liability. The waiver and release are part of the consideration for issuance of the notes. The waiver may not be effective to waive liabilities under the federal securities laws.

Legal Defeasance and Covenant Defeasance

Mercer may at any time, at the option of its Board of Directors evidenced by a resolution set forth in an officers' certificate, elect to have all of its obligations discharged with respect to the outstanding notes ("*Legal Defeasance*") except for:

(1) the rights of holders of outstanding notes to receive payments in respect of the principal of, or interest or premium, if any, on, such notes when such payments are due from the trust referred to below;

(2) Mercer's obligations with respect to the notes concerning issuing temporary notes, registration of notes, mutilated, destroyed, lost or stolen notes and the maintenance of an office or agency for payment and money for security payments held in trust;

(3) the rights, powers, trusts, duties and immunities of the trustee, and Mercer's obligations in connection therewith; and

(4) the Legal Defeasance and Covenant Defeasance provisions of the indenture.

In addition, Mercer may, at its option and at any time, elect to have the obligations of Mercer released with respect to certain covenants (including its obligation to make Change of Control Offers and Asset Sale Offers) that are described in the indenture ("*Covenant Defeasance*") and thereafter any omission to comply with those covenants will not constitute a Default or Event of Default with respect to the notes. In the event Covenant Defeasance occurs, certain events (not including non-payment,

bankruptcy, receivership, rehabilitation and insolvency events) described under " Events of Default and Remedies" will no longer constitute an Event of Default with respect to the notes.

In order to exercise either Legal Defeasance or Covenant Defeasance:

(1) Mercer must irrevocably deposit with the trustee, in trust, for the benefit of the holders of the notes, cash in U.S. dollars, non-callable Government Securities, or a combination of cash in U.S. dollars and non-callable Government Securities, in amounts as will be sufficient, in the opinion of a nationally recognized investment bank, appraisal firm or firm of independent public accountants, to pay the principal of, or interest and premium, if any, on, the outstanding notes on the stated date for payment thereof or on the applicable redemption date, as the case may be, and Mercer must specify whether the notes are being defeased to such stated date for payment or to a particular redemption date;

(2) in the case of Legal Defeasance, Mercer must deliver to the trustee an opinion of counsel reasonably acceptable to the trustee confirming that (a) Mercer has received from, or there has been published by, the Internal Revenue Service a ruling or (b) since the date of the supplemental indenture, there has been a change in the applicable federal income tax law, in either case to the effect that, and based thereon such opinion of counsel will confirm that, the holders of the outstanding notes will not recognize income, gain or loss for federal income tax purposes as a result of such Legal Defeasance and will be subject to federal income tax on the same amounts, in the same manner and at the same times as would have been the case if such Legal Defeasance had not occurred;

(3) in the case of Covenant Defeasance, Mercer must deliver to the trustee an opinion of counsel reasonably acceptable to the trustee confirming that the holders of the outstanding notes will not recognize income, gain or loss for federal income tax purposes as a result of such Covenant Defeasance and will be subject to federal income tax on the same amounts, in the same manner and at the same times as would have been the case if such Covenant Defeasance had not occurred;

(4) no Default or Event of Default has occurred and is continuing on the date of such deposit (other than a Default or Event of Default resulting from the borrowing of funds to be applied to such deposit) and the deposit will not result in a breach or violation of, or constitute a default under, any other instrument to which Mercer is a party or by which Mercer is bound;

(5) such Legal Defeasance or Covenant Defeasance will not result in a breach or violation of, or constitute a default under, any material agreement or instrument (other than the indenture) to which Mercer or any of its Restricted Subsidiaries is a party or by which Mercer or any of its Restricted Subsidiaries is bound;

(6) Mercer must deliver to the trustee an officers' certificate stating that the deposit was not made by Mercer with the intent of preferring the holders of notes over the other creditors of Mercer with the intent of defeating, hindering, delaying or defrauding any creditors of Mercer or others; and

(7) Mercer must deliver to the trustee an officers' certificate and an opinion of counsel, each stating that all conditions precedent relating to the Legal Defeasance or the Covenant Defeasance have been complied with.

Amendment, Supplement and Waiver

Except as provided in the next two succeeding paragraphs, the indenture or the notes may be amended or supplemented with the consent of the holders of at least a majority in aggregate principal amount of the notes then outstanding (including, without limitation, consents obtained in connection with a purchase of, or tender offer or exchange offer for, notes), and any existing Default or Event of Default or compliance with any provision of the indenture or the notes may be waived with the consent

of the holders of a majority in aggregate principal amount of the then outstanding notes (including, without limitation, consents obtained in connection with a purchase of, or tender offer or exchange offer for, notes).

Without the consent of each holder of notes affected, an amendment, supplement or waiver may not (with respect to any notes held by a non-consenting holder):

(1) reduce the principal amount of notes whose holders must consent to an amendment, supplement or waiver;

(2) reduce the principal of or change the fixed maturity of any note or alter the provisions with respect to the redemption of the notes (other than provisions relating to the covenants described above under the caption "   Repurchase at the Option of Holders");

(3) reduce the rate of or change the time for payment of interest, including default interest, on any note;

(4) waive a Default or Event of Default in the payment of principal of, or interest or premium, if any, on, the notes (except a rescission of acceleration of the notes by the holders of at least a majority in aggregate principal amount of the then outstanding notes and a waiver of the payment default that resulted from such acceleration);

(5) make any note payable in money other than that stated in the notes;

(6) make any change in the provisions of the indenture relating to waivers of past Defaults or the rights of holders of notes to receive payments of principal of, or interest or premium, if any, on, the notes;

(7) waive a redemption payment with respect to any note (other than a payment required by one of the covenants described above under the caption "   Repurchase at the Option of Holders"); or

(8) make any change in the preceding amendment and waiver provisions.

Notwithstanding the preceding, without the consent of any holder of notes, Mercer and the trustee may amend or supplement the indenture or the notes:

(1) to cure any ambiguity, defect or inconsistency;

(2) to provide for uncertificated notes in addition to or in place of certificated notes in order to comply with any Applicable Procedures, or otherwise after the provisions of Article 2 of the indenture in a manner that does not materially adversely affect any holder of notes;

(3) to provide for the assumption of Mercer's obligations to holders of notes in the case of a merger or consolidation or sale of all or substantially all of Mercer's assets;

(4) to make any change that would provide any additional rights or benefits to the holders of notes or that does not, in the good faith opinion of the Board of Directors of Mercer, adversely affect the legal rights under the indenture of any such holder in any material respect;

(5) to comply with requirements of the SEC in order to effect or maintain the qualification of the indenture under the Trust Indenture Act;

(6)

to conform the text of the indenture or the notes to any provision of this Description of Notes to the extent that such provision in this Description of Notes was intended to be a verbatim recitation of a provision of the indenture or the notes;

(7) to provide for the issuance of additional notes in accordance with the limitations set forth in the indenture as of the date of the supplemental indenture; or

(8) to allow any Restricted Subsidiary to execute a supplemental indenture providing for a Note Guarantee with respect to the Notes.

Satisfaction and Discharge

The indenture will be discharged and will cease to be of further effect as to all notes issued thereunder, when:

(1) either:

(a) all notes that have been authenticated, except lost, stolen or destroyed notes that have been replaced or paid and notes for whose payment money has been deposited in trust and thereafter repaid to Mercer, have been delivered to the trustee for cancellation; or

(b) all notes that have not been delivered to the trustee for cancellation have become due and payable by reason of the mailing of a notice of redemption or otherwise or will become due and payable within one year and Mercer has irrevocably deposited or caused to be deposited with the trustee as trust funds in trust solely for the benefit of the holders, cash in U.S. dollars, non-callable Government Securities, or a combination of cash in U.S. dollars and non-callable Government Securities, in amounts as will be sufficient, without consideration of any reinvestment of interest, to pay and discharge the entire Indebtedness on the notes not delivered to the trustee for cancellation for principal, premium, if any, and accrued interest to the date of maturity or redemption;

(2) no Default or Event of Default has occurred and is continuing on the date of the deposit (other than a Default or Event of Default resulting from the borrowing of funds to be applied to such deposit) and the deposit will not result in a breach or violation of, or constitute a default under, any other instrument to which Mercer is a party or by which Mercer is bound;

(3) Mercer has paid or caused to be paid all sums payable by it under the indenture; and

(4) Mercer has delivered irrevocable instructions to the trustee under the indenture to apply the deposited money toward the payment of the notes at maturity or on the redemption date, as the case may be.

In addition, Mercer must deliver an officers' certificate and an opinion of counsel to the trustee stating that all conditions precedent to satisfaction and discharge have been satisfied.

Concerning the Trustee

If the trustee becomes a creditor of Mercer, the indenture limits the right of the trustee to obtain payment of claims in certain cases, or to realize on certain property received in respect of any such claim as security or otherwise. The trustee will be permitted to engage in other transactions; however, if it acquires any conflicting interest it must eliminate such conflict within 90 days, apply to the SEC for permission to continue as trustee (if the indenture has been qualified under the Trust Indenture Act) or resign.

The holders of a majority in aggregate principal amount of the then outstanding notes will have the right to direct the time, method and place of conducting any proceeding for exercising any remedy available to the trustee, subject to certain exceptions. The indenture provides that in case an Event of Default occurs and is continuing, the trustee will be required, in the exercise of its power, to use the degree of care of a prudent man in the conduct of his own affairs. Subject to such provisions, the trustee will be under no obligation to exercise any of its rights or powers under the indenture at the request of any holder of notes, unless such holder has offered to the trustee security and indemnity satisfactory to it against any loss, liability or expense.

Book-Entry, Delivery and Form

Except as described in the next paragraph, the notes will initially be issued in registered, global form without interest coupons (the "*Global Notes*"). The Global Notes will be deposited upon issuance with the trustee as custodian for The Depository Trust Company ("*DTC*"), in New York, New York, and registered in the name of DTC or its nominee, for credit to an account of a direct or indirect participant in DTC as described below.

Notes that are issued as described below under " Certificated Notes" will be issued in the form of registered definitive certificates (the "*Certificated Notes*"). Upon the transfer of Certificated Notes, Certificated Notes may, unless all Global Notes have previously been exchanged for Certificated Notes, be exchanged for an interest in the Global Note representing the principal amount of notes being transferred, subject to the transfer restrictions set forth in the indenture.

DTC has advised Mercer that DTC is a limited-purpose trust company created to hold securities for its participating organizations (collectively, the "*Participants*") and to facilitate the clearance and settlement of transactions in those securities between Participants through electronic book-entry changes in accounts of its Participants. The Participants include securities brokers and dealers (including the underwriters), banks, trust companies, clearing corporations and certain other organizations. Access to DTC's system is also available to other entities such as banks, brokers, dealers and trust companies that clear through or maintain a custodial relationship with a Participant, either directly or indirectly (collectively, the "*Indirect Participants*"). Persons who are not Participants may beneficially own securities held by or on behalf of DTC only through the Participants or the Indirect Participants. The ownership interests in, and transfers of ownership interests in, each security held by or on behalf of DTC are recorded on the records of the Participants and Indirect Participants.

DTC has also advised Mercer that, pursuant to procedures established by it:

(1) upon deposit of the Global Notes, DTC will credit the accounts of the Participants designated by the underwriters with portions of the principal amount of the Global Notes; and

(2) ownership of these interests in the Global Notes will be shown on, and the transfer of ownership of these interests will be effected only through, records maintained by DTC (with respect to the Participants) or by the Participants and the Indirect Participants (with respect to other owners of beneficial interest in the Global Notes).

Prospective purchasers are advised that the laws of some states require that certain Persons take physical delivery in definitive form of securities that they own. Consequently, the ability to transfer beneficial interests in a Global Note to such Persons will be limited to such extent.

So long as the Global Note Holder is the registered owner of any notes, the Global Note Holder will be considered the sole holder under the indenture of any notes evidenced by the Global Notes. Beneficial owners of notes evidenced by the Global Notes will not be considered the owners or holders of the notes under the indenture for any purpose, including with respect to the giving of any directions, instructions or approvals to the trustee thereunder. Neither Mercer nor the trustee will have any responsibility or liability for any aspect of the records of DTC or for maintaining, supervising or reviewing any records of DTC relating to the notes.

Payments in respect of the principal of, and interest and premium, if any, on, a Global Note registered in the name of DTC or its nominee will be payable to DTC in its capacity as the registered holder under the indenture. Under the terms of the indenture, Mercer and the trustee will treat the Persons in whose names the notes, including the Global Notes, are registered as the owners of the

notes for the purpose of receiving payments and for all other purposes. Consequently, neither Mercer, the trustee nor any agent of Mercer or the trustee has or will have any responsibility or liability for:

(1) any aspect of DTC's records or any Participant's or Indirect Participant's records relating to or payments made on account of beneficial ownership interest in the Global Notes or for maintaining, supervising or reviewing any of DTC's records or any Participant's or Indirect Participant's records relating to the beneficial ownership interests in the Global Notes; or

(2) any other matter relating to the actions and practices of DTC or any of its Participants or Indirect Participants.

DTC has advised Mercer that its current practice, upon receipt of any payment in respect of securities such as the notes (including principal and interest), is to credit the accounts of the relevant Participants with the payment on the payment date unless DTC has reason to believe that it will not receive payment on such payment date. Each relevant Participant is credited with an amount proportionate to its beneficial ownership of an interest in the principal amount of the relevant security as shown on the records of DTC. Payments by the Participants and the Indirect Participants to the beneficial owners of notes will be governed by standing instructions and customary practices and will be the responsibility of the Participants or the Indirect Participants and will not be the responsibility of DTC, the trustee or Mercer. Neither Mercer nor the trustee will be liable for any delay by DTC or any of the Participants or the Indirect Participants in identifying the beneficial owners of the notes, and Mercer and the trustee may conclusively rely on and will be protected in relying on instructions from DTC or its nominee for all purposes.

Certificated Notes

Subject to certain conditions, any Person having a beneficial interest in a Global Note may, upon prior written request to the trustee, exchange such beneficial interest for notes in the form of Certificated Notes. Upon any such issuance, the trustee is required to register such Certificated Notes in the name of, and cause the same to be delivered to, such Person or Persons (or their nominee). In addition, if:

(1) DTC (a) notifies Mercer that it is unwilling or unable to continue as depositary for the Global Notes or (b) has ceased to be a clearing agency registered under the Exchange Act and, in either case, Mercer fails to appoint a successor depositary;

(2) Mercer, at its option, notifies the trustee in writing that it elects to cause the issuance of the Certificated Notes; or

(3) there has occurred and is continuing a Default or Event of Default with respect to the notes;

then, upon surrender by the Global Note Holder of its Global Note, notes in such form will be issued to each Person that the Global Note Holder and DTC identify as being the beneficial owner of the related notes.

Neither Mercer nor the trustee will be liable for any delay by the Global Note Holder or DTC in identifying the beneficial owners of notes and Mercer and the trustee may conclusively rely on, and will be protected in relying on, instructions from the Global Note Holder or DTC for all purposes.

Same Day Settlement and Payment

Mercer will make payments in respect of the notes represented by the Global Notes (including principal, interest and premium, if any) by wire transfer of immediately available funds to the accounts specified by DTC or its nominee. Mercer will make all payments of principal, interest and premium, if any, with respect to Certificated Notes by wire transfer of immediately available funds to the accounts specified by the holders of the Certificated Notes or, if no such account is specified, by mailing a check

to each such holder's registered address. The notes represented by the Global Notes are expected to trade in DTC's Same-Day Funds Settlement System, and any permitted secondary market trading activity in such notes will, therefore, be required by DTC to be settled in immediately available funds. Mercer expects that secondary trading in any Certificated Notes will also be settled in immediately available funds.

Certain Definitions

Set forth below are certain defined terms used in the indenture. Reference is made to the indenture for a full disclosure of all defined terms used therein, as well as any other capitalized terms used herein for which no definition is provided.

"*Acquired Debt*" means, with respect to any specified Person:

(1) Indebtedness of any other Person existing at the time such other Person is merged with or into or became a Subsidiary of such specified Person, whether or not such Indebtedness is incurred in connection with, or in contemplation of, such other Person merging with or into, or becoming a Restricted Subsidiary of, such specified Person; and

(2) Indebtedness secured by a Lien encumbering any asset acquired by such specified Person.

"*Acquisition*" means the acquisition by 0706906 B.C. Ltd. of substantially all of the assets of Stone Venepal (Celgar) Pulp Inc., a corporation organized under the laws of Canada.

"*Affiliate*" of any specified Person means any other Person directly or indirectly controlling or controlled by or under direct or indirect common control with such specified Person. For purposes of this definition, "control," as used with respect to any Person, means the possession, directly or indirectly, of the power to direct or cause the direction of the management or policies of such Person, whether through the ownership of voting securities, by agreement or otherwise; *provided* that beneficial ownership of more than 15% (measured on a fully diluted basis) of the Voting Stock of a Person (except as reportable on Form 13-F or Form 13-G of the SEC) will be deemed to be control. For purposes of this definition, the terms "controlling," "controlled by" and "under common control with" have correlative meanings.

"*Asset Sale*" means:

(1) the sale, lease, conveyance or other disposition of any assets or rights; *provided* that the sale, lease, conveyance or other disposition of all or substantially all of the assets of Mercer and its Restricted Subsidiaries taken as a whole will be governed by the provisions of the indenture described above under the caption " Repurchase at the Option of Holders Change of Control" and/or the provisions described above under the caption " Certain Covenants Merger, Consolidation or Sale of Assets" and not by the provisions of the Asset Sale covenant; and

(2) the issuance of Equity Interests in any of Mercer's Restricted Subsidiaries or the sale of Equity Interests in any of its Subsidiaries.

Notwithstanding the preceding, none of the following items will be deemed to be an Asset Sale:

(1) any single transaction or series of related transactions that involves assets having a Fair Market Value of less than $2.0 million;

(2) a transfer of assets between or among Mercer and its Restricted Subsidiaries;

(3) an issuance of Equity Interests by a Restricted Subsidiary of Mercer to Mercer or to a Restricted Subsidiary of Mercer;

(4) the sale or lease of products, services, accounts receivable or current assets in the ordinary course of business and any sale or other disposition of damaged, worn-out or obsolete assets in the ordinary course of business;

(5) the sale or other disposition of cash or Cash Equivalents;

(6) any release of intangible claims or rights in connection with the loss or settlement of a bona fide lawsuit, dispute or other controversy;

(7) leases or subleases to third persons not interfering in any material respect with the business of the Company or any of its Restricted Subsidiaries;

(8) a Restricted Payment that does not violate the covenant described above under the caption " Certain Covenants Restricted Payments" or a Permitted Investment; and

(9) purchases, sales or other transfers of pulp, fibre, chemicals and other consumables between or among Mercer or any Restricted Subsidiary and any Unrestricted Subsidiary at market prices pursuant to arrangements approved by Mercer's Board of Directors as being fair, from a financial point of view, to Mercer or the applicable Restricted Subsidiary, as the case may be; purchases, sales or other transfers of spare parts or mill consumables between any Restricted Subsidiary and any Unrestricted Subsidiary at book value; and other transactions with customers, clients, suppliers or purchasers or sellers of goods or services, in each case in the ordinary course of business and otherwise in compliance with the terms of the indenture, that are fair to Mercer or the Restricted Subsidiary, as the case may be, in the reasonable determination of Mercer's Board of Directors.

"*Asset Sale Offer"* has the meaning assigned to that term in the indenture governing the notes.

"*Attributable Debt*" in respect of a sale and leaseback transaction means, at the time of determination, the present value of the obligation of the lessee for net rental payments during the remaining term of the lease included in such sale and leaseback transaction including any period for which such lease has been extended or may, at the option of the lessor, be extended. Such present value shall be calculated using a discount rate equal to the rate of interest implicit in such transaction, determined in accordance with GAAP; *provided, however*, that if such sale and leaseback transaction results in a Capital Lease Obligation, the amount of Indebtedness represented thereby will be determined in accordance with the definition of "Capital Lease Obligation."

"*Beneficial Owner*" has the meaning assigned to such term in Rule 13d-3 and Rule 13d-5 under the Exchange Act, except that in calculating the beneficial ownership of any particular "person" (as that term is used in Section 13(d)(3) of the Exchange Act), such "person" will be deemed to have beneficial ownership of all securities that such "person" has the right to acquire by conversion or exercise of other securities, whether such right is currently exercisable or is exercisable only after the passage of time. The terms "Beneficially Owns" and "Beneficially Owned" have a corresponding meaning.

"*Board of Directors*" means:

(1) with respect to a corporation, the board of directors of the corporation or any committee thereof duly authorized to act on behalf of such board;

(2) with respect to a partnership, the Board of Directors of the general partner of the partnership;

(3) with respect to a limited liability company, the managing member or members or any controlling committee of managing members thereof; and

(4) with respect to any other Person (including a business trust), the board of trustees or committee of such Person serving a similar function.

"*Borrowing Base*" means, as of any date, an amount equal to:

(1) 80% of the face amount of all accounts receivable owned by Mercer and its Restricted Subsidiaries as of the end of the most recent fiscal quarter preceding such date, calculated on a consolidated basis and in accordance with GAAP; *plus*

(2) 50% of the book value of all inventory owned by Mercer and its Restricted Subsidiaries as of the end of the most recent fiscal quarter preceding such date, calculated on a consolidated basis and in accordance with GAAP.

"*Capital Lease Obligation*" means, at the time any determination is to be made, the amount of the liability in respect of a capital lease that would at that time be required to be capitalized on a balance sheet prepared in accordance with GAAP.

"*Capital Stock*" means:

(1) in the case of a corporation, corporate stock;

(2) in the case of an association or business entity or trust, any and all shares, interests, participations, rights or other equivalents (however designated) of corporate stock, including shares of beneficial interest;

(3) in the case of a partnership or limited liability company, partnership interests (whether general or limited) or membership interests; and

(4) any other interest or participation that confers on a Person the right to receive a share of the profits and losses of, or distributions of assets of, the issuing Person, but excluding from all of the foregoing any debt securities convertible into Capital Stock, whether or not such debt securities include any right of participation with Capital Stock.

"*Cash Equivalents*" means:

(1) United States dollars, Canadian dollars or Euros;

(2) securities issued or directly and fully guaranteed or insured by the United States, Canadian, German or United Kingdom government or any agency or instrumentality of the United States, Canadian, German or United Kingdom government (*provided* that the full faith and credit of the United States, Canada, Germany or the United Kingdom is pledged in support of those securities) having maturities of not more than six months from the date of acquisition;

(3) certificates of deposit and eurodollar time deposits with maturities of six months or less from the date of acquisition, bankers' acceptances with maturities not exceeding six months and overnight bank deposits, in each case, with any lender party to the Credit Agreements or with any domestic commercial bank having capital and surplus in excess of $500.0 million and a Thomson Bank Watch Rating of "B" or better;

(4) repurchase obligations with a term of not more than seven days for underlying securities of the types described in clauses (2) and (3) above entered into with any financial institution meeting the qualifications specified in clause (3) above;

(5) commercial paper having one of the two highest ratings obtainable from Moody's or S&P and, in each case, maturing within six months after the date of acquisition; and

(6) money market funds at least 95% of the assets of which constitute Cash Equivalents of the kinds described in clauses (1) through (5) of this definition.

"*Change of Control*" means the occurrence of any of the following:

(1) the direct or indirect sale, lease, transfer, conveyance or other disposition (other than by way of merger or consolidation), in one or a series of related transactions, of all or substantially all of the properties or assets of Mercer and its Subsidiaries taken as a whole to any "person" (as that term is used in Section 13(d) of the Exchange Act);

(2) the adoption of a plan relating to the liquidation or dissolution of Mercer;

(3) the consummation of any transaction (including, without limitation, any merger or consolidation), the result of which is that any "person" (as defined above) becomes the Beneficial Owner, directly or indirectly, of more than 50% of the Voting Stock of Mercer, measured by voting power rather than number of shares, *provided that*, however, it is not a Change in Control if, pursuant to such transaction, all of the Voting Stock of Mercer is changed into or exchanged for securities of a parent corporation that after such transaction owns all of the Capital Stock of Mercer and no person is the Beneficial Owner, directly or indirectly, of more than 50% of the Voting Stock of such parent corporation;

(4) during any consecutive two-year period, individuals who at the beginning of that two-year period constituted Mercer's Board of Directors (together with any new persons whose election to Mercer's Board of Directors, or whose nomination for election by Mercer's shareholders, was approved by a vote of a majority of the directors who were either directors at the beginning of such period or whose election or nomination for election was approved by Mercer's Board of Directors or the nominating committee thereof, the majority of the members of which meet the above criteria) cease for any reason to constitute a majority of Mercer's Board of Directors then in office; or

(5) Mercer consolidates with, or merges with or into, any Person, or any Person consolidates with, or merges with or into, Mercer, in any such event pursuant to a transaction in which any of the outstanding Voting Stock of Mercer or such other Person is converted into or exchanged for cash, securities or other property, other than any such transaction where the Voting Stock of Mercer outstanding immediately prior to such transaction is converted into or exchanged for Voting Stock (other than Disqualified Stock) of the surviving or transferee Person constituting a majority of the outstanding shares of such Voting Stock of such surviving or transferee Person (immediately after giving effect to such issuance).

"Change of Control Offer" has the meaning assigned to that term in the indenture governing the notes.

"*Consolidated EBITDA*" means, with respect to any specified Person for any period, the Consolidated Net Income of such Person for such period *plus*, without duplication:

(1) an amount equal to any extraordinary loss plus any net loss realized by such Person or any of its Restricted Subsidiaries in connection with an Asset Sale, to the extent such losses were deducted in computing such Consolidated Net Income; *plus*

(2) provision for taxes based on income or profits of such Person and its Restricted Subsidiaries for such period, to the extent that such provision for taxes was deducted in computing such Consolidated Net Income; *plus*

(3) the Fixed Charges of such Person and its Restricted Subsidiaries for such period, to the extent that such Fixed Charges were deducted in computing such Consolidated Net Income; *plus*

(4) depreciation, amortization (including amortization of intangibles but excluding amortization of prepaid cash expenses that were paid in a prior period) and other non-cash expenses (excluding any such non-cash expense to the extent that it represents an accrual of or reserve for cash

expenses in any future period or amortization of a prepaid cash expense that was paid in a prior period) of such Person and its Restricted Subsidiaries for such period to the extent that such depreciation, amortization and other non-cash expenses were deducted in computing such Consolidated Net Income; *plus*

(5) any expenses directly related to consummation of the Acquisition, the offering of these Notes and concurrent offering of Mercer Capital Stock, to the extent such amounts were deducted in computing such Consolidated Net Income; *plus*

(6) the following expenses, losses or gains to the extent such amounts were included in the computation of Consolidated Net Income:

(a) nonrecurring or unusual recruiting, severance and restructuring costs or gains during such period, as determined in good faith by the Board of Directors of Mercer; provided that the total of such costs shall not exceed $2.0 million per twelve-month period;

(b) foreign exchange gains or losses incurred with respect to receivables (net of the impact on payables) on product sales;

(c) expenses related to any special or contested meetings of shareholders, including any proxy solicitation costs, settlement and related costs; and

(d) expenses related to equipment failures (including, without limitation, costs of repair, equipment replacement or addition) where a good faith application for the recovery of such costs from the vendor or an insurer has been made, less any such recovery and the amount of any such claim to the extent it has been finally determined to be uncollectible, the net amount not to exceed $2.0 million in the aggregate over any twelve-month period; *minus*

(7) non-cash items increasing such Consolidated Net Income for such period, other than the accrual of revenue in the ordinary course of business,

in each case, on a consolidated basis for such Person and its Restricted Subsidiaries and determined in accordance with GAAP.

Notwithstanding the preceding, the provision for taxes based on the income or profits of, and the depreciation and amortization and other non-cash expenses of, a Restricted Subsidiary of Mercer will be added to Consolidated Net Income to compute Consolidated EBITDA of Mercer only to the extent that a corresponding amount would be permitted at the date of determination to be dividended or distributed, directly or indirectly, to Mercer by such Restricted Subsidiary without prior governmental approval (that has not been obtained), and without direct or indirect restriction pursuant to the terms of its charter and all agreements, instruments, judgments, decrees, orders, statutes, rules and governmental regulations applicable to that Restricted Subsidiary or its stockholders.

"*Consolidated Net Income*" means, with respect to any specified Person for any period, the aggregate of the Net Income of such Person and its Restricted Subsidiaries for such period, on a consolidated basis, determined in accordance with GAAP; *provided* that:

(1) the Net Income (but not loss) of any Person that is not a Restricted Subsidiary or that is accounted for by the equity method of accounting will be included only to the extent of the amount of dividends or similar distributions paid in cash to the specified Person or a Restricted Subsidiary of the Person;

(2) the Net Income of any Restricted Subsidiary will be excluded to the extent that the declaration or payment of dividends or similar distributions by that Restricted Subsidiary of that Net Income is not at the date of determination permitted without any prior governmental approval (that has not been obtained) or, directly or indirectly, by operation of the terms of its charter or any agreement,

instrument, judgment, decree, order, statute, rule or governmental regulation applicable to that Restricted Subsidiary or its stockholders;

(3) the cumulative effect of a change in accounting principles will be excluded;

(4) any goodwill impairment charges pursuant to Financial Accounting Standards Board Statement No. 142 will be excluded; and

(5) notwithstanding clause (1) above, the Net Income of any Unrestricted Subsidiary or Landqart AG (including, without limitation, the impact of any Hedging Obligations) will be excluded, whether or not distributed to the specified Person or one of its Subsidiaries.

"*Credit Agreements*" means (i) that certain Credit Agreement by and among 0706906 B.C. Ltd. and Royal Bank of Canada, as Agent, providing for up to $30.0 million of revolving credit borrowings, including any related notes, Guarantees, collateral documents, instruments and agreements executed in connection therewith, and, in each case, as amended, restated, modified, renewed, refunded, replaced (whether upon or after termination or otherwise) or refinanced (including by means of sales of debt securities to institutional investors) in whole or in part from time to time, and (ii) that certain Credit Agreement by and among Zellstoff-und Papierfabrik Rosenthal GmbH & Co. KG and Bayerische Hypo-und Vereinsbank AG, as Lead Arranger, providing for up to €40.0 million of revolving credit borrowings, including any related notes, Guarantees, collateral documents, instruments and agreements executed in connection therewith, and, in each case, as amended, restated, modified, renewed, refunded, replaced (whether upon or after termination or otherwise) or refinanced (including by means of sales of debt securities to institutional investors) in whole or in part from time to time.

"*Credit Facilities*" means, one or more debt facilities (including, without limitation, the Credit Agreements) or commercial paper facilities, in each case, with banks or other institutional lenders providing for revolving credit loans, term loans, receivables financing (including through the sale of receivables to such lenders or to special purpose entities formed to borrow from such lenders against such receivables) or letters of credit, in each case, as amended, restated, modified, renewed, refunded, replaced (whether upon or after termination or otherwise) or refinanced (including by means of sales of debt securities to institutional investors) in whole or in part from time to time.

"*Default*" means any event that is, or with the passage of time or the giving of notice or both would be, an Event of Default.

"*Disqualified Stock*" means any Capital Stock that, by its terms (or by the terms of any security into which it is convertible, or for which it is exchangeable, in each case, at the option of the holder of the Capital Stock), or upon the happening of any event, matures or is mandatorily redeemable, pursuant to a sinking fund obligation or otherwise, or redeemable at the option of the holder of the Capital Stock, in whole or in part, on or prior to the date that is 91 days after the date on which the notes mature. Notwithstanding the preceding sentence, any Capital Stock that would constitute Disqualified Stock solely because the holders of the Capital Stock have the right to require Mercer to repurchase such Capital Stock upon the occurrence of a change of control or an asset sale will not constitute Disqualified Stock if the terms of such Capital Stock provide that Mercer may not repurchase or redeem any such Capital Stock pursuant to such provisions unless such repurchase or redemption complies with the covenant described above under the caption " Certain Covenants Restricted Payments." The amount of Disqualified Stock deemed to be outstanding at any time for purposes of the indenture will be the maximum amount that Mercer and its Restricted Subsidiaries may become obligated to pay upon the maturity of, or pursuant to any mandatory redemption provisions of, such Disqualified Stock, exclusive of accrued dividends.

"*Domestic Subsidiary*" means any Restricted Subsidiary of Mercer that was formed under the laws of the United States or any state of the United States or the District of Columbia or that guarantees or otherwise provides direct credit support for any Indebtedness of Mercer.

"*Equity Interests*" means Capital Stock and all warrants, options or other rights to acquire Capital Stock (but excluding any debt security that is convertible into, or exchangeable for, Capital Stock).

"*Existing Indebtedness*" means the Indebtedness of Mercer and its Restricted Subsidiaries (other than Indebtedness under the Credit Agreements) in existence on the date of the supplemental indenture, until such amounts are repaid.

"*Fair Market Value*" means the value that would be paid by a willing buyer to an unaffiliated willing seller in a transaction not involving distress or necessity of either party. In the case of a transaction not exceeding $10.0 million, Fair Market Value may be determined in good faith by the Chief Financial Officer, Controller or Treasurer of Mercer, and in the case of a transaction exceeding $10.0 million, Fair Market Value shall be determined in good faith by the Board of Directors of Mercer (unless otherwise provided in the indenture).

"*Fixed Charge Coverage Ratio*" means with respect to any specified Person for any period, the ratio of the Consolidated EBITDA of such Person for such period to the Fixed Charges of such Person for such period. In the event that the specified Person or any of its Restricted Subsidiaries incurs, assumes, guarantees, repays, repurchases, redeems, defeases or otherwise discharges any Indebtedness (other than ordinary working capital borrowings**,** including working capital borrowings under Credit Facilities) or issues, repurchases or redeems preferred stock subsequent to the commencement of the period for which the Fixed Charge Coverage Ratio is being calculated and on or prior to the date on which the event for which the calculation of the Fixed Charge Coverage Ratio is made (the "*Calculation Date*"), then the Fixed Charge Coverage Ratio will be calculated giving pro forma effect to such incurrence, assumption, Guarantee, repayment, repurchase, redemption, defeasance or other discharge of Indebtedness, or such issuance, repurchase or redemption of preferred stock, and the use of the proceeds therefrom, as if the same had occurred at the beginning of the applicable four-quarter reference period.

In addition, for purposes of calculating the Fixed Charge Coverage Ratio:

(1) acquisitions that have been made by the specified Person or any of its Restricted Subsidiaries, including through mergers or consolidations, or any Person or any of its Restricted Subsidiaries acquired by the specified Person or any of its Restricted Subsidiaries, and including any related financing transactions and including increases in ownership of Restricted Subsidiaries, during the four-quarter reference period or subsequent to such reference period and on or prior to the Calculation Date will be given pro forma effect (in accordance with Regulation S-X under the Securities Act) as if they had occurred on the first day of the four-quarter reference period;

(2) the Consolidated EBITDA which is attributable to discontinued operations (as determined in accordance with GAAP), and operations or businesses (and ownership interests therein) disposed of prior to the Calculation Date, will be excluded;

(3) the Fixed Charges attributable to discontinued operations, as determined in accordance with GAAP, and operations or businesses (and ownership interests therein) disposed of prior to the Calculation Date, will be excluded, but only to the extent that the obligations giving rise to such Fixed Charges will not be obligations of the specified Person or any of its Restricted Subsidiaries following the Calculation Date;

(4) any Person that is a Restricted Subsidiary on the Calculation Date will be deemed to have been a Restricted Subsidiary at all times during such four-quarter period;

(5) any Person that is not a Restricted Subsidiary on the Calculation Date will be deemed not to have been a Restricted Subsidiary at any time during such four-quarter period; and

(6) if any Indebtedness bears a floating rate of interest, the interest expense on such Indebtedness will be calculated as if the rate in effect on the Calculation Date had been the applicable rate for the

entire period (taking into account any Hedging Obligation applicable to such Indebtedness if such Hedging Obligation has a remaining term as at the Calculation Date in excess of 6 months).

"*Fixed Charges*" means, with respect to any specified Person for any period, the sum, without duplication, of:

(1) the consolidated interest expense of such Person and its Restricted Subsidiaries for such period, whether paid or accrued, including, without limitation, amortization of debt issuance costs and original issue discount, non-cash interest payments (but excluding any non-cash interest expense attributable to the movement in the mark to market valuation of Hedging Obligations in accordance with GAAP)**,** the interest component of any deferred payment obligations, the interest component of all payments associated with Capital Lease Obligations, imputed interest with respect to Attributable Debt, commissions, discounts and other fees and charges incurred in respect of letter of credit or bankers' acceptance financings, and net of the effect of all payments made or received pursuant to Hedging Obligations in respect of interest rates (excluding, for the avoidance of doubt, amounts due upon settlement of any such Hedging Obligations)**;** *plus*

(2) the consolidated interest expense of such Person and its Restricted Subsidiaries that was capitalized during such period; *plus*

(3) any interest on Indebtedness of another Person that is guaranteed by such Person or one of its Restricted Subsidiaries (other than Indebtedness of the Paper Subsidiaries not to exceed €4.7 million in existence as of the date of the supplemental indenture guaranteed by Mercer) or secured by a Lien on assets of such Person or one of its Restricted Subsidiaries, whether or not such Guarantee or Lien is called upon; *plus*

(4) the product of (a) all dividends, whether paid or accrued and whether or not in cash, on any series of preferred stock of such Person or any of its Restricted Subsidiaries, other than dividends on Equity Interests payable solely in Equity Interests of Mercer (other than Disqualified Stock) or to Mercer or a Restricted Subsidiary of Mercer, *times* (b) a fraction, the numerator of which is one and the denominator of which is one minus the then current combined federal, state and local statutory tax rate of such Person, expressed as a decimal, in each case, determined on a consolidated basis in accordance with GAAP.

"*Foreign Subsidiary*" means any Restricted Subsidiary of Mercer that is not a Domestic Subsidiary.

"*GAAP*" means generally accepted accounting principles set forth in the opinions and pronouncements of the Accounting Principles Board of the American Institute of Certified Public Accountants and statements and pronouncements of the Financial Accounting Standards Board or in such other statements by such other entity as have been approved by a significant segment of the accounting profession, which are in effect from time to time.

"*Guarantee*" means a guarantee other than by endorsement of negotiable instruments for collection in the ordinary course of business, direct or indirect, in any manner including, without limitation, by way of a pledge of assets or through letters of credit or reimbursement agreements in respect thereof, of all or any part of any Indebtedness (whether arising by virtue of partnership arrangements, or by agreements to keep-well, to purchase assets, goods, securities or services, to take or pay or to maintain financial statement conditions or otherwise).

"*Guarantor*" means each Subsidiary of Mercer that executes a Note Guarantee in accordance with the provisions of the indenture, and its successors and assigns, in each case, until the Note Guarantee of such Person has been released in accordance with the provisions of the indenture.

"*Hedging Obligations*" means, with respect to any specified Person, the obligations of such Person under:

(1) interest rate swap agreements (whether from fixed to floating or from floating to fixed), interest rate cap agreements and interest rate collar agreements;

(2) other agreements or arrangements designed to manage interest rates or interest rate risk; and

(3) other agreements or arrangements designed to protect such Person against fluctuations in currency exchange rates (including, without limitation, foreign currency futures and options, currency swaps, currency forwards and related interest rate swaps and/or forwards) or commodity prices (including, without limitation, commodity futures, swaps or options).

"*Indebtedness*" means, with respect to any specified Person, any indebtedness of such Person (excluding accrued expenses and trade payables), whether or not contingent:

(1) in respect of borrowed money;

(2) evidenced by bonds, notes, debentures or similar instruments or letters of credit (or reimbursement agreements in respect thereof);

(3) in respect of banker's acceptances;

(4) representing Capital Lease Obligations or Attributable Debt in respect of sale and leaseback transactions;

(5) representing the balance deferred and unpaid of the purchase price of any property or services due more than six months after such property is acquired or such services are completed, except any balance that constitutes an accrual of expenses or trade payable; or

(6) representing any Hedging Obligations (the amount of any such Hedging Obligations to be equal at any time to the termination value of the agreement or arrangement giving rise to such Hedging Obligations that would be payable by such Person at such time),

if and to the extent any of the preceding items (other than letters of credit, Attributable Debt and Hedging Obligations) would appear as a liability upon a balance sheet of the specified Person prepared in accordance with GAAP. In addition, the term "Indebtedness" includes all Indebtedness of others secured by a Lien on any asset of the specified Person (whether or not such Indebtedness is assumed by the specified Person) and, to the extent not otherwise included, the Guarantee by the specified Person of any Indebtedness of any other Person.

"*Investments*" means, with respect to any Person, all direct or indirect investments by such Person in other Persons (including Affiliates) in the forms of loans (including Guarantees or other obligations), advances or capital contributions (excluding commission, travel and similar advances to officers and employees made in the ordinary course of business), purchases or other acquisitions for consideration of Indebtedness, Equity Interests or other securities, together with all items that are or would be classified as investments on a balance sheet prepared in accordance with GAAP. If Mercer or any Restricted Subsidiary of Mercer sells or otherwise disposes of any Equity Interests of any direct or indirect Restricted Subsidiary of Mercer such that, after giving effect to any such sale or disposition, such Person is no longer a Subsidiary of Mercer, Mercer will be deemed to have made an Investment on the date of any such sale or disposition equal to the Fair Market Value of Mercer's Investments in such Restricted Subsidiary that were not sold or disposed of in an amount determined as provided in the final paragraph of the covenant described above under the caption " Certain Covenants Restricted Payments." The acquisition by Mercer or any Restricted Subsidiary of Mercer of a Person

that holds an Investment in a third Person will be deemed to be an Investment by Mercer or such Subsidiary in such third Person in an amount equal to the Fair Market Value of the Investments held by the acquired Person in such third Person in an amount determined as provided in the final paragraph of the covenant described above under the caption " Certain Covenants Restricted Payments." Except as otherwise provided in the indenture, the amount of an Investment will be determined at the time the Investment is made and without giving effect to subsequent changes in value.

"*Lien*" means, with respect to any asset, any mortgage, lien, pledge, charge, security interest or encumbrance of any kind in respect of such asset, whether or not filed, recorded or otherwise perfected under applicable law, including any conditional sale or other title retention agreement, any lease in the nature thereof, any option or other agreement to sell or give a security interest in and any filing of or agreement to give any financing statement under the Uniform Commercial Code (or equivalent statutes) of any jurisdiction.

"*Moody's*" means Moody's Investors Service, Inc.

"*Net Income*" means, with respect to any specified Person, the net income (loss) of such Person, determined in accordance with GAAP and before any reduction in respect of preferred stock dividends, excluding, however:

(1) any gain (but not loss), together with any related provision for taxes on such gain (but not loss), realized in connection with: (a) any Asset Sale; or (b) the disposition of any securities by such Person or any of its Restricted Subsidiaries or the extinguishment of any Indebtedness of such Person or any of its Restricted Subsidiaries;

(2) any extraordinary gain (but not loss), together with any related provision for taxes on such extraordinary gain (but not loss);

(3) any foreign exchange gain (loss) on Indebtedness; and

(4) any marked to market gain (loss) whether realized or accrued, without duplication, on Hedging Obligations.

"*Net Proceeds*" means the aggregate cash proceeds received by Mercer or any of its Restricted Subsidiaries in respect of any Asset Sale (including, without limitation, any cash received upon the sale or other disposition of any non-cash consideration received in any Asset Sale), net of the direct costs relating to such Asset Sale, including, without limitation, legal, accounting and investment banking fees, and sales commissions, and any relocation expenses incurred as a result of the Asset Sale, taxes paid or payable as a result of the Asset Sale, in each case, after taking into account any available tax credits or deductions and any tax sharing arrangements, and amounts required to be applied to the repayment of Indebtedness, other than Indebtedness under a Credit Facility, secured by a Lien on the asset or assets that were the subject of such Asset Sale and any reserve for adjustment in respect of the sale price of such asset or assets established in accordance with GAAP.

"*Non-Recourse Debt*" means Indebtedness:

(1) as to which neither Mercer nor any of its Restricted Subsidiaries (a) provides credit support of any kind (including any undertaking, agreement or instrument that would constitute Indebtedness), (b) is directly or indirectly liable as a guarantor or otherwise, or (c) constitutes the lender, other than the guarantees by Mercer of Indebtedness of the Paper Subsidiaries not to exceed €4.7 million in existence as of the date of the supplemental indenture; and

(2) no default with respect to which (including any rights that the holders of the Indebtedness may have to take enforcement action against an Unrestricted Subsidiary) would permit upon notice, lapse of time or both any holder of any other Indebtedness of Mercer or any of its Restricted Subsidiaries (other than Credit Facilities) to declare a default on such other Indebtedness or cause the payment of the Indebtedness to be accelerated or payable prior to its Stated Maturity.

"*Note Guarantee"* means the Guarantee by each Guarantor of Mercer's obligations under the indenture and the notes, executed pursuant to the provisions of the indenture.

"*Obligations*" means any principal, interest, penalties, fees, indemnifications, reimbursements, damages and other liabilities payable under the documentation governing any Indebtedness.

"*Paper Subsidiaries*" means Dresden Papier GmbH and Fährbrücke GmbH.

"*Permitted Business*" means any business conducted by Mercer and its Restricted Subsidiaries on the date of the supplemental indenture, including the pulp and paper manufacturing and sales business and any business reasonably related thereto, ancillary or complimentary to reasonable extensions thereof, including, without limitation, transportation, logistics and wood harvesting and procurement.

"*Permitted Investments*" means:

(1) any Investment in Mercer or in a Restricted Subsidiary of Mercer;

(2) any Investment in Cash Equivalents;

(3) any Investment by Mercer or any Restricted Subsidiary of Mercer in a Person, if as a result of such Investment:

(a) such Person becomes a Restricted Subsidiary of Mercer; or

(b) such Person is merged, consolidated or amalgamated with or into, or transfers or conveys substantially all of its assets to, or is liquidated into, Mercer or a Restricted Subsidiary of Mercer;

(4) any Investment made as a result of the receipt of non-cash consideration from an Asset Sale that was made pursuant to and in compliance with the covenant described above under the caption " Repurchase at the Option of Holders Asset Sales;"

(5) any acquisition of assets or Capital Stock solely in exchange for the issuance of Equity Interests (other than Disqualified Stock) of Mercer or out of the net proceeds of an issue or sale of Equity Interest of Mercer (other than Disqualified Stock) so long as such acquisition occurs within 60 days thereafter;

(6) any Investments received in compromise or resolution of (A) obligations of trade creditors or customers that were incurred in the ordinary course of business of Mercer or any of its Restricted Subsidiaries, including pursuant to any plan of reorganization or similar arrangement upon the bankruptcy or insolvency of any trade creditor or customer; or (B) litigation, arbitration or other disputes;

(7) Investments represented by Hedging Obligations;

(8) loans or advances to employees made in the ordinary course of business of Mercer or any Restricted Subsidiary of Mercer in an aggregate principal amount not to exceed $2.0 million at any one time outstanding;

(9) repurchases of the notes;

(10) extensions of trade credit or advances to customers on commercially reasonable terms in the ordinary course of business;

(11) Guarantees of Indebtedness of Mercer or any of its Restricted Subsidiaries issued in accordance with the covenant entitled " Incurrence of Indebtedness and Issuance of Preferred Stock;"

(12) Investments resulting from payment of consolidated taxes that include Unrestricted Subsidiaries; and

(13) other Investments in any Person (other than an Affiliate of Mercer that is not a Subsidiary of Mercer) having an aggregate Fair Market Value (measured on the date each such Investment was made and without giving effect to subsequent changes in value), when taken together with all other Investments made pursuant to this clause (13) that are at the time outstanding not to exceed $15.0 million.

"*Permitted Liens*" means:

(1) Liens on assets of Mercer or any of its Restricted Subsidiaries securing Indebtedness and other Obligations under Credit Facilities that was permitted by the terms of the indenture to be incurred and/or securing Hedging Obligations related thereto;

(2) Liens in favor of Mercer;

(3) Liens on property of a Person existing at the time such Person is merged with or into or consolidated with Mercer or any Subsidiary of Mercer; *provided* that such Liens were in existence prior to the contemplation of such merger or consolidation and do not extend to any assets other than those of the Person merged into or consolidated with Mercer or the Subsidiary;

(4) Liens on property (including Capital Stock) existing at the time of acquisition of the property by Mercer or any Subsidiary of Mercer; *provided* that such Liens were in existence prior to, such acquisition, and not incurred in contemplation of, such acquisition;

(5) Liens to secure the performance of statutory obligations, surety or appeal bonds, performance bonds, letters of credit or other obligations of a like nature incurred in the ordinary course of business;

(6) Liens to secure Indebtedness (including Capital Lease Obligations) permitted by clause (4) of the second paragraph of the covenant entitled " Certain Covenants Incurrence of Indebtedness and Issuance of Preferred Stock" covering only the assets acquired with or financed by such Indebtedness;

(7) Liens existing on the date of the supplemental indenture or from contractual commitments existing on the date of the supplemental indenture;

(8) Liens for taxes, assessments or governmental charges or claims that are not yet delinquent or that are being contested in good faith by appropriate proceedings promptly instituted and diligently concluded; *provided* that any reserve or other appropriate provision as is required in conformity with GAAP has been made therefor;

(9) Liens imposed by law, such as carriers', warehousemen's, landlord's and mechanics' Liens, in each case, incurred in the ordinary course of business;

(10) survey exceptions, easements or reservations of, or rights of others for, licenses, rights-of-way, sewers, electric lines, telegraph and telephone lines and other similar purposes, or zoning or other restrictions as to the use of real property that were not incurred in connection with Indebtedness

and that do not in the aggregate materially adversely affect the value of said properties or materially impair their use in the operation of the business of such Person;

(11) Liens created for the benefit of (or to secure) the notes;

(12) Liens to secure any Permitted Refinancing Indebtedness permitted to be incurred under the indenture; *provided, however,* that:

(a) the new Lien shall be limited to all or part of the same property and assets that secured or, under the written agreements pursuant to which the original Lien arose, could secure the original Lien (plus improvements and accessions to, such property or proceeds or distributions thereof); and

(b) the Indebtedness secured by the new Lien is not increased to any amount greater than the sum of (x) the outstanding principal amount, or, if greater, committed amount, of the Permitted Refinancing Indebtedness and (y) an amount necessary to pay any fees and expenses, including premiums, related to such renewal, refunding, refinancing, replacement, defeasance or discharge;

(13) Liens securing Hedging Obligations made in the ordinary course of business and not for speculation; *provided* that such Hedging Obligations are permitted under the indenture;

(14) Liens resulting from sale and leaseback transactions otherwise permitted by the covenant described above under the caption " Certain Covenants Limitation on Sale and Leaseback Transactions" at any one time outstanding that do not exceed $15.0 million; and

(15) Liens incurred in the ordinary course of business of Mercer or any Subsidiary of Mercer with respect to obligations at any one time outstanding that do not exceed $20.0 million.

"*Permitted Refinancing Indebtedness*" means any Indebtedness of Mercer or any of its Restricted Subsidiaries issued in exchange for, or the net proceeds of which are used to renew, refund, refinance, replace, defease or discharge other Indebtedness of Mercer or any of its Restricted Subsidiaries (other than intercompany Indebtedness); *provided* that:

(1) the principal amount (or accreted value, if applicable) of such Permitted Refinancing Indebtedness does not exceed the principal amount (or accreted value, if applicable) of the Indebtedness renewed, refunded, refinanced, replaced, defeased or discharged (plus all accrued interest on the Indebtedness and the amount of all fees and expenses, including premiums, incurred in connection therewith);

(2) such Permitted Refinancing Indebtedness has a final maturity date later than the final maturity date of, and has a Weighted Average Life to Maturity equal to or greater than the Weighted Average Life to Maturity of, the Indebtedness being renewed, refunded, refinanced, replaced, defeased or discharged;

(3) if the Indebtedness being renewed, refunded, refinanced, replaced, defeased or discharged is subordinated in right of payment to the notes, such Permitted Refinancing Indebtedness has a final maturity date later than the final maturity date of, and is subordinated in right of payment to, the notes on terms at least as favorable to the holders of notes as those contained in the documentation governing the Indebtedness being renewed, refunded, refinanced, replaced, defeased or discharged; and

(4) such Indebtedness is incurred either by Mercer or by the Restricted Subsidiary who is the obligor on the Indebtedness being renewed, refunded, refinanced, replaced, defeased or discharged.

"*Person*" means any individual, corporation, partnership, joint venture, association, joint-stock company, trust, unincorporated organization, limited liability company or government or other entity.

"*Restricted Investment*" means an Investment other than a Permitted Investment.

"*Restricted Subsidiary*" of a Person means any Subsidiary of the referent Person that is not an Unrestricted Subsidiary.

"*Rosenthal*" means Zellstoff-und Papierfabrik Rosenthal GmbH & Co. KG and any and all successors thereto.

"*S&P*" means Standard & Poor's Ratings Group.

"*Significant Subsidiary*" means any Subsidiary that would be a "significant subsidiary" as defined in Article 1, Rule 1-02 of Regulation S-X, promulgated pursuant to the Securities Act, as such Regulation is in effect on the date of the supplemental indenture.

"*Stated Maturity*" means, with respect to any installment of interest or principal on any series of Indebtedness, the date on which the payment of interest or principal was scheduled to be paid in the documentation governing such Indebtedness as of the date of the supplemental indenture, and will not include any contingent obligations to repay, redeem or repurchase any such interest or principal prior to the date originally scheduled for the payment thereof.

"*Subordinated Notes*" means Mercer's 8.5% Convertible Senior Subordinated Notes Due 2010.

"*Subordinated Note Indenture*" means the indenture governing the Subordinated Notes.

"*Subsidiary*" means, with respect to any specified Person:

(1) any corporation, association or other business entity of which more than 50% of the total voting power of shares of Capital Stock entitled (without regard to the occurrence of any contingency and after giving effect to any voting agreement or stockholders' agreement that effectively transfers voting power) to vote in the election of directors, managers or trustees of the corporation, association or other business entity is at the time owned or controlled, directly or indirectly, by that Person or one or more of the other Subsidiaries of that Person (or a combination thereof); and

(2) any partnership (a) the sole general partner or the managing general partner of which is such Person or a Subsidiary of such Person or (b) the only general partners of which are that Person or one or more Subsidiaries of that Person (or any combination thereof).

"*Trading Day*" means:

(1) if Mercer's common Capital Stock is quoted on NASDAQ, a day on which trades may be made on NASDAQ; or

(2) if Mercer's common Capital Stock is not so listed, admitted for trading or quoted, any day other than a Saturday or Sunday or a day on which banking institutions in the State of New York are authorized or obligated by law, executive order or otherwise to close.

"*Unrestricted Subsidiary*" means each of Dresden Papier GmbH, Stendal Pulp Holding GmbH, Zellstoff Stendal GmbH, Zellstoff Stendal Holz Service GmbH, Zellstoff Stendal Holz GmbH & Co. KG, ZS Beteiligungs GmbH, Zellstoff Stendal Transport Service GmbH, Zellstoff Stendal Transport GmbH & Co. KG, ZS Transport Beteiligungs GmbH (or any successor to any of them) or any other Subsidiary of Mercer that is designated by the Board of Directors of Mercer as an

Unrestricted Subsidiary pursuant to a resolution of the Board of Directors, but only to the extent that such Subsidiary:

(1) has no Indebtedness other than Non-Recourse Debt;

(2) except as permitted by the covenant described above under the caption " Certain Covenants Transactions with Affiliates," is not party to any agreement, contract, arrangement or understanding with Mercer or any Restricted Subsidiary of Mercer unless the terms of any such agreement, contract, arrangement or understanding are no less favorable to Mercer or such Restricted Subsidiary, as the case may be, than those that might reasonably be obtained at the time from Persons who are not Affiliates of Mercer;

(3) is a Person with respect to which neither Mercer nor any of its Restricted Subsidiaries has any direct or indirect obligation (a) to subscribe for additional Equity Interests or (b) to maintain or preserve such Person's financial condition or to cause such Person to achieve any specified levels of operating results; and

(4) has not guaranteed or otherwise directly or indirectly provided credit support for any Indebtedness of Mercer or any of its Restricted Subsidiaries.

"*Voting Stock*" of any specified Person as of any date means the Capital Stock of such Person that is at the time entitled to vote in the election of the Board of Directors of such Person.

"*Weighted Average Life to Maturity*" means, when applied to any Indebtedness at any date, the number of years obtained by dividing:

(1) the sum of the products obtained by multiplying (a) the amount of each then remaining installment, sinking fund, serial maturity or other required payments of principal, including payment at final maturity, in respect of the Indebtedness, by (b) the number of years (calculated to the nearest one-twelfth) that will elapse between such date and the making of such payment; *by*

(2) the then outstanding principal amount of such Indebtedness.

DESCRIPTION OF CAPITAL STOCK

We are authorized to issue an unlimited number of shares of beneficial interest, $1.00 par value and 50,000,000 preferred shares issuable in series. As of February 8, 2005, there were 18,074,229 shares of beneficial interest and no preferred shares of any series issued and outstanding.

We are also authorized to issue preferred shares from time to time and to: (i) divide the preferred shares into one or more series; (ii) designate the number of shares of each series and the designation thereof; (iii) fix and determine the relative rights and preferences as between series including, but not limited to, the dividend rate (and whether dividends are cumulative), conversion rights, voting rights, rights and terms of redemption (including sinking fund provisions), redemption price and liquidation preferences (if and to the extent that any such rights are to be applicable to any such series); and (iv) amend the relative rights and preferences of any series that is wholly unissued.

Further information relating to our capital stock is set out in the prospectus accompanying this prospectus supplement relating to the securities offered hereby.

MATERIAL U.S. FEDERAL INCOME TAX CONSIDERATIONS

The following summary discusses certain material U.S. federal income tax consequences of the acquisition, ownership and disposition of notes. This discussion is based upon the Internal Revenue Code of 1986, as amended (the "Code"), the applicable proposed or promulgated Treasury regulations, and the applicable judicial and administrative interpretations, all as in effect as of the date hereof and all of which are subject to change, possibly with retroactive effect, and to differing interpretations. This discussion is applicable only to persons who purchase the notes in the initial offering at their original issue price and hold the notes as capital assets for U.S. federal income tax purposes (generally, property held for investment) and not as part of a straddle, a hedge, a conversion transaction or other integrated investment. This discussion is intended for general information only, and does not address all of the tax consequences that may be relevant to holders of notes in light of their particular circumstances, or to certain types of holders (such as financial institutions, insurance companies, tax-exempt entities, partnerships and other pass-through entities for U.S. federal income tax purposes, certain former citizens or residents of the United States, "controlled foreign corporations," "passive foreign investment companies," "foreign personal holding companies," traders in securities that elect to use a marked to market method of accounting for their securities holdings, dealers in securities or currencies, or U.S. Holders (as defined below) whose functional currency is not the U.S. dollar). Moreover, this discussion does not describe any state, local or non-U.S. tax implications, or any aspect of U.S. federal tax law other than income taxation. Prospective investors should consult their tax advisors with regard to the application of the U.S. federal income tax laws to their particular situations, as well as any tax consequences arising under the laws of any state, local, or non-U.S. taxing jurisdiction.

As used herein, a "U.S. Holder" means a beneficial owner of notes that is, for U.S. federal income tax purposes, (a) a citizen or individual resident of the United States, (b) a corporation created or organized in or under the laws of the United States, any State thereof or the District of Columbia, (c) an estate the income of which is subject to U.S. federal income taxation regardless of its source, or (d) a trust, if (1) a court within the United States is able to exercise primary supervision over the trust's administration and one or more U.S. persons have the authority to control all of its substantial decisions or (2) it was in existence on August 20, 1996 and a valid election to be treated as a U.S. person is in effect with respect to such trust. A "Non-U.S. Holder" means a beneficial owner of notes that is neither a U.S. Holder nor a partnership for U.S. federal income tax purposes. The U.S. federal income tax treatment of partners in partnerships holding the notes generally will depend on the activities of the partnership and the status of the partner. Prospective investors that are partnerships (or entities treated as partnerships for U.S. federal income tax purposes) should consult their tax advisors regarding the U.S. federal income tax consequences to them and their partners of the acquisition, ownership and disposition of the notes.

U.S. Federal Income Taxation of U.S. Holders

Payments of Interest. A U.S. Holder must include in gross income, as ordinary interest income, the stated interest on the notes at the time such interest accrues or is received in accordance with the U.S. Holder's regular method of accounting for U.S. federal income tax purposes.

Sale, Retirement or Other Taxable Disposition. Upon the sale, retirement or other taxable disposition of a note, a U.S. Holder generally will recognize taxable gain or tax loss equal to the difference between (a) the sum of cash plus the fair market value of other property received on the sale, retirement or other taxable disposition (except to the extent such cash or property is attributable to accrued but unpaid interest, which will be treated in the manner described above under "-Payments of Interest") and (b) the U.S. Holder's adjusted tax basis in the note. A U.S. Holder's adjusted tax basis in a note generally will equal the amount paid for the note, reduced by any principal payments with respect to the note received by the U.S. Holder. Gain or loss recognized on the sale, retirement or

other taxable disposition of a note generally will be capital gain or loss and will be long-term capital gain or loss if, at the time of sale, retirement or other taxable disposition, the note has been held for more than one year. Certain U.S. Holders (including individuals) are eligible for preferential rates of U.S. federal income tax in respect of long-term capital gain. The deductibility of capital losses by U.S. Holders is subject to limitations under the Code.

U.S. Federal Income Taxation of Non-U.S. Holders

Payments of Interest. Subject to the discussion of backup withholding below and provided that a Non-U.S. Holder's income and gains in respect of a note are not effectively connected with the conduct by the Non-U.S. Holder of a U.S. trade or business, payments of interest on a note to the Non-U.S. Holder generally will not be subject to U.S. federal income or withholding tax, provided that (a) the Non-U.S. Holder does not own, directly or constructively, 10% or more of the total combined voting power of all classes of our stock entitled to vote, (b) the Non-U.S. Holder is not, for U.S. federal income tax purposes, a "controlled foreign corporation" related, directly or constructively, to us through stock ownership, (c) the Non-U.S. Holder is not a bank receiving interest on a loan entered into in the ordinary course of its trade or business and (d) certain certification requirements (as described below) are met.

Under the Code and the applicable Treasury regulations, in order to obtain an exemption from U.S. federal withholding tax, either (a) a Non-U.S. Holder must provide its name and address and certify, under penalties of perjury, that such Non-U.S. Holder is not a U.S. person or (b) a securities clearing organization, bank or other financial institution that holds customers' securities in the ordinary course of its trade or business (a "Financial Institution"), and that holds the notes on behalf of the Non-U.S. Holder, must certify, under penalties of perjury, that such certificate has been received from such Non-U.S. Holder by such Financial Institution or by another Financial Institution between such Financial Institution and such Non-U.S. Holder and, if required, must furnish the payor with a copy thereof. Generally, the foregoing certification requirement may be met if a Non-U.S. Holder delivers a properly executed IRS Form W-8BEN to the payor.

Payments of interest on a note that do not satisfy all of the foregoing requirements generally will be subject to U.S. federal withholding tax at a rate of 30% (or a lower applicable treaty rate, provided certain certification requirements are met). A Non-U.S. Holder generally will be subject to U.S. federal income tax in the same manner as a U.S. Holder with respect to interest on a note if such interest is effectively connected with a U.S. trade or business conducted by the Non-U.S. Holder (or, if an income tax treaty applies, is attributable to a permanent establishment or fixed base maintained by the Non-U.S. Holder in the United States). Under certain circumstances, effectively connected interest income received by a corporate Non-U.S. Holder may be subject to an additional "branch profits tax" at a 30% rate (or a lower applicable treaty rate, provided certain certification requirements are met). Subject to the discussion of backup withholding below, such effectively connected interest income generally will be exempt from U.S. federal withholding tax if a Non-U.S. Holder delivers a properly executed IRS Form W-8ECI to the payor.

Sale, Retirement or Other Disposition. In general, subject to the discussion of backup withholding below, a Non-U.S. Holder generally will not be subject to U.S. federal income or withholding tax on any gain recognized on the sale, retirement or other disposition of the notes, unless (a) the Non-U.S. Holder is an individual who is present in the United States for 183 or more days in the taxable year of disposition and certain other conditions are met or (b) the gain is effectively connected with the conduct of a U.S. trade or business by the Non-U.S. Holder (or, if an income tax treaty applies, is attributable to a permanent establishment or fixed base maintained by the Non-U.S. Holder in the United States).

Information Reporting and Backup Withholding

U.S. Holders. Generally, information reporting will apply to payments of principal and interest on the notes to a U.S. Holder and to the proceeds of sale or other disposition of the notes, unless the U.S. Holder is an exempt recipient (such as a corporation). Backup withholding generally will apply to such payments (currently at a rate of 28%), if a U.S. Holder fails to provide a correct taxpayer identification number or a certification of exempt status or fails to report in full dividend and interest income. Any amount withheld under the backup withholding rules generally will be allowed as a refund or credit against a U.S. Holder's U.S. federal income tax liability provided that the required information is timely furnished to the Internal Revenue Service (the "IRS").

Non-U.S. Holders. Generally, payments of interest on the notes to a Non-U.S. Holder and the amount of any tax withheld from such payments must be reported annually to the IRS and to the Non-U.S. Holder. Copies of these information returns may be made available by the IRS to the tax authorities of the country in which the Non-U.S. Holder is a resident under the provisions of an applicable tax treaty. Under certain circumstances, information reporting also would apply to payments of principal on the notes, and backup withholding of U.S. federal income tax (currently at a rate of 28%) may apply to payments of principal and interest on the notes to a Non-U.S. Holder if the Non-U.S. Holder fails to certify under penalties of perjury that it is not a U.S. person.

Payments of the proceeds of the sale or other disposition of the notes by or through a foreign office of a U.S. broker or of a foreign broker with certain specified U.S. connections will be subject to information reporting requirements, but generally not backup withholding, unless the broker has evidence in its records that the payee is not a U.S. person and the broker has no actual knowledge or reason to know to the contrary. Payments of the proceeds of a sale or other disposition of the notes by or through the U.S. office of a broker will be subject to information reporting and backup withholding unless the payee certifies under penalties of perjury that it is not a U.S. person or otherwise establishes an exemption.

Any amount withheld under the backup withholding rules generally will be allowed as a refund or credit against a Non-U.S. Holder's U.S. federal income tax liability, provided that the required information is timely furnished to the IRS.

STATE AND OTHER TAX CONSIDERATIONS

In addition to the United States federal income tax consequences described in "Material U.S. Federal Income Tax Considerations", above, potential investors should consider the state, local and foreign tax consequences of acquiring, owning and disposing of the notes. State, local and foreign tax laws may differ substantially from the corresponding United States federal law, and the discussion above does not purport to describe any aspect of the tax laws of any state or other jurisdiction. Therefore, prospective investors should consult their tax advisors with respect to the various tax consequences of investments in the notes.

UNDERWRITING

RBC Capital Markets Corporation and Credit Suisse First Boston LLC are acting as the joint lead managers of the offering. Subject to the terms and conditions of the underwriting agreement, we have agreed to sell to the underwriters, and each underwriter has agreed to purchase from us, the principal amount of notes listed below. The underwriters' obligations are several, which means that each underwriter is required to purchase a specified principal amount of notes, but other than the limited circumstances set forth in the underwriting agreement, is not responsible for the commitment of any other underwriter to purchase notes.

Underwriters		Principal Amount
RBC Capital Markets Corporation	$	145,700,000
Credit Suisse First Boston LLC	$	145,700,000
CIBC World Markets Corp	$	18,600,000
Total	$	310,000,000

The underwriting agreement provides that the underwriters' obligations to purchase the notes are subject to approval of legal matters by counsel and to the satisfaction of other conditions. The underwriters are obligated to purchase all of the notes if they purchase any notes.

Concurrently with this offering of notes, we are also offering to the public approximately $80 million of shares of beneficial interest to pay a portion of the purchase price of the Acquisition. The public offering of shares is being underwritten by a syndicate of underwriters for whom RBC Capital Markets Corporation is acting as the representative. The completion of the offering of notes under this prospectus supplement and the Share Offering are contingent upon each other and both such offerings are contingent upon the satisfaction or waiver of all conditions relating to the Acquisition other than the condition relating to the Financings.

Jimmy S.H. Lee, our President and Chief Executive Officer and a trustee, will be purchasing $2.0 million of our senior notes pursuant to this offering and 350,000 of our shares pursuant to the Share Offering.

Commissions and Expenses

The joint lead managers have advised us that the underwriters propose to offer the notes directly to the public at the public offering price presented on the cover page of this prospectus supplement. The following table summarizes the underwriting discounts and commissions that we will pay to the underwriters in connection with this offering.

	Per Note		Total
Public offering price	100%	$	310,000,000
Underwriting discount paid by us	2.5%	$	7,750,000

Any NASD member that participates in an offering of notes must comply with, and make filings required by, Rule 2710 of the conduct Rules of the NASD. The maximum commission or discount to be received by any NASD member or independent broker dealer may not exceed 8% of the aggregate principal amount of the securities offered pursuant to this prospectus supplement.

We estimate that the total expenses of this offering including registration, filing and listing fees, printing fees and legal and accounting expenses, but excluding underwriting discounts and commissions, will be approximately €1.4 million. In addition, RBC Capital Markets Corporation has made arrangements with its affiliated broker-dealer, RBC Dain Rauscher, to perform settlement and other activities in connection with the offering, for which RBC Dain Rauscher will receive compensation from RBC Capital Markets Corporation.

Indemnification

We have agreed to indemnify the underwriters against liabilities relating to the offering, including liabilities under the Securities Act and Canadian securities laws, and to contribute to payments that the underwriters may be required to make for these liabilities.

New Issue of Notes

The notes are a new issue of securities with no established trading market. The underwriters have advised us that they currently intend to facilitate a secondary market in the notes, but are not obligated to do so and may discontinue market making at any time. No assurance can be given as to the liquidity of the trading market for the notes.

Stabilization, Short Positions and Penalty Bids

The joint lead managers may engage in stabilizing transactions, over-allotment, syndicate covering transactions and penalty bids or purchases for the purpose of pegging, fixing or maintaining the price of our notes in accordance with Regulation M under the Exchange Act.

Stabilizing transactions permit bids to purchase the underlying security so long as the stabilizing bids do not exceed a specific maximum.

Over-allotment transactions involve sales by the underwriters of notes in excess of the number of notes the underwriters are obligated to purchase, which creates a syndicate short position. The underwriters may close out any short position by purchasing notes in the open market.

Syndicate covering transactions involve purchases of our notes in the open market after the distribution has been completed in order to cover syndicate short positions. A short position is likely to be created if the underwriters are concerned that there may be downward pressure on the price of the notes in the open market after pricing that could adversely affect investors who purchase in the offering.

Penalty bids permit the joint lead managers to reclaim a selling concession from a syndicate member when the notes originally sold by the syndicate member is purchased in a stabilizing or syndicate covering transaction to cover syndicate short positions.

These stabilizing transactions, syndicate covering transactions and penalty bids may have the effect of raising or maintaining the market price of our notes and/or other of our debt securities or preventing or retarding a decline in the market price of our notes. As a result, the price of our notes (or such other securities) may be higher than the price that might otherwise exist on the open market. These transactions may be effected on the over-the-counter market or otherwise and, if commenced, may be discontinued at any time.

Neither we nor any of the underwriters make any representation or prediction as to the direction or magnitude of any effect that the transactions described above may have on the price of our notes. In addition, neither we nor any of the underwriters make any representation that the representatives will engage in these stabilizing transactions or that any transaction, once commenced, will not be discontinued without notice.

Electronic Distribution

The prospectus supplement and the prospectus in electronic format may be made available on the websites maintained by one or more of the underwriters participating in this offering and one or more of the underwriters participating in this offering may distribute such documents electronically. The joint lead managers may agree to allocate a number of notes to underwriters for sale to their online brokerage account holders. Internet distributions will be allocated by the underwriters that will make internet distributions on the same basis as other allocations.

Relationships

The underwriters may, from time to time, engage in transactions with or perform services for us in the ordinary course of their business.

RBC Capital Markets Corporation and CIBC World Markets Corp., underwriters for this offering of notes, are acting as underwriters in the Share Offering, for which they are receiving customary fees.

In connection with the $30 million working capital facility for the Celgar mill expected to be entered into on the closing of the Acquisition, an affiliate of RBC Capital Markets Corporation is acting as arranger on a best efforts basis, for which it will receive customary fees. Royal Bank of Canada, also an affiliate of RBC Capital Markets Corporation, has committed $15 million to the facility, for which it will receive customary fees. Royal Bank of Canada will also act as the administrative agent for the lenders under the working capital facility.

In October 2003, RBC Capital Markets Corporation acted as the initial purchaser for our private placement of offering of $82.5 million of 8.5% convertible senior subordinated notes due 2010, for which it received customary underwriting fees.

Credit Suisse First Boston LLC has been engaged by us to provide strategic and financial advisory services through 2005, for which they will receive customary fees.

In November 2004, an affiliate of CIBC World Markets Corp. provided financial advisory services to us in connection with the Acquisition, for which such affiliate received customary fees.

Qualified Independent Underwriter

We intend to use more than 10% of the net proceeds from the sale of the notes to pay a portion of the purchase price for the Acquisition. Royal Bank of Canada, an affiliate of RBC Capital Markets Corporation, one of the joint lead managers of this offering, is a secured creditor and owner of the Celgar mill. Royal Bank of Canada will receive approximately $93 million of the proceeds of this offering and the Share Offering and will receive approximately $20 million of our shares of beneficial interest in consideration for the assets of Celgar that we are acquiring in the Acquisition.

Accordingly, this offering is being made in compliance with the requirements of Rules 2710(h) and 2720(c)(3) of the Conduct Rules of the National Association of Securities Dealers, Inc. This rule provides generally that if more than 10% of the net proceeds from the sale of debt securities, not including underwriting compensation, is paid to the underwriters of such debt securities or their affiliates, the yield on the securities may not be lower than that recommended by a "qualified independent underwriter" meeting certain standards. Credit Suisse First Boston LLC is assuming the responsibilities of acting as the qualified independent underwriter in pricing the offering and conducting due diligence. The yield on the notes, when sold to the public at the public offering price set forth on the cover page of this prospectus supplement, will be no lower than that recommended by Credit Suisse First Boston LLC.

Credit Suisse First Boston LLC will not receive any compensation for its services as a qualified independent underwriter; however, we will agree to indemnify Credit Suisse First Boston LLC against liabilities incurred in connection with acting as qualified independent underwriter, including liabilities under the Securities Act of 1933.

NOTICE TO INVESTORS

This prospectus supplement and the accompanying prospectus does not constitute an offer to sell or a solicitation of an offer to buy the notes in any jurisdiction which, or to any person to whom, it is unlawful to make such offer or solicitation in such jurisdiction. The distribution of this prospectus supplement and the accompanying prospectus and the offer and sale of the notes is restricted by law in certain jurisdictions. Persons into whose possession this prospectus supplement or any of the notes may come must inform themselves about, and observe, any such restrictions. This prospectus supplement may not be used for, or in connection with, any offer to, or solicitation by, anyone in any jurisdiction or circumstances in which such offer or solicitation is not authorized or is unlawful. Neither the Company nor any underwriter is making any representation to any offeree or purchaser of the notes herein regarding the legality of the investment therein by such offeree or purchaser.

Each underwriter has agreed that (1) it has not offered or sold, and prior to the six months after the date of issue will not offer or sell, any notes to persons in the United Kingdom except to a person whose ordinary activities involve them in acquiring, holding, managing or disposing of investments (as principal or agent) for the purposes of their business or otherwise in circumstances which have not resulted and will not result in an offer to the public in the United Kingdom within the meaning of the Public Offers of Securities Regulations 1995, (2) it has only communicated or caused to be communicated, and will only communicate or cause to be communicated, any invitation or inducement to engage in investment activity (within the meaning of section 21 of the Financial Services and Markets Act ("FSMA")) received by it in connection with the issue or the sale of any notes in circumstances in which section 21(1) of the FSMA does not apply to us, and (3) it has complied with all applicable provisions of the FSMA with respect to anything done by it in relation to any notes in, from or otherwise involving the United Kingdom.

This prospectus supplement has not been prepared in the context of a public offering of securities in France within the meaning of Article L.411-1 of the French *Code Monétaire et Financier* and Regulations No. 98-01 and 98-08 of the *Commission des Opérations de Bourse* ("COB") and has therefore not been submitted to the COB for prior approval. It is made available only to qualified investors and/or to a limited circle of investors (as defined in Article L.411-2 of the French *Code Monétaire et Financier* and in the Decree No. 98-880 dated 1 October 1998), on the condition that it shall not be passed on to any person nor reproduced (in whole or in part) and that applicants act for their own account in accordance with the terms set out by the said Decree and undertake not to retransfer, directly or indirectly, the notes in France, other than in compliance with applicable laws and regulations (Articles L.411-1, L.411-2, L.412-1 and L.621-8 of the French *Code Monétaire et Financier*).

The offer of securities for sale in Germany is subject to certain restrictions, namely the restrictions provided in the German Securities Selling Prospectus Act (*Wertpapier-Verkaufsprospektgesetz*). The offer of the notes does not constitute a public offer of securities for sale in Germany. This prospectus supplement has not been approved by the German Federal Supervisory Authority for Financial Services (*Bundesanstalt für Finanzdienstleistungsaufsicht*) or any other competent German authority under the relevant laws. This prospectus supplement may not be publicly distributed in Germany and may not be used in connection with any resale of the notes. The notes may not be resold in Germany by way of a public offer. The notes will only be available to persons who on a professional or commercial basis purchase securities themselves for their own account or for the account of a third party.

The notes may not and will not be offered or sold to any individual or legal entity in The Netherlands other than to individuals or legal entities who or which trade in securities in the conduct of their profession or trade within the meaning of section 2 of the exemption regulation pursuant to the Dutch Securities Market Supervision Act (*Vrijstellingregeling Wet toezicht effectenverker* 1995), which includes banks, securities intermediaries (including dealers and brokers), insurance companies, pension

funds, other institutional investors and commercial enterprises which, as an ancillary activity, regularly invest or trade in securities.

The notes are sold in Switzerland on the basis of a private placement. This prospectus supplement does not, therefore, constitute a "Prospectus" within the meaning of Art. 652A of the Swiss Federal Code of Obligations.

LEGAL MATTERS

The validity of the senior notes offered hereby and certain other legal matters in connection with the issuance and sale of the senior notes offered hereby will be passed upon for the Company by Sangra Moller, Vancouver, British Columbia and Heller Ehrman White & McAuliffe LLP, Seattle, Washington. Certain legal matters in connection with the issuance and sale of the senior notes offered hereby will be passed upon for the underwriters by Latham & Watkins LLP, Los Angeles, California, Lawson Lundell, Vancouver, British Columbia and Stoel Rives LLP, Seattle, Washington.

EXPERTS

The consolidated financial statements of Mercer as at December 31, 2003 and for the year then ended included in this prospectus supplement have been audited by Deloitte & Touche LLP, independent registered chartered accountants, as stated in their report which is included in this prospectus supplement, and have been so included in reliance upon the report of such firm and given upon their authority as experts in accounting and auditing.

The annual audited consolidated balance sheet of Mercer as at and for the year ended December 31, 2002 and the related consolidated statements of operations, comprehensive income, changes in shareholders' equity, and cash flows for the years ended December 31, 2002 and 2001 included in this prospectus supplement have been so included in reliance on the report of Peterson Sullivan P.L.L.C., an independent registered public accounting firm, given on the authority of said firm as experts in accounting and auditing.

The annual audited balance sheets of Celgar as at and for the years ended December 31, 2003 and 2002 and the related statements of loss and deficit and cash flows for the years ended December 31, 2003, 2002 and 2001 included in this prospectus supplement have been so included in reliance on the report of Deloitte & Touche LLP, independent registered chartered accountants, given on the authority of said firm as experts in accounting and auditing.

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MERCER INTERNATIONAL INC.
Report of Independent Registered Chartered Accountants
and
Consolidated Financial Statements
For the Year Ended December 31, 2003

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REPORT OF INDEPENDENT REGISTERED CHARTERED ACCOUNTANTS

To the Board of Trustees and Shareholders of
Mercer International Inc.

We have audited the accompanying consolidated balance sheet of Mercer International Inc. and subsidiaries (the "Company") as of December 31, 2003, and the related consolidated statements of operations, comprehensive income (loss), changes in shareholders' equity, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the consolidated financial position of the Company as of December 31, 2003, and the consolidated results of their operations and their cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

/s/ DELOITTE & TOUCHE LLP

Vancouver, British Columbia
February 26, 2004

INDEPENDENT AUDITORS' REPORT

To the Shareholders
Mercer International Inc.

We have audited the accompanying consolidated balance sheet of Mercer International Inc. and Subsidiaries as of December 31, 2002, and the related consolidated statements of operations, comprehensive income, changes in shareholders' equity, and cash flows for the years ended December 31, 2002 and 2001. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Mercer International Inc. and Subsidiaries as of December 31, 2002, and the consolidated results of their operations and their cash flows for the years ended December 31, 2002 and 2001, in conformity with accounting principles generally accepted in the United States of America.

/s/ PETERSON SULLIVAN
P.L.L.C.

January 31, 2003
Seattle, Washington

MERCER INTERNATIONAL INC.

CONSOLIDATED BALANCE SHEETS

December 31, 2003 and 2002
(In Thousands of Euros)

	2003	2002
ASSETS		
Current Assets		
Cash and cash equivalents	€ 51,993	€ 30,261
Cash restricted (Note 1)	15,187	9,459
Investments (Note 2)	6	307
Receivables (Note 3)	32,285	28,132
Cumulative derivative gains	743	3,792
Inventories (Note 4)	23,909	16,375
Prepaid expenses	4,278	7,891
Total current assets	128,401	96,217
Long-Term Assets		
Cash restricted (Note 1)	44,180	38,795
Property, plant and equipment (Note 5)	745,178	441,990
Investments (Note 2)	1,644	5,592
Equity method investments (Note 2)	2,309	7,019
Deferred note issuance costs	4,213	
Deferred income tax (Note 10)	9,980	10,137
	807,504	503,533
Total assets	€ 935,905	€ 599,750
LIABILITIES		
Current Liabilities		
Accounts payable and accrued expenses (Note 6)	€ 37,414	€ 32,866
Construction in progress costs payable	42,756	24,885
Note payable (Note 7)	1,377	832
Note payable, construction in progress (Note 7)		15,000
Debt, construction in progress (Note 8)	80,000	
Debt, current portion (Note 9)	15,801	16,306
Total current liabilities	177,348	89,889
Long-Term Liabilities		
Debt, construction in progress (Note 9)	324,238	146,485
Debt, less current portion (Note 9)	255,901	205,393
Derivative financial instruments, construction in progress (Note 15)	43,151	30,108
Capital leases and other	2,412	2,906
	625,702	384,892
Total liabilities	803,050	474,781
Minority Interest		
Commitments and Contingencies (Note 17)		

SHAREHOLDERS' EQUITY

	2003	2002
Preferred shares, no par value; 50,000,000 authorized and issuable in series		
Series A, 500,000 authorized, none issued and outstanding		
Series B, 3,500,000 authorized, none issued and outstanding		
Shares of beneficial interest, U.S.$1 par value; unlimited authorized; 17,099,899 issued and outstanding at December 31, 2003 and 16,874,899 at December 31, 2002	78,139	76,995
Additional paid-in capital, stock options	223	
Retained earnings	49,196	52,789
Accumulated other comprehensive income (loss)	5,297	(4,815)
Total shareholders' equity	132,855	124,969
Total liabilities and shareholders' equity	€ 935,905	€ 599,750

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

MERCER INTERNATIONAL INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

For the Years Ended December 31, 2003, 2002 and 2001
(In Thousands of Euros, Except Per Share Data)

	2003	2002	2001
Revenues			
Sales of pulp and paper	€ 182,456	€ 227,883	€ 205,001
Transportation	3,607	4,953	5,491
Other	8,493	6,296	5,955
	194,556	239,132	216,447
Cost of sales			
Pulp and paper	176,655	208,454	180,603
Transportation	3,035	5,009	4,076
Gross profit	14,866	25,669	31,768
General and administrative	19,323	24,979	18,436
Settlement expenses	1,041		
Flooding grants, less losses and expenses	(957)	1,835	
(Loss) income from operations	(4,541)	(1,145)	13,332
Other income (expense)			
Interest expense	(11,523)	(13,753)	(16,170)
Investment income	1,653	436	2,872
Derivative financial instruments			
Unrealized loss, construction in progress financing	(13,042)	(30,108)	
Realized gain, construction in progress financing	743		
Net gains (losses), other	28,467	23,429	(2,504)
Impairment of equity method investments	(2,255)		
Impairment of available-for-sale securities	(5,570)		
Other		3,590	(270)
Total other expense	(1,527)	(16,406)	(16,072)
Loss before income taxes and minority interest	(6,068)	(17,551)	(2,740)
Income tax (provision) benefit (Note 10)	(3,172)	264	(83)
Loss before minority interest	(9,240)	(17,287)	(2,823)
Minority interest	5,647	10,965	
Net loss	€ (3,593)	€ (6,322)	€ (2,823)
Loss per share (Note 13)			
Basic	€ (0.21)	€ (0.38)	€ (0.17)
Diluted	€ (0.21)	€ (0.38)	€ (0.17)

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

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MERCER INTERNATIONAL INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

For the Years Ended December 31, 2003, 2002 and 2001
(In Thousands of Euros)

	2003	2002	2001
Net loss	€ (3,593)	€ (6,322)	€ (2,823)
Other comprehensive income (loss)			
Foreign currency translation adjustment	2,501	2,186	(942)
Unrealized gains (losses) on securities			
Unrealized holding gains (losses) arising during the period	(201)	(3,615)	1,881
Reclassification adjustment for losses included in net loss	2,293	834	
Reclassification adjustment for other than temporary decline in value	5,519		
	7,611	(2,781)	1,881
Other comprehensive income (loss)	10,112	(595)	939
Comprehensive income (loss)	€ 6,519	€ (6,917)	€ (1,884)

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

MERCER INTERNATIONAL INC.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

For the Years Ended December 31, 2003, 2002 and 2001
(In Thousands of Euros)

	Shares of Beneficial Interest					Accumulated Other Comprehensive Income (Loss)			
	Number of Shares	Par Value	Amount Paid in Excess of Par Value	Additional paid-in capital, stock options	Retained Earnings	Foreign Currency Translation Adjustments	Unrealized Gains (Losses) on Securities	Total	Shareholders' Equity
Balance at December 31, 2000	16,794,899	€ 12,781	€ 63,941	€	€ 61,934	€ 2,247	€ (7,406)	€ (5,159)	€ 133,497
Net loss					(2,823)				(2,823)
Other comprehensive income (loss)						(942)	1,881	939	939
Balance at December 31, 2001	16,794,899	12,781	63,941		59,111	1,305	(5,525)	(4,220)	131,613
Shares issued for cash	200,000	191	695						886
Repurchase of shares	(120,000)	(121)	(492)						(613)
Net loss					(6,322)				(6,322)
Other comprehensive income (loss)						2,186	(2,781)	(595)	(595)
Balance at December 31, 2002	16,874,899	12,851	64,144		52,789	3,491	(8,306)	(4,815)	124,969
Shares issued on exercise of stock options	225,000	202	942	(231)					913
Granting of stock options				454					454
Net loss					(3,593)				(3,593)
Other comprehensive income						2,501	7,611	10,112	10,112
Balance at December 31, 2003	17,099,899	€ 13,053	€ 65,086	€ 223	€ 49,196	€ 5,992	€ (695)	€ 5,297	€ 132,855

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

MERCER INTERNATIONAL INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Years Ended December 31, 2003, 2002 and 2001
(In Thousands of Euros)

	2003	2002	2001
Cash Flows from Operating Activities			
Net loss	€ (3,593)	€ (6,322)	€ (2,823)
Adjustments to reconcile net loss to cash flows from operating activities			
Loss on derivative financial instruments, construction in progress, net	12,299	30,108	
Depreciation and amortization	24,105	25,614	22,966
Impairment of investments	7,825		
Minority interest	(5,647)	(10,965)	
Loss from equity investee	1,676		
Stock compensation expense	454		
Changes in current assets and liabilities			
Investments	298	4,356	514
Inventories	(7,534)	1,717	2,611
Receivables	(4,699)	18,238	8,233
Cumulative unrealized gains on derivatives	3,792	(3,329)	(463)
Accounts payable and accrued expenses	1,082	(12,661)	(292)
Other	1,382	(6,310)	(382)
Net cash from operating activities	31,440	40,446	30,364
Cash Flows used in Investing Activities			
Purchase of property, plant and equipment, net of investment grants	(325,257)	(199,171)	(6,962)
Sale of properties	48	4,394	
Purchases of available-for-sale securities		(612)	(636)
Sale of available-for-sale securities	6,408	948	
Purchase of a subsidiary, net of cash acquired			(2,055)
Disposal of a subsidiary		(1,156)	
Other	342	(56)	
Net cash used in investing activities	(318,459)	(195,653)	(9,653)
Cash Flows from (used in) Financing Activities			
Cash restricted	(11,113)	(14,866)	(6,615)
Increase in construction in progress costs payable	19,347	24,885	
Decrease in operating pulp mill renovation costs payable			(1,008)
Proceeds from borrowings of notes payable and debt	367,588	183,017	6,503
Repayment of notes payable and debt	(68,581)	(23,725)	(28,962)
Repayment of capital lease obligations	(1,011)	(1,097)	(1,266)
Issuance of shares of beneficial interest	913	273	
Equity and loans from minority shareholders		6,259	
Net cash from (used in) financing activities	307,143	174,746	(31,348)
Effect of exchange rate changes on cash and cash equivalents	1,608	(1,019)	2,689
Net increase (decrease) in cash and cash equivalents	21,732	18,520	(7,948)
Cash and Cash Equivalents, beginning of year	30,261	11,741	19,689
Cash and Cash Equivalents, end of year	€ 51,993	€ 30,261	€ 11,741

2003	2002	2001

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

MERCER INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 1. The Company and Summary of Significant Accounting Policies

Mercer International Inc. ("the Company") is a business trust organized under the laws of the State of Washington, U.S. Under Washington law, shareholders of a business trust have the same limited liability as shareholders of a corporation. The Company produces and markets pulp and paper products. The amounts in the notes are rounded to the nearest thousand of Euros except for the share and per share amounts.

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its subsidiaries or investees in which the Company exercises control. Significant intercompany accounts and transactions have been eliminated.

Cash and Cash Equivalents

Cash and cash equivalents include highly liquid investments with original maturities of three months or less. The Company maintains cash balances in foreign financial institutions in excess of insured limits.

At December 31, 2003, €15,187 in cash was restricted by a lender to pay construction in progress costs payable. In addition, the Company had €44,180 of long-term restricted cash representing debt service reserve accounts required by long-term debt agreements.

Investments

Trading securities, consisting of marketable securities, are classified as current investments and are reported at fair values with realized gains or losses and unrealized holding gains or losses included in the results of operations.

The Company has certain equity investments in publicly traded companies in which it has less than 20% of the voting interest and in which it does not exercise significant influence. These securities are classified as available-for-sale securities and reported at fair values; based upon quoted market prices, with the unrealized gains or losses included as a separate component of shareholders' equity, until realized. If a loss in value in available-for-sale securities is considered to be other than temporary, the loss is recognized in the determination of net income. Available-for-sale securities have been classified as long-term investments.

The Company has certain equity investments in non-publicly traded companies in which it has less than 20% of the voting interest and in which it does not exercise significant influence. The Company monitors these securities for impairment and makes appropriate reductions in carrying values when necessary. These investments have been classified as long-term investments.

The cost of securities sold is based on the specific identification method to determine realized gains or losses.

Investments in entities where the Company owns between 20% and 50% of the voting interest, and in which the Company exercises significant influence are accounted for using the equity method. Under this method, the investment is initially recorded at cost then reduced by dividends and increased or decreased by the Company's proportionate share of the investee's net earnings or loss. The amount of earnings or losses from equity investees is included in other investment income.

Inventories

Inventories of pulp, paper and logs are valued at the lower of average cost and net realizable value. Other materials and supplies are valued at the lower of average cost and replacement cost.

Property, plant and equipment

Property, plant and equipment is stated at cost less accumulated depreciation. Depreciation of buildings and production equipment is based on the estimated useful lives of the assets and is computed using the straight-line method. Buildings are depreciated over 10 to 50 years and production equipment over 8 to 20 years. Repairs and maintenance are charged to expense as incurred. Expenditures for new facilities and those expenditures that substantially increase the useful lives of existing property, plant and equipment are capitalized, as well as interest costs associated with major capital projects until ready for their intended use. Construction in progress includes costs related to building the Stendal pulp mill in Germany and capitalized interest (Note 5).

The Company reviews its long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value of such assets may not be recoverable. To determine recoverability, the Company compares the carrying value of the assets to the estimated future undiscounted cash flows. Measurement of an impairment loss for long-lived assets held for use is based on the fair value of the asset.

The Company provides for asset retirement obligations when there are legislated or contractual bases for those obligations and fair value can be reasonably estimated. Due to the long-term nature of the underlying assets and discount rates, such amounts cannot currently be reliably estimated. Obligations, if any, are capitalized and amortized over the remaining useful life of the related operations.

Government Grants

The Company records investment grants from federal and state governments when they are received. Grants related to assets are government grants whose primary condition is that the company qualifying for them should purchase, construct or otherwise acquire long-term assets. Secondary conditions may also be attached restricting the type or location of the assets and/or other conditions must be met. Grants related to assets, when received, are deducted from the asset costs. Grants related to income are government grants which are either unconditional or related to the Company's normal business operations, and are reported as income when received.

Deferred Note Issuance Costs

Note issuance costs are deferred and amortized as expenses over the term of the related debt instrument.

Foreign Operations and Currency Translation

The Company translates foreign assets and liabilities of its subsidiaries, other than those denominated in Euros, at the rate of exchange at the balance sheet date. Revenues and expenses are translated at the average rate of exchange throughout the year. Gains or losses from these translations are reported as a separate component of other comprehensive income (loss), until all or a part of the

investment in the subsidiaries is sold or liquidated. The translation adjustments do not recognize the effect of income tax because the Company expects to reinvest the amounts indefinitely in operations.

Transaction gains and losses that arise from exchange rate fluctuations on transactions denominated in a currency other than the local functional currency are included in "General and administrative expenses" in the statement of operations, which amounted to €(1,664), €(3,026) and €3,361 for the years ended December 31, 2003, 2002 and 2001, respectively.

Effective January 1, 2002, the Company changed its reporting currency from the U.S. dollar to the Euro (except for currency amounts as contractually required). The reason for this change was because a significant majority of the Company's assets and operations are located in Germany where the currency is the Euro. The Company's functional currency and reporting currency are now the same. Prior years' financial statements had been reported in U.S. dollars, but have been restated into Euros using the guidance of Statement of Financial Accounting Standards ("SFAS") No. 52, "Foreign Currency Translation." Therefore, the financial statements for prior years depict the same trends as the previous financial statements presented in U.S. dollars.

Revenue and Related Cost Recognition

The Company recognizes revenue from product sales, transportation and other when persuasive evidence of an arrangement exists, the sales price is fixed or determinable, title of ownership and risk of loss have passed to the customer and collectibility is reasonably assured. Sales are reported net of discounts and allowances. Amounts charged to customers for shipping and handling are recognized as revenue. Shipping and handling costs incurred by the Company are included in cost of sales.

Environmental Conservation

Liabilities for environmental conservation are recorded when it is probable that obligations have been incurred and their fair value can be reasonably estimated. Any potential recoveries of such liabilities are recorded when there is an agreement with the reimbursing entity and recovery is assessed as likely to occur.

Stock-Based Employee Compensation

The Company has a stock-based employee compensation plan, which is described more fully in Note 11. The Company accounts for the plan under the recognition and measurement principles of APB Opinion No. 25 ("APB 25"), "Accounting for Stock Issued to Employees," and related interpretations. In 2002, no stock-based employee compensation cost is reflected in net loss, as all options granted under the plan had an exercise price equal to or greater than the market value of the underlying common stock on the date of grant. In 2003, the Company granted stock options to its Chief Financial Officer to acquire up to 100,000 shares of beneficial interest of the Company. At the date of the granting, the market value of the options was greater than the exercise price. Accordingly, the intrinsic value of the stock options was recognized as a stock-based compensation expense in accordance with APB 25 and included in the consolidated statements of operations. The following table illustrates the effect on net loss and loss per share if the Company had applied the fair value

recognition provisions of SFAS No. 123, "Accounting for Stock-Based Compensation," to stock-based employee compensation.

	2003	2002	2001
Net Loss			
As reported	€ (3,593)	€ (6,322)	€ (2,823)
Deduct: Total stock-based employee compensation expense determined under fair value based methods for all awards, net of any related tax effects	(29)	(9)	(3,213)
Add: Reversal of stock-based compensation expense recognized under APB Opinion No. 25	14		
Pro forma	€ (3,608)	€ (6,331)	€ (6,036)

	2003	2002	2001
Basic Loss Per Share			
As reported	€ (0.21)	€ (0.38)	€ (0.17)
Pro forma	€ (0.21)	€ (0.38)	€ (0.36)
Diluted Loss Per Share			
As reported	€ (0.21)	€ (0.38)	€ (0.17)
Pro forma	€ (0.21)	€ (0.38)	€ (0.36)

The fair value of each option granted is estimated on the grant date using the Black Scholes Model. The assumptions used in calculating fair value are as follows:

	2003	2002	2001
Risk-free interest rate	2.0%	8.03%	
Expected life of the options	3 years	3 years	
Expected volatility	32.4%	34.7%	
Expected dividend yield	0.0%	0.0%	

No stock options were granted in fiscal 2001 (Note 12).

Taxes on Income

Income taxes are reported under SFAS No. 109, "Accounting for Income Taxes", and, accordingly, deferred income taxes are recognized using the asset and liability method, whereby deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, and operating loss and tax credit carry forwards. Valuation allowances are provided if, after considering available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized.

Derivative Financial Instruments

The Company adopted SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS No. 133"), effective January 1, 2001. All derivative financial instruments are marked-to-market and any resulting unrealized gains and losses on such derivative contracts are recorded in cumulative derivative gains, accounts payable and accrued expenses and derivative financial instruments, construction in progress, on the Company's consolidated balance sheets.

The Company enters into derivative financial instruments, including foreign currency forward contracts and swaps and interest rate swaps, caps and forward rate agreements, to limit exposures to changes in foreign currency exchange rates and interest rates. These derivative instruments are not designated as hedging instruments under SFAS No. 133 and, accordingly, any change in their fair value is recognized in other income (expense) in the consolidated statements of operations.

Loss Per Share

Basic loss per share is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding in the period. Diluted loss per share takes into consideration common shares outstanding (computed under basic earnings per share) plus potentially dilutive common shares. Dilutive common shares consist of stock options, warrants and convertible notes.

Reclassifications

Certain prior year amounts in the consolidated financial statements have been reclassified to conform to the current year presentation.

Estimates

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Estimates are used for, but not limited to, the accounting for doubtful accounts, depreciation and amortization, asset impairments, derivative financial instruments, environmental conservation, income taxes, and contingencies. Actual results could differ from these estimates.

New Accounting Standards

In June 2001, the Financial Accounting Standards Board ("FASB") issued SFAS No. 143, "Accounting for Asset Retirement Obligations" ("SFAS 143"), which addresses financial accounting and reporting for obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and (or) the normal operation of long-lived assets, except for certain obligations of leases. SFAS 143 requires entities to record the fair value of a liability for an asset retirement obligation in the period in which it is incurred. When the liability is initially recorded an entity capitalizes the cost by increasing the carrying amount of the related long-lived assets. Over time the liability is accreted to its present value each period, and the capitalized cost is amortized over the useful life of the related asset. Upon settlement of the liability, an entity either settles the obligation for its recorded amount or incurs a gain or loss upon settlement. SFAS 143 is effective for

financial statements issued for fiscal years beginning after June 15, 2002 with earlier application encouraged. Adoption of this standard did not have a material effect on the Company's results of operations, financial position or disclosures.

In November 2002, the FASB issued FASB Interpretation No. 45 ("FIN 45"), "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others". FIN 45 requires that upon issuance of a guarantee, a guarantor must recognize a liability for the fair value of an obligation assumed under a guarantee. FIN 45 also requires additional disclosures by a guarantor in its interim and annual financial statements about the obligations associated with guarantees issued. The disclosure requirements of FIN 45 were effective for financial statements for period ending after December 15, 2002. The Company adopted the disclosure requirements of FIN 45 in fiscal 2002. The initial recognition and measurement provisions of FIN 45 are effective for any guarantees that are issued or modified after December 31, 2002. The Company adopted the recognition and measurement requirements of FIN 45 in fiscal 2003, which had no material impact on its results of operations, financial position or liquidity.

In January 2003, the FASB issued Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities", an Interpretation of ARB No. 51. FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after December 15, 2003 however, earlier adoption is permitted. The Company adopted FIN 46 on July 1, 2003. Adoption of this standard did not have a material effect on the Company's results of operations, financial position or disclosures.

In April 2003, SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities," was issued. In general, this statement amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133. The Company adopted SFAS No. 149 on July 1, 2003. Adoption of this standard did not have a material impact on the Company's financial position or disclosures.

In May 2003, SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity", was issued. In general this statement requires that those instruments be classified as liabilities rather than equity on the balance sheet. The Company adopted this standard on July 1, 2003. Adoption of this standard did not have a material impact on the Company's financial position or disclosures.

Note 2. Investments

Investments Current

As of December 31, 2003, an investment in common shares of one company represents 100% of the total value of trading securities. As of December 31, 2002, an investment in common shares of one company represents 95% of the total value of trading securities. The change in net unrealized holding

gains (losses) on trading securities which has been included in earnings was €184, €(501) and €1,383 during 2003, 2002 and 2001, respectively.

Investments Non-Current

Equity securities of two companies represented 96% and 98% of the total available-for-sale securities at December 31, 2003 and 2002, respectively.

The proceeds from sales of these securities amounted to €6,408, €948 and none which resulted in realized gains of €682, €66 and none during 2003, 2002 and 2001, respectively. The fair value of available-for-sale securities included on the balance sheets at December 31, 2003, 2002 and 2001, was €1,021, €4,727 and €8,202, respectively. The cost of these securities was €1,716, €13,033 and €13,727 which resulted in unrealized losses being recorded in comprehensive income of €(695), €(8,306) and €(5,525) at December 31, 2003, 2002 and 2001, respectively. Also, included in long-term investments were equity securities stated at cost of €623 and €865 at December 31, 2003 and 2002, respectively, which did not have a readily determinable fair value. However, management believes that the estimated market value is not less than the carrying value.

Equity method investments

At December 31, 2002, the Company exchanged its 80% interest in Landqart AG ("Landqart") for a 49% interest in Equitable Industries Limited Partnership ("Equitable"), resulting in a 39% indirect interest in Landqart. The Company recorded this non-monetary exchange based on the carrying value of Landqart, resulting in no gain or loss being recorded.

In the year ended December 31, 2003, in addition to recognition of equity losses, an impairment charge of €2,255 was taken to reflect uncertainty about value.

Note 3. Receivables

	December 31	
	2003	2002
Sale of pulp and paper products (net of allowance of €137 and €115, respectively)	€ 16,854	€ 13,582
Value added tax	11,250	7,096
Other	4,181	7,454
	€ 32,285	€ 28,132

The Company reviews the collectability of receivables on a periodic basis. The Company maintains an allowance for doubtful accounts at an amount estimated to cover the potential losses on the receivables. Any amounts that are determined to be uncollectible are charged off against the allowance. The amounts of allowance and charge-off are based on the Company's evaluation of numerous factors, including the payment history and financial position of the debtors. The Company does not generally require collateral for any of its receivables.

Note 4. Inventories

	December 31	
	2003	2002
Pulp and paper		
Raw materials	€ 16,203	€ 10,394
Work in process and finished goods	7,706	5,981
	€ 23,909	€ 16,375

Note 5. Property, plant and equipment

	December 31	
	2003	2002
Land	€ 8,034	€ 7,945
Buildings	13,504	12,490
Production and other equipment	336,204	335,738
	357,742	356,173
Less: Accumulated depreciation	(115,799)	(100,753)
	241,943	255,420
Construction in progress	503,235	186,570
	€ 745,178	€ 441,990

Construction in progress represents the costs incurred (including €17,407 and €3,134 of debt interest capitalized in 2003 and 2002, respectively) to build a 552,000 tonne softwood kraft pulp mill located in Stendal, Germany. A subsidiary that is owned 63.6% by the Company is building the mill and will operate it on completion. Management estimates the total cost of the mill will be approximately €1,000,000. Under German legislation, non-repayable grants are provided to qualifying

businesses that comply with the terms of the grants and are operating in eastern Germany to finance capital investments and when received, they will reduce the overall cost. As at December 31, 2003, the Company has total claims of approximately €82,085 in construction grants which are expected to be received prior to the end of 2004.

Included in production and other equipment is equipment under capital leases which had gross amounts of €6,645 and €5,693, and accumulated depreciation of €4,185 and €3,113, respectively, as at December 31, 2003 and 2002. During the years 2003, 2002 and 2001, production and other equipment totaling €2,809, €385 and €685, respectively, was acquired under capital lease obligations.

Note 6. Accounts Payable and Accrued Expenses

	December 31	
	2003	2002
Trade payables	€ 12,241	€ 13,691
Accounts payable and other	12,697	12,494
Accrued expenses	11,320	4,378
Derivative contracts	1,156	2,303
	€ 37,414	€ 32,866

Note 7. Notes Payable

At December 31, 2002, the Company had a note payable to a financial institution in the amount of €15,000 relating to the Company's investment in the Stendal pulp mill project. The note payable was repaid in October 2003.

The Company also has a note payable to banks of €1,377 and €832 at December 31, 2003 and 2002, respectively. The notes bear interest at a rate of 5.25% as at December 31, 2003.

Note 8. Debt Construction in Progress

As part of the Company's total Stendal credit facility (Note 9), the Company has secured a line of credit specifically to finance a portion of construction in progress that will be recovered by way of government grants (Note 5). The interest rate is described in Note 9 and the balance will be extinguished upon receipt of the grants. As at December 31, 2003, €80,000 had been advanced to the Company, and €74,000 of applications for grant recoveries were outstanding.

MERCER INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 9. Long-Term Debt

Long-term debt consists of the following:

	December 31	
	2003	**2002**
Note payable to bank, included in a total credit facility of €827,950 to finance our construction in progress related to the Stendal pulp mill, interest at rates varying from Euribor plus 0.90% to Euribor plus 1.85% (rates on amounts of borrowing at December 31, 2003 range from 3.0% to 4.0%), principal due in required installments beginning September 30, 2006 until September 30, 2017, collateralized by the assets of the Stendal pulp mill, and at December 31, 2003, restricted cash amounting to €19,074, with 48% and 32% guaranteed by the Federal Republic of Germany and the State of Sachsen-Anhalt, respectively, of up to €586,550 of outstanding principal balance, subject to a debt service reserve account required to pay amounts due in the following twelve months under the terms of credit facility (none required at December 31, 2003); payment of dividends is permitted if certain cash flow requirements are met. A €80,000 special purpose tranche is described in Note 8.	€ 314,400	€ 101,000
Loans payable to minority shareholders of Stendal pulp mill, interest at 7% payable in September 2006 then payable semi-annually beginning March 2007, unsecured, subordinated to all liabilities of the Stendal pulp mill, due in 2017, €5,647 and €4,707 of Stendal's net loss was applied to these loans in 2003 and 2002 due to a right of offset under German law	9,838	15,485
Note payable to bank relating to the Company's investment in the Stendal pulp mill project. Repaid in October 2003.		30,000
Debt, construction in progress.	324,238	146,485
Note payable to bank, interest at rates varying from 4.5% to 6.8% at December 31, 2003, principal due in semi-annual installments based on a percentage of the final loan amount beginning at 2.4% to 5.1%, until the note is due on September 30, 2013, collateralized by receivables (amounting to €13,716 and €10,522 at December 31, 2003 and 2002, respectively), inventory (amounting to €15,791 and €10,885 at December 31, 2003 and 2002, respectively) and a subsidiary's operating pulp mill assets with 48% and 32% principal plus interest guaranteed by the Federal Republic of Germany and the State of Thuringia, respectively; restricted cash amounted to €25,106 and €19,721 at December 31, 2003 and 2002, respectively, in connection with this borrowing; payment of dividends by the subsidiary is permitted if certain cash flow requirements are met. This borrowing was used to finance the completed conversion of the operating pulp mill	191,653	204,855
Subordinated convertible notes due October 2010, interest at 8.5% accrued and payable semi-annually, convertible at any time by the holder into shares of beneficial interest of the Company at U.S. $7.75 per share, unsecured. The Company may redeem for cash all or a portion of these notes at any time on or after October 15, 2008 at 100% of the principal amount of the notes plus accrued and unpaid interest up to the redemption date, the holders of the convertible notes will have the option to require the Company to purchase for cash all or a portion of the	65,496	

	December 31	
notes not previously redeemed upon a specified change of control at a price equal to 100% of the principal amount of the notes, plus accrued and unpaid interest, the notes are not subject to any sinking fund requirements.		
Note payable to bank, interest at Euribor plus 4.5% (rate on amount of borrowing at December 31, 2003, is 7.4%), unsecured, due in semi-annual installments beginning in March 2004, due in 2013	7,600	5,158
Notes payable to a bank, interest at 4.15% and 4.3% at December 31, 2003, secured by paper mill property, inventory and guarantee, due in semi-annual installments beginning in June 2005, due in December 2012	3,500	
Notes payable to a bank, interest at 2.65% at December 31, 2003, secured by paper mill property and guarantee, due in quarterly instalments beginning in December 2004, due in June 2013	2,500	
Note payable to a company, interest at 6%, due February 26, 2004, unsecured	953	8,582
Debenture payable, repaid during 2003.		3,104
	271,702	221,699
Less: Current portion	(15,801)	(16,306)
Debt, other operations	255,901	205,393
Total	€580,139	€351,878

As of December 31, 2003, the principal maturities of long-term debt are as follows:

Matures	Amount
2004	€ 15,801
2005	16,461
2006	35,903
2007	43,943
2008	43,770
Thereafter	440,062
	€ 595,940

	Amount
Consisting of:	
Debt, construction in progress	€ 324,238
Debt, other operations before current portion	271,702
	€ 595,940

For information on derivative financial instruments, see Note 15.

Interest paid amounted to €25,441 in 2003, €13,984 in 2002 and €15,854 in 2001.

Note 10. Income Taxes

The provision for income taxes is current and consists entirely of non U.S. taxes for the years ended December 31, 2003, 2002 and 2001, respectively.

Differences between the U.S. Federal Statutory and the Company's effective rates are as follows:

	Year Ended December 31		
	2003	2002	2001
U.S. Federal statutory rates on loss from operations benefit	€ 2,063	€ 5,967	€ 932
Tax differential on foreign income (loss)	(66)	474	3,521
Valuation allowance	(1,992)	(6,356)	(6,138)
Provision for tax reassessments	(2,962)		
Other	(215)	179	1,602
	€ (3,172)	€ 264	€ (83)

Deferred tax assets are composed of the following:

	December 31	
	2003	2002
German tax loss carryforwards	€ 62,672	€ 68,917
Basis difference between income tax and financial reporting with respect to German operating pulp mill	1,079	742
Derivative financial instruments	16,251	10,983
U.S. tax loss carryforwards	4,481	5,440
	84,483	86,082
Valuation allowance	(74,503)	(75,945)
Net deferred tax asset	€ 9,980	€ 10,137

Subsequent to year end the Company initiated action to merge certain German subsidiary companies retroactive to November 30, 2003. The above table reflects balances that existed as at December 31, 2003. Further, the Company's subsidiaries in Germany are the subject of income tax audits in Germany on a continuing basis which may result in changes to the amounts in the above table. Because of this and other uncertainties regarding future amounts of taxable income in Germany, the Company has provided a valuation reserve for much of its German deferred tax assets. However, management believes that, while realization of the net deferred tax asset in Germany is not assured, it is more likely than not that it will be realized.

The Company's U.S. losses carried forward amount to approximately €13,179 at December 31, 2003, and will expire in years ending in 2021, if not used. Management believes that these tax loss carryforwards are not likely to be utilized under current circumstances and has fully reserved any resulting potential tax benefit.

Income (loss) from foreign source operations amounted to €5,270, €(3,275) and €2,366 for the years ended December 31, 2003, 2002 and 2001, respectively. These amounts are intended to be indefinitely reinvested in operations. Since available-for-sale securities are primarily securities held by foreign subsidiaries and the proceeds are expected to be reinvested, no tax has been provided in the determination of other comprehensive income for the years ended December 31, 2003, 2002 and 2001.

Income taxes paid amounted to €309, €895 and €83 in 2003, 2002 and 2001, respectively.

Note 11. Shareholders' Equity

In December 2003, the Company adopted a shareholder protection rights plan to replace its current plan which expired on December 31, 2003. The new plan is on substantially similar terms as the Company's prior rights plan and will expire on December 31, 2005. Under the new plan, the Company issued one attached preferred share purchase right for each outstanding share of beneficial interest. A total of 17,099,899 rights were issued which allow the holder to acquire from the Company one one-hundredth of a share of Series A Junior Participating Preferred Stock at a price of U.S. $75 per one one-hundredth of a preferred share. The Company has the right to repurchase the rights for U.S. $0.01 each.

The Company has reserved 110,000 Series A Junior Participating Preferred Shares in connection with the rights. The preferred shares are entitled to quarterly dividends of U.S. $10 per share and have 100 votes per share. However, the preferred shares will be entitled to an aggregate dividend of 100 times any dividends declared on shares of beneficial interest and an aggregate of 100 times any payment to shares of beneficial interest on merger or liquidation.

Also, during a prior year, the Company authorized the issuance of 3.5 million shares of Cumulative Retractable Convertible Preferred Shares, Series B at a price of U.S. $20 per share. These shares have a cumulative dividend rate of up to 4%, a liquidation preference of $20 per share plus unpaid dividends, a redemption right beginning January 1, 2004, at $20 per share plus unpaid dividends, and may convert up to 10% of the issued and outstanding shares into shares of beneficial interest based on dividing the issue price plus unpaid dividends by $20 per share.

Note 12. Stock-Based Compensation

The Company has a non-qualified stock option plan which provides for options to be granted to officers and employees to acquire a maximum of 3,600,000 shares of beneficial interest including options for 130,000 shares to trustees who are not officers or employees.

During 2003, options to acquire 100,000 shares of beneficial interest at U.S. $5.65 per share were granted to an officer of the Company which vest one-third at grant date and one-third each for the next two years. These options expire in ten years. The weighted fair value of these options was U.S. $1.70 each. Another 100,000 options were surrendered by the president of the Company and cancelled. Options to acquire 100,000 shares of beneficial interest at U.S.$6.375 per share were granted to another officer of the Company. The weighted fair value of these options was U.S.$0.57 each. Options to acquire 272,500 shares of beneficial interest were cancelled as a result of the termination of employment of the officers and employees and the resignation of a trustee.

During 2002, options to acquire 18,000 shares of beneficial interest at U.S. $7.46 per share were granted to trustees of the Company which vest one-third at the grant date and one-third each of the next two years. The options expire in ten years. The weighted fair value of these options was U.S. $2.07 each. The options granted to one trustee expired upon his resignation in 2002.

Following is a summary of the status of the plan during 2003, 2002 and 2001:

	Number of Shares	Weighted Average Exercise Price
		(In U.S. Dollars)
Outstanding at December 31, 2001 and 2000	2,206,000	$ 7.67
Granted	18,000	7.46
Cancelled	(6,000)	7.46
Outstanding at December 31, 2002	2,218,000	7.67
Granted	200,000	6.01
Cancelled	(372,500)	9.83
Outstanding at December 31, 2003	2,045,500	$ 7.12

In 2003, the Company and one of its major shareholders entered into a settlement agreement pursuant to which, among other things, the Company issued options to acquire an aggregate of 375,000 shares of beneficial interest of the Company exercisable at a price of U.S.$4.53 per share expiring between September 22, 2003 and June 20, 2004, of which options to acquire 225,000 shares of beneficial interest were exercised in 2003, and options to acquire 150,000 shares of beneficial interest were outstanding as of December 31, 2003. The total fair value of these stock options were €440, which is estimated on the grant date using the Black-Scholes model, based on the risk-free interest rate of 0.60%, expected life of 0.28 years, expected volatility of 20.84% and expected dividend yield of 0%. The fair value of these stock options are included in settlement expense in the consolidated statements of operations.

Following is a summary of the status of options outstanding at December 31, 2003:

	Outstanding Options			Exercisable Options	
Exercise Price Range	**Number**	**Weighted Average Remaining Contractual Life**	**Weighted Average Exercise Price**	**Number**	**Weighted Average Exercise Price**
(In U.S. Dollars)					**(In U.S. Dollars)**
$ 4.53	150,000	0.5	$ 4.53	150,000	$ 4.53
5.65 - 6.375	1,775,000	6.2	6.32	1,708,333	6.34
7.46	6,000	8.3	7.46	4,000	7.46
8.50 - 11.66	141,000	3.4	8.63	141,000	8.63
16.89 - 17.53	123,500	1.5	16.92	123,500	16.92

Note 13. Loss Per Share

Loss per share data for years ended December 31 is summarized as follows:

	2003	2002	2001
Net loss	€(3,593)	€(6,322)	€(2,823)

	Shares		
	2003	2002	2001
Weighted average number of shares outstanding basic and diluted	16,940,858	16,774,515	16,874,899

For 2003, subordinated convertible notes were not included in the computation of diluted loss per share because they were anti-dilutive. For 2003, 2002 and 2001, options and warrants were not included in the computation of diluted loss per share because they were anti-dilutive.

Note 14. Business Segment Information

The Company operates in two reportable business segments: pulp and paper. The segments are managed separately because each business requires different production and marketing strategies.

The pulp segment consists of a single operating mill located in Germany which produces and markets kraft pulp. The paper segment consists of two mills located in Germany. In 2002 the paper segment also consisted of a mill located in Switzerland. As of December 31, 2002, this mill became an equity investee with its losses included as one line item on the consolidated statements of operations in 2003.

Both segments operate in industries which are cyclical in nature and their markets are affected by fluctuations in supply and demand in each cycle. These fluctuations have significant effect on the cost of materials and the eventual sales prices of products.

Summarized financial information concerning the segments is shown in the following table:

	Pulp	**Paper**	**Total**
2003			
Sales to external customers	€126,594	€55,862	€182,456
Intersegment net sales	2,335		2,335
Depreciation and amortization	21,881	2,026	23,907
Segment income (loss) including net gain on financial derivative instruments for pulp operations of €29,210	18,006	(2,814)	15,192
Segment assets, excluding pulp mill construction in progress of €555,966	374,738	30,523	405,261
Capital expenditures, excluding pulp mill construction in progress of €399,403	6,869	7,778	14,647
Reconciliations			
Loss:			
Total income for reportable segments			€15,192
Elimination of intersegment profits			5,532
Net loss on financial derivative instruments, construction in progress financing			(12,299)
Impairment of investments			(7,825)
Unallocated amounts, other corporate expenses			(6,668)
Consolidated loss before income taxes and minority interest			€(6,068)
Assets:			
Total assets for reportable segments			€405,261
			555,966

	Pulp	Paper	Total
Stendal pulp mill under construction			
Intersegment investments and receivables			(42,911)
Other unallocated amounts			17,589
Consolidated total assets			€935,905

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	Pulp	Paper	Total
2002			
Sales to external customers	€130,173	€97,710	€227,883
Intersegment net sales	4,878		4,878
Depreciation and amortization	21,567	3,991	25,558
Segment income (loss) including gain on financial derivative instruments for pulp operations of €23,429	16,557	(1,928)	14,629
Segment assets, excluding pulp mill construction in progress of €225,386	405,002	29,438	434,440
Capital expenditures, excluding pulp mill construction in progress of €186,570	8,426	5,374	13,800

Reconciliations	
Loss:	
Total income for reportable segments	€14,629
Elimination of intersegment profits	3,391
Loss on financial derivative instruments, construction in progress financing	(30,108)
Unallocated amounts, other corporate expenses	(5,463)
Consolidated loss before income taxes and minority interest	€(17,551)
Assets:	
Total assets for reportable segments	€434,440
Stendal pulp mill under construction	223,386
Intersegment investments and receivables	(67,476)
Other unallocated amounts	9,400
Consolidated total assets	€599,750

	Pulp	Paper	Total
2001			
Sales to external customers	€146,245	€58,756	€205,001
Intersegment net sales	5,795		5,795
Depreciation and amortization	21,422	1,492	22,914
Segment income (loss) including loss on financial derivative instruments for pulp operations of €2,504	4,546	(3,230)	1,316
Segment assets	374,287	53,198	427,485
Capital expenditures	7,416	2,681	10,097

Reconciliations	
Loss:	
Total income for reportable segments	€1,316
Elimination of intersegment profits	2,541
Unallocated amounts, other corporate expenses	(6,597)
Consolidated loss before income taxes	€(2,740)
Assets:	
Total assets for reportable segments	€427,485
Intersegment receivable	(7,365)
Other unallocated amounts	9,473
Consolidated total assets	€429,593

The following table presents net sales to external customers by geographic area based on location of the customer.

	2003	2002	2001
Germany	€80,306	€88,809	€94,486
Italy	46,609	46,027	50,016
Other European Union countries	29,936	31,631	21,938
Eastern European and other	25,605	61,416	38,561
	€182,456	€227,883	€205,001

The following table presents total assets by geographic area based on location of the asset.

	2003	2002	2001

	2003	2002	2001
Germany	€918,316	€590,350	€395,794
Other	17,589	9,400	33,799
	€935,905	€599,750	€429,593

In 2003, pulp sales to one customer amounted to 11% of total pulp sales, pulp sales to one customer amounted to 12% of total pulp sales in 2002, and pulp sales to two customers amounted to 22% in 2001.

Note 15. Financial Instruments

The fair value of financial instruments at December 31 is summarized as follows:

	2003		2002	
	Carrying Amount	**Fair Value**	**Carrying Amount**	**Fair Value**
Cash and cash equivalents	€ 51,993	€ 51,993	€ 30,261	€ 30,261
Cash restricted	59,367	59,367	48,254	48,254
Notes payable	1,377	1,377	15,832	15,832
Long-term debt and debt, construction in progress	675,940	675,940	368,184	368,184
Interest rate derivative contract liability, construction in progress	43,151	43,151	30,108	30,108
Currency and other interest rate derivative contracts asset	743	743	3,792	3,792
Currency and other interest rate derivative contracts liability	1,156	1,156	2,303	2,303

In common with other pulp and paper companies, sales are made basis U.S. dollars. As a result of these transactions the Company has financial risk that the value of the Company's financial instruments will vary due to fluctuations in foreign exchange rates, and the degree of volatility of these rates.

The carrying value of cash and cash equivalents approximates the fair value due to its short-term maturity. The fair value of cash restricted was equal to its carrying amount because it is in an account which bears a market rate of interest. The fair value of notes payable and long-term debt was determined using discounted cash flows at prevailing market rates. The fair values of the interest rate and foreign currency exchange contracts are obtained from dealer quotes. These values represent the estimated amount the Company would receive or pay to terminate agreements taking into consideration current interest rates, the creditworthiness of the counterparties and current foreign currency exchange rates.

At December 31, 2003, the Company has entered into certain variable-to-fixed interest rate swaps in connection with the construction in progress in Stendal with respect to an aggregate maximum amount of approximately €612,619 of the principal amount of the long-term indebtedness under the Stendal loan facility. The aggregate notional amount of these contracts ranges from €341,882 to €612,619, interest rates range from 3.795% to 5.28% and they mature from May 2004 to October 2017 (the maturity of the Stendal loan facility). The Company recognized a loss of €13,042 and €30,108 with respect to these interest rate swaps for the year ended December 31, 2003 and 2002, respectively. The Company also entered into a currency forward contract in connection with the construction in progress in Stendal in 2003 and recognized a gain of €743. There was no currency forward contract outstanding as at December 31, 2003.

At December 31, 2003, the Company has entered into certain currency swaps with an aggregate notional amount of €Nil and recognized a gain of €24,059 and €23,595 with respect to these currency swap contracts for the year ended December 31, 2003 and 2002, respectively.

At December 31, 2003, the Company has entered into certain currency forward contracts with an aggregate notional amount of €Nil and recognized a gain of €4,519 and €2,137 with respect to these currency forward contracts for the year ended December 31, 2003 and 2002, respectively.

At December 31, 2003, the Company has entered into certain interest rate contracts with an aggregate notional amount of €153,389, maturing September 2007 and recognized a loss of €111 and €2,303 with respect to these interest rate cap contracts for the year ended December 31, 2003 and 2002, respectively.

The Company does not have significant exposure to any individual customer or counterparty. Concentrations of credit risk on the sale of paper and pulp products are with customers based in Germany, Italy, other European countries, and other. The Company has entered into interest rate and foreign exchange derivative instruments in connection with certain of its long-term debt (Note 9). The contracts are with the same banks which hold the debt and the Company does not anticipate non-performance by the banks.

Note 16. Lease Commitments

Minimum lease payments under capital and non-cancelable operating leases and the present value of net minimum payments at December 31, 2003 were as follows:

	Capital Leases	Operating Leases
2004	€1,932	€2,097
2005	1,510	1,750
2006	344	1,399
2007	214	3,224
2008	239	56
Thereafter		80
Total	4,239	€8,606
Less imputed interest	193	
Total present value of minimum capitalized payments	4,046	
Less current portion of capital lease obligations	1,843	
Long-term capital lease obligations	€2,203	

Rent expense under non-cancelable operating leases was €2,231, €1,876 and €1,587 for 2003, 2002 and 2001, respectively. The current portion of the capital lease obligations is included in accounts payable and accrued expenses and the long-term portion is included in capital leases and other in the consolidated balance sheets.

Note 17. Commitments and Contingencies

At December 31, 2003 and 2002, the Company recorded a liability for environmental conservation expenditures of €1,848 and €2,309, respectively. Management believes the liability amount recorded is sufficient.

The Company is required to pay certain charges based on water pollution levels at its mills. Unpaid charges can be reduced by investing in qualifying equipment that results in less water pollution. The Company believes that equipment investments already made will offset most of these charges, although it has not received final determination from the appropriate authorities. Accordingly, a liability for these water charges has only been recognized to the extent that equipment investments have not been made.

The Company is involved in various matters of litigation arising in the ordinary course of business. In the opinion of management, the estimated outcome of such issues will not have a material effect on the Company's financial statements.

Note 18. Certain Relationships

Prior to June, 1996, MFC Bancorp ("MFC") was the Company's 92% owned subsidiary. In June, 1996, the Company distributed shares of MFC to its shareholders by way of a special dividend in kind and spun off approximately 83% of the issued shares of MFC. Prior to the spin off, MFC provided and arranged for the majority of the Company's financial requirements. From time to time, since then, the Company and MFC (and its affiliates) have entered into certain arm's length transactions.

A trustee and former Chief Financial Officer of the Company, became a Vice President of MFC in August, 2003 and resigned in December, 2003. For that period of time, MFC was considered to be a related party.

As at December 31, 2003 the Company was not related to MFC, but in recognition of the brief period of the trustee's joint interests:

- The Company has a current trade receivable of €1,400 from a subsidiary of MFC in connection with certain pulp sales made under normal market terms;

- The Company indirectly holds 37,000 common shares of MFC, representing an insignificant portion of the common shares of MFC;

- The Company has a loan receivable from a director of MFC in the amount of €245; and

- The Company and MFC are limited partners in a partnership which holds an 80% interest in Landqart. MFC assists with purchases and sales for Landqart.

During the year, the Company repaid a bridge loan obtained during 2002 from a Swiss banking subsidiary of MFC, and liquidated miscellaneous residual investment and credit accounts which it shared with MFC.

MFC has an indirect interest in an entity which holds a 7% interest in the Stendal Project.

MERCER INTERNATIONAL INC.
Consolidated Financial Statements
For the Nine Months Ended September 30, 2004
(Unaudited)

MERCER INTERNATIONAL INC.

CONSOLIDATED BALANCE SHEETS

As at September 30, 2004 and December 31, 2003
(Unaudited)
(Euros in thousands)

	September 30, 2004	December 31, 2003
ASSETS		
Current Assets		
Cash and cash equivalents	€ 42,643	€ 51,993
Cash restricted	29,346	15,187
Receivables	33,003	32,285
Unrealized foreign exchange derivative gains	899	743
Inventories	59,225	23,909
Prepaid expenses	4,603	4,284
Total current assets	169,719	128,401
Long-Term Assets		
Cash restricted	47,538	44,180
Property, plant and equipment	942,249	745,178
Investments	878	1,644
Equity method investments	3,993	2,309
Deferred note issuance costs	3,908	4,213
Unrealized foreign exchange derivative gains	14,442	
Deferred income tax	10,000	9,980
Total assets	€ 1,192,727	€ 935,905
LIABILITIES		
Current Liabilities		
Accounts payable and accrued expenses	€ 64,373	€ 37,414
Construction costs payable	160,952	42,756
Note payable	1,403	1,377
Debt, Stendal	50,000	80,000
Debt, current portion	15,465	15,801
Total current liabilities	292,193	177,348
Long-Term Liabilities		
Debt, Stendal	476,301	324,238
Debt, less current portion	234,317	255,901
Unrealized interest rate derivative losses	58,874	43,151
Unrealized foreign exchange derivative losses	594	
Capital leases and other	8,853	2,412
Total liabilities	1,071,132	803,050
Minority Interest		
SHAREHOLDERS' EQUITY		
Shares of beneficial interest	79,736	78,139

	September 30, 2004	December 31, 2003
Additional paid-in capital, stock options	14	223
Retained earnings	36,592	49,196
Accumulated other comprehensive income	5,253	5,297
Total shareholders' equity	121,595	132,855
Total liabilities and shareholders' equity	€ 1,192,727	€ 935,905

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

MERCER INTERNATIONAL INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

For Nine Months Ended September 30, 2004 and 2003
(Unaudited)
(Euros in thousands, except for earnings per share)

	2004	2003
Revenues		
Pulp and paper	€ 145,084	€ 134,935
Transportation	2,134	2,850
Other	6,650	6,351
	153,868	144,136
Cost of sales		
Pulp and paper	131,420	131,838
Transportation	2,222	2,388
	133,642	134,226
Gross profit	20,226	9,910
General and administrative expenses	(21,182)	(12,961)
Settlement expenses		(630)
Impairment of capital assets	(6,000)	
Flooding losses and expenses, less grant income	(669)	1,162
Loss from operations	(7,625)	(2,519)
Other income (expense)		
Interest expense	(9,554)	(6,887)
Investment income	1,679	1,055
Derivative financial instruments		
Unrealized loss on interest rate derivatives	(15,825)	(22,832)
Unrealized and realized gain on foreign exchange rate derivatives	14,748	19,228
Other		20
Impairment of available-for-sale securities		(5,511)
Total other income (expense)	(8,952)	(14,927)
Loss before income taxes and minority interest	(16,577)	(17,446)
Income tax benefit (expense)	37	(226)
Loss before minority interest	(16,540)	(17,672)
Minority interest	3,936	8,499
Net loss	(12,604)	(9,173)
Retained earnings, beginning of period	49,196	52,789
Retained earnings, end of period	€ 36,592	€ 43,616
Loss per share		
Basic	€ (0.73)	€ (0.54)

	2004	2003
Diluted	€ (0.73)	€ (0.54)

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

MERCER INTERNATIONAL INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

For Three Months Ended September 30, 2004 and 2003
(Unaudited)
(Euros in thousands, except for earnings per share)

	2004	2003
Revenues		
Pulp and paper	€ 47,316	€ 43,661
Transportation	667	828
Other	1,119	1,333
	49,102	45,822
Cost of sales		
Pulp and paper	39,752	45,366
Transportation	753	525
	40,505	45,891
Gross profit (loss)	8,597	(69)
General and administrative expenses	(7,348)	(4,231)
Settlement expenses		(630)
Impairment of capital assets	(6,000)	
Flooding losses and expenses, less grant income		(214)
Loss from operations	(4,751)	(5,144)
Other income (expense)		
Interest expense	(4,200)	(2,236)
Investment income	215	416
Derivative financial instruments		
Unrealized gain (loss) on interest rate derivatives	(14,110)	5,933
Unrealized and realized gain on foreign exchange rate derivatives	6,005	3,806
Other		9
Total other income (expense)	(12,090)	7,928
Income (loss) before income taxes and minority interest	(16,841)	2,784
Income tax benefit (expense)	236	(28)
Income (loss) before minority interest	(16,605)	2,756
Minority interest	6,726	(1,880)
Net income (loss)	(9,879)	876
Retained earnings, beginning of period	46,471	42,740
Retained earnings, end of period	€ 36,592	€ 43,616
Income (loss) per share		
Basic	€ (0.57)	€ 0.05

	2004	2003
Diluted	€ (0.57)	€ 0.05

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

MERCER INTERNATIONAL INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

For Nine Months Ended September 30, 2004 and 2003
(Unaudited)
(Euros in thousands)

	2004	2003
Net loss	€ (12,604)	€ (9,173)
Other comprehensive income (loss):		
Foreign currency translation adjustments	313	1,240
Unrealized gains (losses) on securities		
Unrealized holding gains (losses) arising during the period	(269)	2,084
Reclassification adjustment for other than temporary decline in value		5,511
Other comprehensive income (loss)	44	8,835
Total comprehensive loss	€ (12,560)	€ (338)

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

MERCER INTERNATIONAL INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

For Three Months Ended September 30, 2004 and 2003
(Unaudited)
(Euros in thousands)

		2004		2003
Net income (loss)	€	(9,879)	€	876
Other comprehensive income (loss):				
Foreign currency translation adjustments		(2,039)		115
Unrealized gains (losses) on securities				
Unrealized holding gains (losses) arising during the period		(19)		2,345
Other comprehensive income (loss)		(2,058)		2,460
Total comprehensive income (loss)	€	(11,937)	€	3,336

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

MERCER INTERNATIONAL INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

For Nine Months Ended September 30, 2004 and 2003
(Unaudited)
(Euros in thousands)

	2004	2003
Cash Flows from (used in) Operating Activities:		
Net loss	€ (12,604)	€ (9,173)
Adjustments to reconcile net loss to cash flows from operating activities		
Unrealized net loss on interest rate derivatives	15,825	22,832
Unrealized and realized net gains on foreign exchange rate derivatives	(14,748)	(19,228)
Depreciation and amortization	17,217	18,135
Impairment of capital assets	6,000	
Impairment of investments		5,511
Minority interest	(3,936)	(8,499)
Stock-based expenses	690	432
Other	1,139	748
Changes in current assets and liabilities		
Inventories	(35,825)	(6,554)
Receivables	(2,056)	(8,138)
Accounts payable and accrued expenses	26,331	11,554
Other	782	(651)
Net cash from (used in) operating activities	(1,185)	6,969
Cash Flows from (used in) Investing Activities:		
Purchase of property, plant and equipment, net of investment grants	(213,115)	(226,240)
Sale of long-term investments	1,161	296
Other	115	48
Net cash used in investing activities	(211,839)	(225,896)
Cash Flows from (used in) Financing Activities:		
Cash restricted	(17,517)	(486)
Increase in construction costs payable	118,196	34,362
Proceeds from borrowings of notes payable and debt	126,000	186,859
Repayment of notes payable and debt	(21,886)	(15,444)
Repayment of capital lease obligations	(1,781)	(38)
Issuance of shares of beneficial interest	582	913
Net cash from financing activities	203,594	206,166
Effect of exchange rate changes on cash and cash equivalents	80	54
Net decrease in cash and cash equivalents	(9,350)	(12,707)
Cash and cash equivalents, beginning of period	51,993	30,261
Cash and cash equivalents, end of period	€ 42,643	€ 17,554

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

MERCER INTERNATIONAL INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

For Nine Months Ended September 30, 2004
(Unaudited)
(Euros in thousands, except for shares and per share data)

Note 1. Basis of Presentation

The interim period consolidated financial statements contained herein include the accounts of Mercer International Inc. and its wholly-owned and majority-owned subsidiaries (the "Company").

The interim period consolidated financial statements have been prepared by the Company pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (the "SEC"). Certain information and footnote disclosure normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to such SEC rules and regulations. The interim period consolidated financial statements should be read together with the audited consolidated financial statements and accompanying notes included in the Company's latest annual report on Form 10-K for the fiscal year ended December 31, 2003. In the opinion of the Company, the unaudited consolidated financial statements contained herein contain all adjustments necessary to present a fair statement of the results of the interim periods presented. The results for the periods presented herein may not be indicative of the results for the entire year.

Note 2. Stock-Based Expenses

The Company has a stock-based employee compensation plan, which is described more fully in the Company's annual report on Form 10-K for the year ended December 31, 2003. The Company also has a 2004 Stock Incentive Plan, which is described more fully in the Form S-8 filed by the Company with the SEC on June 16, 2004. The Company accounts for the plans under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. The following tables illustrate the effect on net income (loss) and income (loss) per

share if the Company had applied the fair value recognition provisions of Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*.

	Nine Months Ended September 30,	
	2004	**2003**
	(Euros in thousands, except per share amounts)	
Net Loss		
As reported	€ (12,604)	€ (9,173)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of any related tax effects	(31)	(13)
Add: Reversal of stock-based compensation expense recognized under APB Opinion No. 25		14
Pro forma	€ (12,635)	€ (9,172)
Basic Loss Per Share		
As reported	€ (0.73)	€ (0.54)
Pro forma	€ (0.73)	€ (0.54)
Diluted Loss Per Share		
As reported	€ (0.73)	€ (0.54)
Pro forma	€ (0.73)	€ (0.54)

	Three Months Ended September 30,	
	2004	2003
	(Euros in thousands, except per share amounts)	
Net Income (Loss)		
As reported	€ (9,879)	€ 876
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of any related tax effects	(2)	(5)
Add: Reversal of stock-based compensation expense recognized under APB Opinion No. 25		14
Pro forma	€ (9,881)	€ 885
Basic Income (Loss) Per Share		
As reported	€ (0.57)	€ 0.05
Pro forma	€ (0.57)	€ 0.05
Diluted Income (Loss) Per Share		
As reported	€ (0.57)	€ 0.05
Pro forma	€ (0.57)	€ 0.05

In March 2004, 73,330 shares of beneficial interest were issued as a result of the cashless exercise of 150,000 stock options. This resulted in a total stock-based expense of €532, which was charged to net loss immediately.

In January 2004, 25,000 restricted shares of beneficial interest were issued to a trustee in connection with his role as Lead Trustee of the Board of Trustees. One-third of such shares vested on January 20, 2004, one-third will vest on November 11, 2004 and the remaining one-third on November 11, 2005. This resulted in a total expense of €161, one-third of which was charged to net loss immediately, while the remaining two-thirds is to be amortized over the period to November 2005 on a straight-line basis.

In June 2004, a total of 15,000 restricted shares of beneficial interest were issued to three trustees in connection with their roles as independent trustees of the Board of Trustees. These shares vest on June 18, 2005. This resulted in a total expense of €112, which will be amortized over the period to June 2005.

In June 2004, 21,000 shares of beneficial interest were issued as a result of the exercise of stock options by a former trustee.

Note 3. Earnings (Loss) Per Share

Basic earnings (loss) per share is computed by dividing income (loss) available to common shareholders by the weighted average number of shares outstanding during a period. Diluted earnings (loss) per share takes into consideration shares outstanding (computed under basic earnings per share) and potentially dilutive shares. The following table sets out the computation of basic and diluted earnings (loss) per share for the nine months and three months ended September 30, 2004 and 2003, respectively:

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2004	**2003**	**2004**	**2003**
	(Euros in thousands, except per share amounts)			
Income (loss) from continuing operations basic	€ (12,604)	€ (9,173)	€ (9,879)	€ 876
Interest on convertible notes, net of tax				
Income (loss) from continuing operations diluted	€ (12,604)	€ (9,173)	€ (9,879)	€ 876
Weighted average number of common shares outstanding:				
Basic	17,256,894	16,887,262	17,324,229	16,911,584
Effect of dilutive shares:				
Stock options and awards				31,389
Convertible notes				
Diluted	17,256,894	16,887,262	17,324,229	16,942,973
Income (loss) from continuing operations per share:				
Basic	€ (0.73)	€ (0.54)	€ (0.57)	€ 0.05
Diluted	€ (0.73)	€ (0.54)	€ (0.57)	€ 0.05

For the nine months ended September 30, 2004 and 2003 and the three months ended September 30, 2004, warrants, options and convertible notes were not included in the computation of diluted earnings (loss) per share because they were anti-dilutive.

Note 4. Stendal Pulp Mill Project

The Stendal pulp mill was substantially complete and ready for its intended use on September 18, 2004. Effective September 18, 2004, the Company began expensing all of the costs, including interest, related to the mill and began depreciating it. A depreciation period of 25 years was established based on the expected useful life of the production assets. Depreciation was computed using the straight-line method in accordance with the Company's accounting policies.

Note 5. Business Segment Information

The Company operates in two reportable business segments: pulp and paper. The segments are managed separately because each business requires different production and marketing strategies.

Summarized financial information concerning the segments is shown in the following table:

	Rosenthal Pulp	Stendal Pulp	Total Pulp	Paper	Corporate, Other and Eliminations	Consolidated Total
Nine Months Ended September 30, 2004						
Sales to external customers	€ 103,743	€	€ 103,743	€ 41,341	€	€ 145,084
Transportation and other	8,338	600	8,938	314	(468)	8,784
Intersegment net sales	1,822		1,822		(1,822)	
	113,903	600	114,503	41,655	(2,290)	153,868
Operating costs	78,773	509	79,282	39,869	(2,210)	116,941
Depreciation and amortization	14,166	795	14,961	1,740		16,701
General and administrative	7,960	6,645	14,605	3,960	2,617	21,182
Impairment of capital assets				6,000		6,000
Flooding grants, less losses and expenses				669		669
	100,899	7,949	108,848	52,238	407	161,493
Income (loss) from operations	13,004	(7,349)	5,655	(10,583)	(2,697)	(7,625)
Interest expense	(6,345)	(1,888)	(8,233)	(421)	(900)	(9,554)
Net loss on derivative financial instruments	(275)	(802)	(1,077)			(1,077)
Other income (expense)	2,327	(453)	1,874	152	(347)	1,679
Income (loss) before income taxes and minority interest	€ 8,711	€ (10,492)	€ (1,781)	€ (10,852)	€ (3,944)	€ (16,577)
Nine Months Ended September 30, 2003						
Sales to external customers	€ 92,418	€	€ 92,418	€ 42,517	€	€ 134,935
Transportation and other	8,249		8,249	796	156	9,201
Intersegment net sales	2,178		2,178		(2,178)	
	102,845		102,845	43,313	(2,022)	144,136
Operating costs	80,968		80,968	37,581	(2,179)	116,370
Depreciation and amortization	16,311		16,311	1,545		17,856
General and administrative	5,588	1,752	7,340	3,721	1,900	12,961
Settlement expenses					630	630
Flooding grants, less losses and expenses				(1,162)		(1,162)
	102,867	1,752	104,619	41,685	351	146,655
Income (loss) from operations	(22)	(1,752)	(1,774)	1,628	(2,373)	(2,519)
Interest expense	(5,961)	(8)	(5,969)	(323)	(595)	(6,887)
Net gain (loss) on derivative financial instruments	18,335	(21,939)	(3,604)			(3,604)
Impairment of investments	(4,441)		(4,441)	(1,070)		(5,511)
Other income (expense)	1,475	50	1,525	(51)	(399)	1,075
Income (loss) before income taxes and minority interest	€ 9,386	€ (23,649)	€ (14,263)	€ 184	€ (3,367)	€ (17,446)

	Rosenthal Pulp	Stendal Pulp	Total Pulp	Paper	Corporate, Other and Eliminations	Consolidated Total
Three Months Ended September 30, 2004						
Sales to external customers	€ 34,517	€	€ 34,517	€ 12,799	€	€ 47,316
Transportation and other	2,575	(327)	2,248	(124)	(338)	1,786
Intersegment net sales	643		643		(643)	
	37,735	(327)	37,408	12,675	(981)	49,102
Operating costs	24,702	509	25,211	11,837	(967)	36,081
Depreciation and amortization	3,030	795	3,825	599		4,424
General and administrative	3,186	1,185	4,371	1,849	1,128	7,348
Impairment of capital assets				6,000		6,000
	30,918	2,489	33,407	20,285	161	53,853
Income (loss) from operations	6,817	(2,816)	4,001	(7,610)	(1,142)	(4,751)
Interest expense	(1,953)	(1,720)	(3,673)	(137)	(390)	(4,200)
Net gain (loss) on derivative financial instruments	4,997	(13,102)	(8,105)			(8,105)
Other income (expense)	713	(108)	605	21	(411)	215
Income (loss) before income taxes and minority interest	€ 10,574	€ (17,746)	€ (7,172)	€ (7,726)	€ (1,943)	€ (16,841)
Three Months Ended September 30, 2003						
Sales to external customers	€ 30,004	€	€ 30,004	€ 13,657	€	€ 43,661
Transportation and other	1,993		1,993	236	(68)	2,161
Intersegment net sales	633		633		(633)	
	32,630		32,630	13,893	(701)	45,822
Operating costs	27,212		27,212	13,223	(634)	39,801
Depreciation and amortization	5,534		5,534	556		6,090
General and administrative	1,611	913	2,524	951	756	4,231
Settlement expenses					630	630
Flooding grants, less losses and expenses				214		214
	34,357	913	35,270	14,944	752	50,966
Loss from operations	(1,727)	(913)	(2,640)	(1,051)	(1,453)	(5,144)
Interest expense	(1,978)		(1,978)	(120)	(138)	(2,236)
Net gain on derivative financial instruments	3,734	6,005	9,739			9,739
Other income (expense)	698	(356)	342	(379)	462	425
Income (loss) before income taxes and minority interest	€ 727	€ 4,736	€ 5,463	€ (1,550)	€ (1,129)	€ 2,784

The total assets for the Stendal pulp mill were €838,679 and €555,966 as at September 30, 2004 and December 31, 2003, respectively.

Note 6. Inventories

	September 30, 2004	December 31, 2003
Pulp and paper		
Raw materials	€ 47,099	€ 16,203
Work in process and finished goods	12,126	7,706
	€ 59,225	€ 23,909

Note 7. Derivatives Transactions

In addition to the derivatives reported in the Company's annual report on Form 10-K for the year ended December 31, 2003, the Company entered into certain new derivative transactions in the first nine months of 2004.

The Company's wholly-owned subsidiary, Zellstoff-und Papierfabrik Rosenthal GmbH & Co., KG ("Rosenthal"), entered into two currency swaps in the aggregate principal amount of approximately €184,500 to convert all of its long-term indebtedness under its bank loan facility into U.S. dollars. The swaps mature in September 2008 and September 2013, respectively. In addition, in the first nine months of 2004, Rosenthal entered into a currency forward in the notional amount of approximately €40,700 which matures in March 2005. A marked to market non-cash holding loss of approximately €174 and a non-cash holding gain of approximately €4,949 was recognized in respect of these derivatives in the nine months and three months ended September 30, 2004, respectively.

In the first nine months of 2004, Stendal entered into a currency swap in the principal amount of approximately €306,300 which matures in April 2011 and a currency forward in the notional amount of approximately €20,600 which matures in March 2005. A net non-cash holding gain of approximately €14,921 and €1,055 was recognized in respect of these derivatives in the nine months and three months ended September 30, 2004, respectively.

Note 8. Change in Accounting Estimate

In conjunction with establishing the depreciation period for the Stendal mill (see note 4), the Company also reviewed the useful life of the Rosenthal mill, which resulted in a change in the estimate of its useful life from an initial 15 to 25 years. The change in estimate was reflected effective July 1, 2004. As the Rosenthal mill had been depreciated for approximately 5 years as of July 1, 2004, the change in estimate reflects a remaining depreciable life of approximately 20 years. The total effect of the change in estimate resulted in a decrease of approximately €2,188 in cost of sales and net loss, and a decrease in basic and diluted net loss per share of €0.13 for the nine and three months ended September 30, 2004.

Note 9. Impairment Charge

The paper segment has reported weaker than expected returns for a period of time and certain initiatives to increase the return on the assets have been unsuccessful to date. As a result, during the quarter, the Company reviewed the paper segment for possible impairment of value. The Company has

recorded an impairment of €6,000 against the Fährbrücke mill assets during the nine and three months ended September 30, 2004, respectively. Fair value of the assets was based primarily on cash flow analysis and information available from unsolicited third-party interests in these assets.

Note 10. Subsequent Event

Subsequent to September 30, 2004, 750,000 shares of beneficial interest were issued as a result of the exercise of stock options by the Company's Chief Executive Officer for total proceeds of €3,792.

Note 11. Reclassifications

Certain prior period amounts in the interim period consolidated financial statements contained herein have been reclassified to conform to the current period's presentation.

STONE VENEPAL (CELGAR) PULP INC.
(In Bankruptcy)
Report of Independent Registered Chartered Accountants
and
Financial Statements
For the Year Ended December 31, 2003

F-44

REPORT OF INDEPENDENT REGISTERED CHARTERED ACCOUNTANTS

To KPMG Inc.,
Trustee of the Estate of Stone Venepal (Celgar) Pulp Inc., In Bankruptcy

We have audited the balance sheets of Stone Venepal (Celgar) Pulp Inc. as at December 31, 2003 and 2002 and the statements of loss and deficit and cash flows for each of the years in the three year period ended December 31, 2003. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards and the standards of the Public Company Accounting Oversight Board (United States). These standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2003 and 2002 and the results of its operations and its cash flows for each of the years in the three year period ended December 31, 2003 in accordance with Canadian generally accepted accounting principles.

/s/ DELOITTE & TOUCHE LLP
Independent Registered Chartered Accountants
Vancouver, British Columbia
January 23, 2004 (except as to Notes 1 (c), 1 (d) and 12, which are as of December 8, 2004)

COMMENTS BY AUDITOR ON CANADA-UNITED STATES OF AMERICA REPORTING DIFFERENCE

The standards of the Public Company Accounting Oversight Board (United States) require the addition of an explanatory paragraph when the financial statements are affected by conditions and events that cast substantial doubt on the Company's ability to continue as a going concern, such as those described in Note 1 (b) to the financial statements and when there is change in accounting policy as described in Note 1 (c). The accompanying financial statements do not purport to reflect or provide for the consequences of bankruptcy proceedings. In particular, such financial statements do not purport to show (a) as to assets, their realizable value on a liquidation basis, (b) as to pre-bankruptcy debt, the amounts that may be allocated for claims, or the status and priority thereof, or (c) as to operations, the effect of any changes that may be made in its business. As discussed in Note 1 (b), there is substantial doubt about the Company's ability to continue as a going concern. The financial statements do not include adjustments that might result from the outcome of this uncertainty. Although we conducted our audits in accordance with both Canadian generally accepted auditing standards and the standards of the Public Company Accounting Oversight Board (United States), our report to KPMG Inc. dated January 23, 2004 (except as to Note 1(c), 1(d) and 12, which are as of December 8, 2004) is expressed in accordance with Canadian reporting standards which do not permit a reference to such conditions and events in the auditors' report when these are adequately disclosed in the financial statements.

/s/ DELOITTE & TOUCHE LLP
Independent Registered Chartered Accountants
Vancouver, British Columbia
January 23, 2004 (except as to Notes 1 (c), 1 (d) and 12, which are as of December 8, 2004)

STONE VENEPAL (CELGAR) PULP INC.
(In Bankruptcy)

BALANCE SHEET

December 31, 2003
(In thousands of Canadian dollars)

	2003	2002
	(Restated Notes 1 (c) and (d))	(Restated Notes 1 (c) and (d))
ASSETS		
CURRENT		
Accounts receivable	$ 23,346	$ 25,361
Inventories (Note 3)	52,457	58,181
Prepaid expenses and other	1,134	1,119
	76,937	84,661
PROPERTY, PLANT AND EQUIPMENT (Note 4)	402,633	436,542
	$ 479,570	$ 521,203
LIABILITIES		
CURRENT		
Bank indebtedness (Note 5)	$ 3,754	$ 10,102
Accounts payable and accrued liabilities	20,333	18,136
Current portion of obligation under capital leases (Note 7)	394	365
	24,481	28,603
ASSET RETIREMENT OBLIGATIONS	930	886
PRE-BANKRUPTCY AND OTHER DEBT (Note 6)	1,119,280	1,194,125
OBLIGATION UNDER CAPITAL LEASES (Note 7)	374	675
	1,145,065	1,224,289
SHAREHOLDERS' DEFICIENCY		
Share capital (Note 8)	17,800	17,800
Deficit	(683,295)	(720,886)
	(665,495)	(703,086)
	$ 479,570	$ 521,203

BASIS OF PRESENTATION (Note 1)
COMMITMENTS (Note 7)

ON BEHALF OF KPMG INC., TRUSTEE OF THE ESTATE OF STONE VENEPAL (CELGAR) PULP INC., IN BANKRUPTCY

/s/ TODD M. MARTIN

Senior Vice President

See accompanying Notes to the Financial Statements.

STONE VENEPAL (CELGAR) PULP INC.
(In Bankruptcy)

STATEMENT OF LOSS AND DEFICIT

Year ended December 31, 2003
(In thousands of Canadian dollars)

	2003	2002	2001
	(Restated Notes 1 (c) and (d))	(Restated Notes 1 (c) and (d))	(Restated Notes 1 (c) and (d))
Sales	**$ 271,566**	$ 249,366	$ 246,139
Operating expenses:			
Cost of products sold	**230,555**	213,602	239,938
Depreciation and amortization	**39,225**	38,932	38,966
General and administrative	**38,069**	30,642	25,877
	307,849	283,176	304,781
Operating loss	**(36,283)**	(33,810)	(58,642)
Other income (expense)			
Short-term interest expense	**(512)**	(921)	(952)
Interest expense on term credit facility	**(47,579)**	(50,798)	(68,602)
Foreign exchange gain (loss) on term credit facility	**121,965**	5,950	(35,959)
	73,874	(45,769)	(105,513)
Net earnings (loss) for the period	**37,591**	(79,579)	(164,155)
Deficit, beginning of period	**(720,886)**	(641,307)	(477,152)
Deficit, end of period	**$ (683,295)**	$ (720,886)	$ (641,307)

See accompanying Notes to the Financial Statements.

STONE VENEPAL (CELGAR) PULP INC.
(In Bankruptcy)

STATEMENT OF CASH FLOWS

Year ended December 31, 2003
(In thousands of Canadian dollars)

	2003	2002	2001
	(Restated Notes 1 (c) and (d))	(Restated Notes 1 (c) and (d))	(Restated Notes 1 (c) and (d))
Cash provided by (used for):			
Cash flows from operating activities:			
Net earnings (loss) for the period	$ **37,591**	$ (79,579)	$ (164,155)
Items not involving cash:			
Foreign exchange gain on pre-bankruptcy accounts payable	**(84)**	(13)	
Increase in pension and other plans liability	**966**	877	
Increase in pre-bankruptcy accounts payable			603
Foreign exchange loss (gain) on term credit facility	**(121,965)**	(5,950)	35,959
Interest on term credit facility	**47,579**	50,798	68,602
Gain on disposal of property, plant and equipment	**(45)**		
Depreciation and amortization	**39,225**	38,932	38,966
Accretion expense	**44**	42	40
Net change in non-cash working capital items:			
Decrease in accounts receivable	**2,015**	495	1,304
Decrease in inventories	**5,724**	3,453	16,568
Increase in prepaid expenses	**(15)**	(71)	(336)
Increase (decrease) in accounts payable and accrued liabilities	**2,197**	(899)	(4,952)
	13,232	8,085	(7,401)
Cash flows from investing activities:			
Additions to property, plant and equipment	**(5,201)**	(3,912)	(6,262)
Proceeds on disposal of property, plant and equipment	**45**		
	(5,156)	(3,912)	(6,262)
Cash flows from financing activities:			
Increase (decrease) in bank indebtedness	**(6,348)**	(3,888)	13,850
Principal repayments under capital lease obligations	**(388)**	(285)	(187)
Repayment of term credit facility	**(1,340)**		
	(8,076)	(4,173)	13,663
Net increase in cash position			
Cash position, beginning of period			
Cash position, end of period	$	$	
Supplemental information:			
Interest paid	$ **512**	$ 921	$

See accompanying Notes to the Financial Statements.

STONE VENEPAL (CELGAR) PULP INC.
(In Bankruptcy)

NOTES TO THE FINANCIAL STATEMENTS

Year ended December 31, 2003
(In thousands of Canadian dollars)

1. BANKRUPTCY PROCEEDINGS AND BASIS OF PRESENTATION

Stone Venepal (Celgar) Pulp Inc. ("Celgar" or the "Company") is incorporated under the Canada Business Corporations Act and operates a pulp mill located at Castlegar, B.C.

(a)

Bankruptcy proceedings

Effective July 23, 1998, the directors of Celgar made an assignment in bankruptcy for the general benefit of creditors and KPMG Inc. was appointed Trustee of the Estate of Celgar (the "Trustee"). KPMG Inc. was also appointed Receiver of all the property, assets and undertakings of Celgar pursuant to security granted by the Company to Montreal Trust Company ("MTCC") (the "Receiver"). The Receiver's appointment was effective July 24, 1998.

Pursuant to the Bankruptcy and Insolvency Act, Canada, all assets of Celgar vest in the Trustee subject to the security interests of MTCC. All liabilities outstanding as at July 23, 1998 are obligations of Celgar.

The Trustee has been operating the Celgar pulp mill facility pursuant to an agreement between the Trustee and the Receiver effective the date of bankruptcy.

(b)

Basis of presentation
These financial statements have been prepared in accordance with generally accepted accounting principles in Canada which conform with those established in the United States, except as described in Note 12.

The accompanying financial statements have been prepared on a "going concern" basis. The "going concern" basis of presentation assumes that the Company will continue in operation for the foreseeable future and will be able to realize its assets and discharge its liabilities and commitments in the normal course of business. There is doubt about the appropriateness of the use of the "going concern" assumption because of the bankruptcy of the Company. As such, realization of assets and discharge of pre-bankruptcy debt are subject to uncertainty.

The financial statements do not reflect adjustments that would be necessary if the "going concern" basis was not appropriate. If the "going concern" basis was not appropriate for these financial statements, then adjustments would be necessary in the carrying value of assets and liabilities and the reported revenues and expenses. The appropriateness of the "going concern" basis is dependent upon, among other things, the confirmation of a plan of reorganization, future profitable operations and the ability to generate sufficient cash from operations and financing arrangements to meet obligations.

(c)

Changes in accounting policies and presentation

The Company has presented shipping and handling costs (including related commissions and insurance) as part of cost of products sold in the statement of loss and reclassified the prior periods' presentation accordingly. Previously, these expenses were presented as a reduction of net sales in accordance with industry practice. As a result, shipping and handling costs have been reclassified from "Net Sales" to "Cost of Products Sold", which resulted in an increase in "Sales" and "Cost of Products Sold" for the years ended December 31, 2003, 2002 and 2001 by $41,485, $39,440 and $42,086, respectively.

(d)

Asset retirement obligations

The Company adopted the new CICA recommendations of Handbook Section 3110, "Asset Retirement Obligations", with respect to recording the fair value of a liability for an asset retirement obligation in the period in which it is incurred, and a corresponding increase in the carrying amount of the related long-lived asset. In the periods subsequent to the initial measurement, period to period changes in the liability balance from accretion expense, due to the passage of time, is included in selling, general and administrative expenses.

This standard was applied retroactively with restatement of 2001 opening retained earnings of $804.

2. SIGNIFICANT ACCOUNTING POLICIES

(a)

Foreign currency translation
Monetary assets and liabilities denominated in foreign currencies are translated into Canadian dollars at exchange rates prevailing on the balance sheet date. Revenues and expenses are translated at average rates prevailing during the year. Exchange gains or losses are included in earnings.

(b)

Inventory valuation

Pulpwood, chips, raw materials and supplies are stated at cost, determined on a monthly moving average basis. Work in process and finished goods inventories, the cost of which includes raw materials, direct labour and certain manufacturing overhead expenses, are stated at the lower of average cost and net realizable value. Provision is made for slow-moving and obsolete inventories.

(c)

Property, plant and equipment, depreciation and capitalization

Property, plant and equipment are stated at cost, which includes capitalized interest. Upon retirement or disposal of property, plant and equipment, the Company removes the cost of the assets and the related accumulated depreciation. Gains or losses on disposal of assets are included in earnings.

Depreciation, calculated principally on the straight-line method, is charged to operations at rates based upon the estimated useful life of each property. The following rates apply to those assets being depreciated on the straight-line method:

Assets	**Rate**
Buildings	2$^1/_2$%
Machinery and equipment	4%
Computer and automotive equipment and start-up costs	20%

Those portions of the former mill that remain in use are aggregated as mill infrastructure costs and the net book values are being amortized over ten years.

Expenditures which result in a material enhancement of the value of the facilities involved are capitalized. Maintenance and repair costs are expensed as incurred.

(d)

Pensions

The Company has a defined benefit pension plan for its salaried employees which is funded, trusteed and non-contributory. The cost of the benefits earned by the salaried employees is determined using the projected benefit method prorated on services. The pension expense reflects the current service cost, the interest on the unfunded liability and the amortization over the estimated average remaining service life of the employees of (i) the unfunded liability and (ii) experience gains or losses.

With respect to the pensions of its hourly-paid employees, who are covered by a multi-employer pension plan, the Company charges its contributions to this plan against earnings.

(e)

Revenue recognition

The Company recognizes revenue when persuasive evidence of an arrangement exists, the sales price is fixed or determinable, title of ownership and risk of loss have passed to the customer and collectibility is reasonably assured. Sales are reported net of discounts and allowances. Amounts charged to customers for shipping and handling are recognized as revenue. Title of the products is transferred to the customers at the time of shipment and payment is based on agreed prices and credit terms contained on sales invoices.

(f)

Financial instruments

The carrying amounts of accounts receivable and accounts payable and accrued liabilities approximate their fair values due to the short term to maturity of those instruments. The fair value of the Company's pre-bankruptcy and other debt (Note 6) has not been determined as the Company does not believe that it is practicable to determine such fair value with sufficient reliability due to the absence of a readily available secondary market for such debt.

(g)

Measurement uncertainty

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Significant areas requiring the use of management estimates are chip pile inventory quantities, valuation of long-lived assets, useful lives for amortization of fixed assets and estimates of asset retirement, reclamation and environmental obligations. Financial results as determined by actual events could differ from those estimates.

3. INVENTORIES

	2003	2002
Pulpwood and chips	**$ 7,960**	$ 11,462
Other raw materials and supplies	**15,053**	14,556
Work-in-process and finished goods	**29,444**	32,163
	$ 52,457	$ 58,181

4. PROPERTY, PLANT AND EQUIPMENT

	2003			2002
	Cost	**Accumulated Depreciation**	**Net Book Value**	**Net Book Value**
Buildings	**$ 70,053**	**$ 19,264**	**$ 50,789**	$ 51,314
Machinery and equipment	**874,835**	**364,229**	**510,606**	541,019
Computer and automotive equipment	**2,422**	**691**	**1,731**	
Mill infrastructure	**22,512**	**22,512**		2,245
Capital projects in progress	**4,665**		**4,665**	6,851
Automotive equipment under capital leases	**1,420**	**649**	**771**	1,042
	975,907	**407,345**	**568,562**	602,471
Land	**1,056**		**1,056**	1,056
	$ 976,963	**$ 407,345**	**569,618**	603,527
Write-down of capital assets (Note 11)			**166,985**	166,985
			$ 402,633	$ 436,542

Amortization of the automotive equipment under capital leases of $277 (2002 $372) is included in depreciation and amortization expense.

5. BANK INDEBTEDNESS

The Receiver has a $25,000 bank overdraft facility with interest at the bank's prime lending rate.

6. PRE-BANKRUPTCY AND OTHER DEBT

	2003	2002
Pre-bankruptcy accounts payable (i)	**$ 11,738**	$ 11,822
Pre-bankruptcy taxes payable (ii)	**6,545**	6,545
Pension plan and post-retirement benefits (Note 9)	**10,665**	9,699
Due to Stone Container (Canada) Inc. ("SCCI") (i)	**968**	968
Shareholder advances (i)	**78,531**	78,531
Short-term loan SCCI (i)	**120,941**	120,941
Term credit facility (iii)	**889,892**	965,619
	$ 1,119,280	$ 1,194,125

(i) These payables are in some instances secured, however, the security is subordinate to the secured claim of the term credit facility which exceeds the value of the assets of the Company. No interest has been accrued on these liabilities.

(ii) The pre-bankruptcy taxes payable balance represents British Columbia capital and large corporations capital taxes owing for the period to July 23, 1998. No capital taxes are exigible for the period from July 23, 1998 to December 31, 2003.

(iii) The term credit facility consists of Canadian and U.S. dollar borrowings which are secured by the Celgar Mill. Interest rates pertaining to the credit term facility are based upon the secured creditors' prime commercial rate, the bankers' acceptance rate, or the London Interbank Offered Rate ("LIBOR"). The amounts owing under the term credit facility, including accrued interest were as follows:

	2003	2002
Canadian dollar credit facility	**$ 310,764**	$ 294,188
U.S. dollar credit facility (2003 U.S.$446,720; 2002 U.S.$422,412)	**579,128**	671,431
	$ 889,892	$ 965,619

7. OBLIGATIONS UNDER CAPITAL LEASES AND COMMITMENTS

The minimum lease payments required for the next three years are as follows:

2004	$ 460
2005	365
2006	33
Total minimum lease payments	858
Less amount representing interest	90
	$ 768
Represented by:	
Current portion	$ 394
Long-term portion	374
	$ 768

Interest of $76 (2002 $24) relating to capital lease obligations has been included in short-term interest expense.

The Company has entered into exclusive natural gas purchase and sale contracts under which it is committed to purchase 6,000GJ of natural gas per day from a supplier through to October 31, 2004. The contracts fix a portion of the cost of the purchase commitment and the balance is based upon market price indexes. The Company is allowed to convert an index price into a fixed price for any quantity up to the baseload. If the Company takes less than the 100% load factor (calculated on a monthly basis) on the fixed price quantity, such shortfall will be sold at market prices with price variances to the cost or benefit of the Company.

8. COMMON SHARES

The Company has authorized an unlimited number of common shares. As at December 31, 2003, 178,000 common shares were issued and outstanding. Smurfit Stone and Celgar Investments Inc. each own 45% of the Company. Venepal Canadian Investment Limited owns the remaining 10% of the Company's common shares.

9. PENSION PLAN AND POST-RETIREMENT BENEFITS

Celgar maintains defined benefit pension plans and post-retirement benefit plans for certain employees. The most recent actuarial valuations of these plans were conducted at December 31, 2003.

Information about these plans, in aggregate for the twelve months ended December 31, 2003, is as follows:

	2003			2002
	Pension Benefit Plans	**Other Benefit Plans**	**Total**	**Total**
Plan assets				
Fair market value, beginning of year	**$ 19,277**	**$**	**$ 19,277**	$ 20,665
Annual return on assets	**2,774**		**2,774**	(1,610)
Funding contributions	**2,488**	**327**	**2,815**	1,898
Benefits paid	**(1,481)**	**(327)**	**(1,808)**	(1,676)
	23,058		**23,058**	19,277
Accrued benefit obligation				
Balance, beginning of year	**27,999**	**12,538**	**40,537**	38,202
Current service cost	**924**	**538**	**1,462**	1,328
Interest cost	**1,846**	**1,064**	**2,910**	2,557
Benefits paid	**(1,481)**	**(327)**	**(1,808)**	(1,676)
Past service cost	**16**		**16**	
Actuarial losses	**2,031**	**5,124**	**7,155**	126
	31,335	**18,937**	**50,272**	40,537
Funded status plan deficit	**(8,277)**	**(18,937)**	**(27,214)**	(21,260)
Unamortized past service cost	**274**		**274**	291
Unamortized actuarial losses	**7,373**	**8,902**	**16,275**	11,270
Accrued benefit liability	**$ (630)**	**$ (10,035)**	**$ (10,665)**	$ (9,699)

The significant actuarial assumptions adopted in measuring the Company's accrued benefit obligations are as follows:

Discount rate	6.5%
Rate of compensation increase	3.0%
Expected rate of return on plan assets	7.5%

For measurement purposes, a 10% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2003. The rate was assumed to decrease gradually to 5% over the next five years and remain at that level thereafter.

The Company's benefit plan expense is as follows:

	Years ended December 31,				
	2003			2002	2001
	Pension Benefit Plans	**Other Benefit Plans**	**Total**	**Total**	**Total**
Current service cost	**$ 924**	**$ 538**	**$ 1,462**	$ 1,328	$ 1,051
Interest cost	**1,846**	**1,064**	**2,910**	2,557	2,228
Expected return on plan assets	**(1,483)**		**(1,483)**	(1,558)	(1,606)
Amortization					
Past service cost	**32**		**32**	31	31
Actuarial loss	**422**	**438**	**860**	417	171
	$ 1,741	**$ 2,040**	**$ 3,781**	$ 2,775	$ 1,875

10. INCOME TAXES

The Company has incurred substantial net losses which will be adjusted for income tax purposes and claimed as non-capital tax loss carryforwards. These tax loss carryforwards are sufficient to eliminate any income taxes otherwise payable. Non-capital tax loss carryforwards are available to reduce future years' income for tax purposes prior to their expiry after seven years.

Due to the uncertainty surrounding the realization of the future benefit of these future income tax assets in future income tax returns, the Company maintains a full valuation allowance against its future income tax assets.

11. WRITE-DOWN OF CAPITAL ASSETS AND APPLICATION OF RESTRUCTURING PAYMENT AGAINST TERM CREDIT FACILITY

Effective May 22, 2000, the Receiver entered into an agreement for the purchase and sale of the capital assets of the Company (the "Agreement"). The purchase price was U.S.$355,000. Consequently, the recorded capital assets include a write-down of Cdn.$166,985. The purchase and sale pursuant to the Agreement did not complete.

On or about October 2, 2000, the Agreement was terminated and the prospective purchaser forfeited a restructuring payment of U.S.$20,000 plus accrued interest. The restructuring payment was paid directly to the lenders of the term credit facility and applied against the term credit facility.

12. DIFFERENCES BETWEEN UNITED STATES AND CANADIAN GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

As indicated in Note 1, these financial statements have been prepared in accordance with Canadian GAAP, which are different in some respects from those applicable in the United States and from practices prescribed by the United States Securities and Exchange Commission ("US GAAP"). The significant differences between Canadian GAAP and US GAAP with respect to the Company's financial statements are as follows:

Adjustments to statements of loss:

(a)

Net earnings (loss) for the year

	December 31,		
	2003	**2002**	**2001**
Net earnings (loss) in accordance with Canadian GAAP	$ 37,591	$ (79,579)	$ (164,155)
Adjustment:			
Purchase and supply contracts (i)	(1,055)	195	
Net earnings (loss) in accordance with US GAAP	36,536	(79,384)	(164,155)
Adjustment for comprehensive income:			
Minimum pension liability adjustment (ii)	248	(4,262)	
Comprehensive earnings (loss) for the year	$ 36,784	$ (83,646)	$ (164,155)

(b)

Balance Sheet items in accordance with US GAAP

	2003	2002
Current assets in accordance with Canadian GAAP	$ 76,937	$ 84,661
Purchase and supply contracts (i)		195
Current assets in accordance with US GAAP	$ 76,937	$ 84,856
Other assets in accordance with Canadian GAAP	$	$
Minimum pension liability (ii)	973	291
Other assets in accordance with US GAAP	$ 973	$ 291

	2003	2002
Current liabilities in accordance with Canadian GAAP	$ 24,481	**$ 28,603**
Purchase and supply contracts (i)	860	
Current liabilities in accordance with US GAAP	$ 25,341	**$ 28,603**
Long-term liabilities in accordance with Canadian GAAP	$ 1,120,584	**$ 1,195,686**
Minimum pension liability (ii)	4,987	**4,553**
Long-term liabilities in accordance with US GAAP	$ 1,125,571	**$ 1,200,239**

(c)

Reconciliation of shareholders' deficiency in accordance with US GAAP

	2003	2002
Total shareholders' deficiency in accordance with Canadian GAAP	$ (665,495)	$ (703,086)
Cumulative change in retained earnings relating to:		
Purchase and supply contracts (i)	(860)	195
Minimum pension liability adjustment (ii)	(4,014)	(4,262)
Total shareholders' deficiency in accordance with US GAAP	$ (670,369)	$ (707,153)

Adjustments:

(i)

Forward purchase contracts:

The Company enters into natural gas forward supply contracts under which it is required to purchase its natural gas requirements for a contracted period of time. Under Canadian GAAP, the Company does not record these contracts on a mark-to-market basis. Instead, the Company only recognizes purchases under these contracts as expenditures

occur. Under U.S. GAAP, these contracts would not be exempt normal purchase and sales arrangements and such contracts would be recorded at fair value and on a mark-to-market basis at each reporting period.

(ii)

Comprehensive income and minimum pension liability:

Statement of Financial Accounting Standards No. 130 "Reporting Comprehensive Income", requires that a company classify items of other comprehensive income by their nature in a financial statement and display the accumulated balance of other comprehensive income separately from retained earnings and additional paid-in capital in the equity section of the balance sheet. Other comprehensive income includes a minimum pension liability.

The Company's accumulated deficit obligation for its pension plans exceeds the fair value of plan assets. US GAAP requires the recognition of an additional minimum pension liability in the amount of the excess of the unfunded accumulated benefit obligation over the recorded pension benefits liability. An offsetting intangible asset is recorded equal to the unrecognized prior service costs, with any difference recorded as a reduction of accumulated other comprehensive income. No similar requirement exists under Canadian GAAP.

(iii)

Asset retirement obligations:

As discussed in Note 1 (d), the Company adopted the new CICA recommendations of Handbook Section 3110, "Asset Retirement Obligations". This standard was applied retroactively with restatement for all periods presented. Under U.S. GAAP, the Company was required to apply Statement of Financial Accounting Standards No. 143 "Accounting for Asset Retirement Obligations", "SFAS 143" as of January 1, 2003. SFAS 143 is consistent with Canadian GAAP with the exception of the adoption date and the method of implementation. SFAS 143 requires the recording of the fair value of a liability for an asset retirement obligation in the period in which it is incurred, and a corresponding increase in the carrying amount of the related long-lived asset. In periods subsequent to the initial measurement, period to period charges in the liability balance from accretion expense, due to the passage of time, is included in selling, general and administrative expenses. Under US GAAP, the cumulative effect adjustment related to prior years at the adoption date is included in earnings in the period of adoption whereas under Canadian GAAP prior year financial statements are restated. The Company has applied the new Canadian GAAP standard on a retroactive basis with restatement of earlier periods which results in no material U.S. GAAP difference.

(iv)

Recent accounting pronouncements:

(1)

In November 2002, the Financial Accounting Standards Board issued Interpretation No. 45 (the "Interpretation"), "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others", which addresses the disclosure to be made by a guarantor in its interim and annual financial statements about its obligations under guarantees. The Interpretation also requires the recognition of a liability by a guarantor at the inception of certain guarantees for the non-contingent component of the guarantee, this is the obligation to stand ready to perform in the event that specified triggering events or conditions occur. The initial measurement of this liability is the fair value of the guarantee at inception.

The disclosure requirements of the Interpretation apply at December 31, 2002 and the recognition and measurement provisions apply to all guarantees entered into or modified after December 31, 2002. To date the Company does not have material guarantees that require recognition.

(2)

In December 2003, the Financial Accounting Standards Board issued Interpretation No. 46R ("FIN 46R"), "Consolidation of Variable Interest Entities" that replaced FIN 46 that had been issued in January 2003. FIN 46R provides guidance on the identification of variable interest entities, entities ("VIEs") for which control is achieved through means other than through voting rights, and how to determine whether a variable interest holder should consolidate the VIEs. This interpretation applies to financial statements of public entities that have interests in VIEs or potential VIEs commonly referred to as special purpose entities for periods ending after December 15, 2003. FIN 46R applies to all public entities for all other types of VIEs in financial statements for periods ending after March 15, 2004. The adoption of FIN 46 did not have a material impact on the consolidated financial statements.

(3)

In April 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities, which amends FASB Statements No. 133, Accounting for Derivative Instruments and Hedging Activities, to clarify under what circumstances a contract with an initial net investment meets the characteristics of a derivative, to clarify when a derivative contains a financing component, to amend the definition of an underlying to conform it to language in FASB Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, and to amend certain other existing pronouncements.
SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003, and is to be applied prospectively.

(4)

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. SFAS No. 150 requires that certain financial instruments issued in the form of shares that are mandatorily redeemable as well as certain other financial instruments be classified as liabilities in the financial statements. SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003 and otherwise is effective beginning the Company's second quarter of 2004.

(v)

Recent and future pronouncements:
The adoption of SFAS 149 or SFAS 150 did not or are not expected to have a material affect on the Company's financial statements.

STONE VENEPAL (CELGAR) PULP INC.
(In Bankruptcy)
Financial Statements
For the Nine Months Ended September 30, 2004
(Unaudited)

STONE VENEPAL (CELGAR) PULP INC.
(In Bankruptcy)

CONDENSED BALANCE SHEET
(Unaudited)

September 30, 2004
(In Thousands of Canadian dollars)

	September 30, 2004	December 31, 2003
ASSETS		
CURRENT		
Accounts receivable	$ 27,551	$ 23,346
Inventories (Notes 1 (b) and 3)	76,136	52,457
Prepaid expenses and other	1,384	1,134
	105,071	76,937
PROPERTY, PLANT AND EQUIPMENT (Notes 1 (b) and 4)	252,613	402,633
	$ 357,684	$ 479,570
LIABILITIES		
CURRENT		
Bank indebtedness	$ 20,662	$ 3,754
Accounts payable and accrued liabilities	24,145	20,333
Current portion of obligation under capital leases (Note 1 (b))	261	394
	45,068	24,481
ASSET RETIREMENT OBLIGATIONS (Note 7)	965	930
PRE-BANKRUPTCY AND OTHER DEBT (Notes 1 (b) and 5)	1,123,660	1,119,280
OBLIGATION UNDER CAPITAL LEASES (Note 1 (b))	174	374
	1,169,867	1,145,065
SHAREHOLDERS' DEFICIENCY		
Share capital	17,800	17,800
Deficit	(829,983)	(683,295)
	(812,183)	(665,495)
	$ 357,684	$ 479,570

BASIS OF PRESENTATION (Note 1)
COMMITMENTS (Note 8)

ON BEHALF OF KPMG INC., TRUSTEE OF THE ESTATE OF STONE VENEPAL (CELGAR) PULP INC., IN BANKRUPTCY

/s/ Todd M. Martin

Senior Vice President

See accompanying Notes to the Condensed Financial Statements

STONE VENEPAL (CELGAR) PULP INC.
(In Bankruptcy)

CONDENSED STATEMENT OF LOSS AND DEFICIT
(Unaudited)

Nine Months Ended September 30, 2004
(In Thousands of Canadian dollars)

	September 30, 2004	September 30, 2003
Sales	$ 214,886	$ 207,593
Operating expenses:		
Cost of products sold	167,637	182,903
Depreciation and amortization	22,833	29,320
Selling, general and administrative	22,784	28,220
Impairment loss on property, plant and equipment (Note 1 (b))	129,204	
	342,458	240,443
Operating income (loss)	(127,572)	(32,850)
Other income (expense)		
Short-term interest expense	(474)	(83)
Interest expense on term credit facility	(34,019)	(35,673)
Foreign exchange gain on term credit facility	15,377	97,772
	(19,116)	62,016
Net earnings (loss) for the period	(146,688)	29,166
Deficit, beginning of period	(683,295)	(720,886)
Deficit, end of period	$ (829,983)	$ (691,720)

See accompanying Notes to the Condensed Financial Statements

STONE VENEPAL (CELGAR) PULP INC.
(In Bankruptcy)

CONDENSED STATEMENT OF CASH FLOWS
(Unaudited)

Nine Months Ended September 30, 2004
(In Thousands of Canadian dollars)

	September 30, 2004	September 30, 2003
Cash provided by (used for):		
Cash flows from operating activities:		
Net earnings (loss) for the period	$ (146,688)	$ 29,166
Items not involving cash:		
Impairment loss on property, plant and equipment	129,204	
Increase in pension and other plans liability	1,002	873
Foreign exchange gain on term credit facility	(15,377)	(97,772)
Interest on term credit facility	34,019	35,673
Depreciation and amortization	22,833	29,320
Accretion expense	35	33
Net changes in non-cash working capital items:		
Increase in accounts receivable	(4,205)	(1,796)
(Increase) decrease in inventory	(23,679)	14,640
Increase in prepaid expenses	(250)	(509)
Increase in accounts payable and accrued liabilities	3,812	571
	706	10,199
Cash flows from investing activities:		
Additions to property, plant and equipment	(2,017)	(3,985)
	(2,017)	(3,985)
Cash flows from financing activities:		
Increase (decrease) in bank indebtedness	16,908	(5,458)
Principal repayments under capital lease obligations	(333)	(204)
Repayment of term credit facility	(15,264)	(552)
	1,311	(6,214)
Net increase in cash position		
Cash position, beginning of period		
Cash position, end of period	$	$
Supplemental information:		
Interest paid	$ 474	$ 390

See accompanying Notes to the Condensed Financial Statements

STONE VENEPAL (CELGAR) PULP INC.
(In Bankruptcy)

NOTES TO THE CONDENSED FINANCIAL STATEMENTS

(Unaudited)

Nine Months Ended September 30, 2004
(In Thousands of Canadian dollars)

1. BANKRUPTCY PROCEEDINGS, PENDING ASSET SALE AND BASIS OF PRESENTATION

Stone Venepal (Celgar) Pulp Inc. ("Celgar" or the "Company") is incorporated under the Canada Business Corporations Act and operates a pulp mill located at Castlegar, B.C.

(a)

Bankruptcy proceedings
Effective July 23, 1998, the directors of Celgar made an assignment in bankruptcy for the general benefit of creditors and KPMG Inc. was appointed Trustee of the Estate of Celgar (the "Trustee"). KPMG Inc. was also appointed Receiver of all the property, assets and undertakings of Celgar pursuant to security granted by the Company to Montreal Trust Company ("MTCC") (the "Receiver"). The Receiver's appointment was effective July 24, 1998.

Pursuant to the Bankruptcy and Insolvency Act, Canada, all assets of Celgar vest in the Trustee subject to the security interests of MTCC. All liabilities outstanding as at July 23, 1998 are obligations of Celgar.

The Trustee has been operating the Celgar pulp mill facility pursuant to an agreement between the Trustee and the Receiver effective the date of bankruptcy.

(b)

Pending asset sale

Effective November 22, 2004, KPMG Inc., in its capacity as Receiver of all the assets and undertakings of the Company, entered into a definitive asset purchase agreement with a third party to acquire substantially all the assets of the Company except for accounts receivable and finished goods inventory. The purchase price under the asset purchase agreement is US$210 million plus the assumption of certain obligations including post-retirement and lease obligations and an amount for defined working capital to be determined upon closing of the transaction.

The asset purchase is subject to the satisfaction of certain conditions including receipt by the purchaser of regulatory approvals of the transaction as well as the purchaser securing satisfactory financing on or before February 28, 2005, with an extension available in certain circumstances.

Property, plant and equipment has been written down to the fair value amounts implicit in this transaction.

(c)

Basis of presentation

The accompanying unaudited interim financial statements of the Company have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP") on a basis consistent with those followed in the most recent annual financial statements, except as described in Note 2 below. These unaudited interim financial statements do not include all information and note disclosures required under Canadian GAAP for annual financial statements, and therefore should be read in conjunction with the Company's annual audited financial statements and notes for the fiscal year ended December 31, 2003. In the opinion of management, all adjustments, consisting of normal recurring adjustments, necessary for fair presentation of the results of operations for the interim periods presented have been reflected herein. The results of operations for the interim periods presented are not necessarily indicative of the results to be expected for the entire fiscal year.

These financial statements materially conform with generally accepted accounting principles in the United States, except as explained in Note 10.

The accompanying financial statements have been prepared after taking into consideration the pending asset sale referred to above. Realization of assets and discharge of pre-bankruptcy debt are subject to uncertainty. The financial statements do not reflect all the adjustments that may be necessary to the carrying value of assets and liabilities. The appropriateness of this basis of accounting is dependent upon, among other things, the completion of the proposed sale transaction and the execution of the realization plan for the remaining assets.

2. SIGNIFICANT ACCOUNTING POLICIES

(a)

Impairment of long-lived assets
Effective January 1, 2004, the Company adopted the new CICA recommendations of Handbook Section 3063, "*Impairment of Long-lived Assets*". These recommendations require an entity to recognize an impairment loss when an event occurs that results in the carrying amount of a long-lived asset to exceed the sum of undiscounted cash flows expected to result from its use and eventual disposition. The impairment loss is measured as the amount by which the long-lived asset's carrying value amount exceeds its fair value.

(b)

Hedging relationships and accounting for trading, speculative, or non-derivative financial instruments

Effective January 1, 2004, the Company adopted the CICA's new Accounting Guideline-13, "*Hedging Relationships*", on the requirements related to the identification, designation, documentation and effectiveness of hedging relationships. The new standards have been applied on a prospective basis to all instruments existing on, or entered into after January 1, 2004.

The Company also applied the accounting treatment prescribed by the CICA's Emerging Issues Committee ("EIC") Recommendation 128 with respect to the accounting for trading, speculative or non-hedging derivative financial instruments. Under this guidance, hedge accounting is optional for derivative transactions that are effective in offsetting financial statement risks. Derivatives for which hedge accounting is not applied are carried on the balance sheet at fair value, with changes in fair value being recorded in the statement of loss. Upon adoption, the Company had no derivative financial instruments which were required to be carried at fair value.

The Company's natural gas forward supply contracts, which call for the physical receipt of natural gas, do not represent a financial instrument.

(c)

Revenue recognition

The Company recognizes revenue when persuasive evidence of an arrangement exists, the sales price is fixed or determinable, title of ownership and risk of loss have passed to the customer and collectibility is reasonably assured. Sales are reported net of discounts and allowances. Amounts charged to customers for shipping and handling are recognized as revenue. Title of the products is transferred to the customers at the time of shipment and payment is based on agreed prices and credit terms contained on sales invoices.

Effective January 1, 2004, the Company applied the accounting treatments of EIC-141, "*Revenue Recognition*". EIC-141 summarizes the principles set as interpretative guidance on the application of Handbook section 3400, "*Revenue*". Specifically, this EIC presents the criteria to be met for revenue recognition to be considered achieved. The application of this accounting treatment had no impact on the financial statements for the nine months ended September 30, 2004.

(d)

Recent accounting pronouncements

In October 2004, the CICA decided to defer the mandatory effective date of proposed Section 1530, "Comprehensive Income", proposed Section 3855, "Financial Instruments Recognition and Measurement" and proposed Section 3865, "Hedges", by one year, in order to allow adequate time for implementation. The guidance will now apply for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2006. Earlier adoption will be permitted only as of the beginning of a fiscal year. The CICA expects to issue the new pronouncements in the first quarter of 2005.

(e)

Measurement uncertainty

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Significant areas requiring the use of management estimates are chip pile inventory quantities, valuation of long-lived assets, useful lives for amortization of fixed assets and estimates of asset retirement, reclamation and environmental obligations. Financial results as determined by actual events could differ from those estimates.

3. INVENTORIES

	September 30, 2004	December 31, 2003
	(Unaudited)	
Pulpwood and chips (a)	$ 17,904	$ 7,960
Other raw materials and supplies (a)	14,790	15,053
Work-in-process and finished goods	43,442	29,444
	$ 76,136	$ 52,457

(a)

These inventories are included in the asset sale transaction described in Note 1 (b) wherein management expects to recover the carrying value.

4. PROPERTY, PLANT AND EQUIPMENT HELD FOR SALE

	September 30, 2004			December 31, 2003
	Cost	Accumulated Depreciation	Net Book Value	Net Book Value
		(Unaudited)		
Buildings	$ 70,053	$ 20,578	$ 49,475	$ 50,789
Machinery and equipment	875,896	384,000	491,896	510,606
Computer and automotive equipment	2,403	2,083	320	1,731
Mill infrastructure	22,512	22,512		
Capital projects in progress	5,620		5,620	4,665
Automotive equipment under capital leases	881	446	435	771
	977,365	429,619	547,746	568,562
Land	1,056		1,056	1,056
	$ 978,421	$ 429,619	548,802	569,618
2000 Write-down of capital assets			166,985	166,985
			381,817	402,633
Impairment loss			(129,204)	
			$ 252,613	$ 402,633

Amortization of the automotive equipment under capital leases of $202 for the nine months ended September 30, 2004 (2003 $648) is included in depreciation and amortization expense.

All property, plant and equipment is the subject of the asset sale transaction referred to in Note 1 (b). As a result, the assets have been impaired to the fair value amounts implicit in that transaction.

5. PRE-BANKRUPTCY AND OTHER DEBT

	September 30, 2004	December 31, 2003
	(Unaudited)	
Pre-bankruptcy accounts payable (a)	$ 11,732	$ 11,738
Pre-bankruptcy taxes payable (b)	6,545	6,545
Pension plan and post-retirement benefits (Note 6)	11,667	10,665
Due to Stone Container (Canada) Inc. ("SCCI") (a)	968	968
Shareholder advances (a)	78,531	78,531
Short-term loan SCCI (a)	120,941	120,941
Term credit facility (c)	893,276	889,892
	$ 1,123,660	$ 1,119,280

(a)

These payables are in some instances secured, however, the security is subordinate to the secured claim of the term credit facility which exceeds the value of the assets of the Company. No interest has been accrued on these liabilities.

(b)

The pre-bankruptcy taxes payable balance represents British Columbia capital and large corporations capital taxes owing for the period to July 23, 1998. No capital taxes are exigible for the period from July 23, 1998 to September 30, 2004.

(c)

The term credit facility consists of Canadian and U.S. dollar borrowings which are secured by the Celgar Mill. Interest rates pertaining to the credit term facility are based upon the secured creditors' prime commercial rate, the bankers' acceptance rate, or the London Interbank Offered Rate ("LIBOR"). The amounts owing under the term credit facility, including accrued interest were as follows:

	September 30, 2004	December 31, 2003
	(Unaudited)	
Canadian dollar credit facility	$ 306,868	$ 310,764
U.S. dollar credit facility (2004 U.S. $464,915; 2003 U.S. $446,720)	586,408	579,128
	$ 893,276	$ 889,892

6. PENSION PLAN AND POST-RETIREMENT BENEFITS

Celgar maintains defined benefit pension plans and post-retirement benefit plans for certain employees. Pension expense is based on estimates from the Company's actuary. Pension contributions for the nine month periods ended September 30, 2004 and 2003 totaled $1,002 and $873, respectively. These plans are intended to be assumed by the purchaser in the asset sale transaction referred to in Note 1 (b).

7. ASSET RETIREMENT OBLIGATION

The Company maintains industrial land fills on its premises for the disposal of waste, primarily from the Company's pulp processing activities. The Company has an obligation under its land fill permits to decommission these disposal facilities pursuant to the requirements of the Provincial Waste Management Act.

A reconciliation of the aggregate carrying amount of the asset retirement obligation is as follows:

Balance at December 31, 2003	