

CANFOR PULP PRODUCTS INC.

CANFOR PULP LIMITED PARTNERSHIP

Management's Discussion and Analysis

For the year ended December 31, 2011

## **Canfor Pulp Products Inc. and Canfor Pulp Limited Partnership 2011 Report to Shareholders Management's Discussion and Analysis**

*Canfor Pulp Products Inc. (CPPI) earns income from its 49.8% interest in Canfor Pulp Limited Partnership (the Partnership). CPPI accounts for its investment in the Partnership on the equity basis and does not consolidate the operations of the Partnership. In order for CPPI's shareholders to understand the results of operations, the audited consolidated financial statements with accompanying notes are presented for both CPPI and the Partnership. This Management's Discussion and Analysis (MD&A) provides a review of the significant developments that have impacted the Partnership's and CPPI's performance for the year ended December 31, 2011 relative to the prior year. This MD&A should be read in conjunction with the audited consolidated financial statements and accompanying notes for CPPI and the Partnership. Additional information relating to CPPI and the Partnership, including CPPI's Annual Information Form dated February 6, 2012, is available on SEDAR at [www.sedar.com](http://www.sedar.com) or at [www.canforpulp.com](http://www.canforpulp.com).*

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

*Calculations of EBITDA and distributable cash are provided in this MD&A.*

*The information in this report is as at February 6, 2012.*

### **Forward-Looking Statements**

*Certain statements in this MD&A constitute "forward-looking statements" which involve known and unknown risks, uncertainties and other factors that may cause actual results to be materially different from any future results, performance or achievements expressed or implied by such statements. Words such as "expects", "anticipates", "intends", "plans", "will", "believes", "seeks", "estimates", "should", "may", "could" and variations of such words and similar expressions are intended to identify such forward-looking statements. In some instances, material assumptions are disclosed elsewhere in this MD&A in respect of forward-looking statements. Other risks and uncertainties are detailed from time to time in reports filed by CPPI with the securities regulatory authorities in all of the provinces and territories of Canada to which recipients of this MD&A are referred for additional information concerning CPPI and the Partnership, their prospects and uncertainties relating to CPPI and the Partnership. Although we believe that the expectations reflected by the forward-looking statements presented in this MD&A are reasonable, these forward-looking statements are based on management's current expectations and beliefs and actual events or results may differ materially. New risk factors may arise from time to time and it is not possible for management to predict all of those risk factors or the extent to which any factor or combination of factors may cause actual events and results, performance and achievements of CPPI and the Partnership to be materially different from those contained in forward-looking statements. The forward-looking statements speak only as of the date on which such statement is made, are based on current information and expectations and CPPI and the Partnership assume no obligation to update such information to reflect later events or developments, except as required by law.*

*Forward-looking statements in this MD&A include statements made under:*

- "Critical Accounting Estimates" on pages 6, 22 and 23;*
- "Changes in Accounting Policies" on pages 6, 7, and 23 – 25;*
- "Outlook – Pulp" on page 12;*
- "Outlook – Kraft Paper" on page 13;*
- "Financial Requirements and Liquidity" on pages 14 – 16*
- "Risks and Uncertainties Related to the Structure of CPPI" on pages 5 and 6*
- "Risks and Uncertainties Related to the Business and Industry" on pages 19 – 22*

*Material risk factors that could cause actual results to differ materially from the forward-looking statements contained in this MD&A include: general economic, market and business conditions; product selling prices; raw material and*

*operating costs; exchange rates; changes in law and public policy; and opportunities available to or pursued by CPPI and the Partnership. Additional information concerning these and other factors can be found in CPPI's Annual Information Form dated February 6, 2012, which is available on [www.sedar.com](http://www.sedar.com).*

## **CANFOR PULP PRODUCTS INC.**

CPPI is the successor to Canfor Pulp Income Fund (the Fund) following the completion of the conversion of the Fund from an income trust to a corporate structure by court approved plan of arrangement under the Business Corporations Act (British Columbia) (the BCBCA) on January 1, 2011 (the Conversion). The Conversion involved the exchange, on a one-for-one basis, of all outstanding Fund Units for common shares of CPPI. Upon completion of the Conversion and the subsequent winding up of the Fund and the Canfor Pulp Trust (the Trust) the unitholders of the Fund became the sole shareholders of CPPI and CPPI became the direct holder of the 49.8% interest in the Partnership.

At February 6, 2012, there were a total of 35,493,307 CPPI shares issued and outstanding, and CPPI held a total of 35,493,542 units of the Partnership, representing 49.8% of the Partnership. Canadian Forest Products Ltd. (Canfor) held 35,776,483 Class B Exchangeable Limited Partnership Units, representing 50.2% of the Partnership. The Class B Exchangeable Limited Partnership Units are exchangeable for an equivalent number of CPPI shares pursuant to the terms of an amended exchange agreement (Exchange Agreement) dated January 1, 2011 between Canfor, CPPI, the Partnership and the General Partner. The Exchange Agreement contains, among other things, the procedure through which the Class B Exchangeable Limited Partnership Units may be exchanged for CPPI shares.

The general partner of the Partnership is Canfor Pulp Holding Inc. (the General Partner) and each limited partner holds an ownership interest in the General Partner equal to its proportionate interest in the Partnership.

The shareholders of CPPI will participate pro-rata in any dividends from CPPI. It is the current intention of CPPI to designate any dividends paid on CPPI shares to be eligible dividends to the extent permitted by the Canadian Income Tax Act such that individuals would benefit from the enhanced gross-up and dividend tax credit mechanism under the Canadian Income Tax Act.

## **2011 HIGHLIGHTS**

- Paid and declared dividends totalling \$42.6 million or \$1.20 per share in 2011. In addition a dividend was declared on February 6, 2012 relating to the fourth quarter of 2011 of \$8.9 million or \$0.25 per share.
- Generated net income of \$72.6 million.
- Completed announced conversion from an income fund to a corporation under the Plan of Arrangement effective January 1, 2011.

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

CPPI's equity investment in the Partnership was as follows:

(thousands of dollars)	<b>Year ended December 31, 2011</b>	Year ended December 31, 2010
Balance, beginning of year	<b>240,425</b>	249,593
Equity income of the Partnership	<b>69,039</b>	89,166
Equity interest in other comprehensive loss of the Partnership	<b>(8,850)</b>	(6,761)
Distributions from the Partnership	<b>(74,535)</b>	(91,573)
Balance, end of year	<b>226,079</b>	240,425

CPPI's investment in the Partnership units was recorded using the equity method.

## SELECTED ANNUAL FINANCIAL INFORMATION

(thousands of dollars, except per unit amounts)	Year ended December 31, 2011	Year ended December 31, 2010 <sup>2</sup>	Year ended December 31, 2009 <sup>3</sup>
Equity income of the Partnership	<b>69,039</b>	89,166	6,644
Net income (loss)	<b>72,601</b>	(198,743)	9,066
Net income (loss) per share	<b>\$2.05</b>	(\$5.60)	\$0.26
Distributions earned from the Partnership	<b>74,535</b>	91,573	9,229
Dividends/distributions declared per share/unit	<b>\$1.20</b>	\$2.58	\$0.26
Partnership distributable cash per unit <sup>1</sup>	<b>\$1.85</b>	\$2.91	\$0.43

Notes: <sup>1</sup> Represents the Partnership's distributable cash on which CPPI was dependent to make its own distributions. For further details on the Partnership's distributable cash see the Partnership's disclosure on page 10.

<sup>2</sup> Fund results for 2010 presented under IFRS. See CPPI's disclosure on pages 6 and 7.

<sup>3</sup> Presented under previous Canadian GAAP. See CPPI's disclosure on pages 6 and 7.

## 2011 COMPARED TO 2010

For the year ended December 31, 2011, CPPI had net income of \$72.6 million, or \$2.05 per share compared to a net loss of \$198.7 million, or \$5.60 per share for the year ended December 31, 2010. The 2011 results are not directly comparable to 2010 due to one time charges to 2010 net income totaling \$290.7 million on the impact of adopting International Financial Reporting Standards (IFRS) as a result of reclassification of Fund units as a liability and treatment of distributions as a financing expense (for further details see disclosures under Impact of Adopting IFRS on the Company's Accounting Policies)

These results represent CPPI's share of the Partnership's earnings, including a deferred income tax recovery of \$19.1 million and a current income tax expense of \$14.6 million for the year ended December 31, 2011 (2010 — deferred income tax recovery of \$2.8 million). CPPI's share of operating earnings decreased in 2011 due to lower shipments of the Partnership's pulp and paper products, lower realized pulp prices and higher unit manufacturing costs, partially offset by higher realized paper prices. CPPI's share of non-operating charges included in equity income of the Partnership for 2011 totaled \$5.9 million, and was primarily the result of interest expense, a foreign exchange loss on translation of US dollar denominated long-term debt and a loss on derivative financial instruments, partially offset by a foreign exchange gain on working capital. In addition, CPPI incurred administrative expenses totalling \$1.2 million during 2011 of which \$0.8 million related to the conversion of the Fund into a corporation.

Distributions declared by the Partnership and accruing to CPPI were \$74.5 million, or \$2.10 per share of which \$3.9 million was receivable at December 31, 2011 as compared to \$91.5 million, or \$2.58 per share of which \$19.5 million was receivable at December 31, 2010. CPPI dividends of \$1.20 per share in 2011 consist of three quarterly dividends and do not include the fourth quarter dividend of \$0.25 per share declared in February 2012.

## SELECTED QUARTERLY FINANCIAL INFORMATION

(thousands of dollars, except per share/unit amounts, unaudited)	CPPI				The Fund <sup>2</sup>			
	Q4 2011	Q3 2011	Q2 2011	Q1 2011	Q4 2010	Q3 2010	Q2 2010	Q1 2010
Equity income in Canfor Pulp Limited Partnership	7,861	11,928	24,023	25,227	23,639	27,374	21,681	16,473
Net income (loss)	5,923	8,299	17,754	40,625	(11,335)	3,239	(71,803)	(118,842)
Net income (loss) per share/unit	\$0.17	\$0.24	\$0.50	\$1.14	(\$0.32)	\$0.09	(\$2.02)	(\$3.34)
Distributions earned from the Partnership	11,712	10,648	24,490	27,685	37,268	24,491	18,457	11,357
Dividends/distributions declared per share/unit	\$0.40	\$0.40	\$0.40	-	\$1.05	\$0.69	\$0.52	\$0.32
Partnership distributable cash per unit <sup>1</sup>	(\$0.04)	\$0.37	\$0.75	\$0.77	\$0.68	\$0.78	\$0.88	\$0.57

Notes: <sup>1</sup> Represents the Partnership's distributable cash on which CPPI is dependent to pay its own dividends. For further details on the Partnership's distributable cash see the disclosure on page 10.

<sup>2</sup> Fund results for 2010 presented under IFRS. See CPPI's disclosure on pages 6 and 7.

## **FOURTH QUARTER 2011 RESULTS**

For the quarter ended December 31, 2011, CPPI had net income of \$5.9 million or \$0.17 per share. The net income was CPPI's share of the Partnership's net income for the fourth quarter of 2011 and includes income tax expense of \$1.9 million. Included in equity income of the Partnership for the fourth quarter of 2011 was CPPI's share of non-operating items with the foreign exchange gain on translation of US dollar denominated long-term debt and a gain on derivative financial instruments offset by a foreign exchange loss on working capital and interest expense. Distributions declared by the Partnership and accruing to CPPI were \$11.7 million of which \$3.9 million was receivable at December 31, 2011. Cash distributions received from the Partnership were the primary source of liquidity for CPPI.

### **CPPI DIVIDENDS**

CPPI is entirely dependent on distributions from the Partnership to make dividend payments to its shareholders. Distributions payable by the Partnership to CPPI and dividends payable by CPPI to its shareholders are recorded when declared. During the year, CPPI declared and paid a dividend of \$1.20 per share or \$42.6 million. In addition, on February 6, 2012, a dividend of \$0.25 per share was declared relating to the fourth quarter of 2011, payable on February 23, 2012 to shareholders of record on February 16, 2012.

Cash distributions from the Partnership were not directly equal to CPPI's pro-rata share of the Partnership's income under the equity method. This was primarily due to capital expenditures, foreign exchange gains or losses on translation of US dollar denominated debt, changes in value of derivative instruments, amortization, and other non-cash expenses of the Partnership.

### **CPPI SHARES**

At February 6, 2012, there were a total of 35,493,307 CPPI shares outstanding.

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

### **Control of the Partnership**

Pursuant to a shareholders' agreement, Canfor is entitled to appoint the majority of directors to the board of the General Partner for so long as it owns not less than a 30% interest in the Partnership. For so long as Canfor holds not less than a 20% interest in the Partnership, Canfor's consent will be required in order to approve certain significant transactions of the Partnership. In addition, under the amended Exchange Agreement, CPPI agreed not to take certain actions without the prior approval of Canfor. As a result of these rights, Canfor exercises significant influence or control over transactions submitted to the board of the General Partner and of CPPI. Canfor may have sufficient voting power to prevent a change of control of the Partnership. CPPI has an interest in the Partnership and has influence, but not control over the transactions of the Partnership.

The interests of Canfor may conflict with those of CPPI shareholders.

### **Dependence on the Partnership**

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

### **Cash Dividends are not Guaranteed and will Fluctuate with the Business Performance**

Although CPPI intends to pay dividends in respect of the cash distributions received from the Partnership, less income taxes and expenses, there can be no assurance regarding the amount of income to be generated by the Partnership's business or ultimately the cash distributed to CPPI. The ability of CPPI to pay cash dividends, and the actual amount paid, will be entirely dependent on the operations and assets of the Partnership, and will be subject to various factors including its financial performance, its obligations under applicable credit facilities, fluctuations in its working capital and its capital expenditure requirements. Accordingly, there is no assurance that dividends will be

maintained at current levels. The market value of CPPI shares may deteriorate if CPPI is unable to maintain its dividend levels in the future.

### **Deferred Income Taxes**

Deferred income tax assets and liabilities are determined based on the difference between the tax basis of CPPI's and the Partnership's assets and liabilities and the respective amounts reported in the financial statements.

### **RELATED PARTY TRANSACTIONS**

All accounting, treasury, legal and administrative functions for CPPI are performed on its behalf by the Partnership pursuant to a support agreement. The value of these services for the year ended December 31, 2011 was \$1.2 million and included a onetime charge of \$0.8 million for costs related to conversion to a corporation on January 1, 2011. These services were included as administrative expenses of CPPI with the balance outstanding of \$0.1 million recorded in accounts payable to the Partnership at December 31, 2011.

Distributions earned from the Partnership for the year ended December 31, 2011 were \$74.5 million of which \$70.6 million was received, with the balance of \$3.9 million receivable as at December 31, 2011.

### **CRITICAL ACCOUNTING ESTIMATES**

The preparation of financial statements in conformity with IFRS requires management to make estimates and assumptions that affect the amounts recorded in the financial statements. Management regularly reviews these estimates and assumptions based on currently available information. The significant area requiring the use of management's estimates is assessing whether there has been an other than temporary decline in the value of the investment in the Partnership. CPPI accounted for its investment in the Partnership using the equity method. CPPI analyzed the carrying value of its investment in the Partnership by considering the underlying value of the Partnership's business. This assessment included various long-term assumptions related to the Partnership's operations which may not be reflected in the current market value of CPPI. Changes in these estimates could have a material impact on the calculation of the equity investment in the Partnership.

### **CHANGE IN ACCOUNTING POLICIES**

#### **Transition to and Initial Adoption of International Financial Reporting Standards**

IFRS became Canadian generally accepted accounting principles (GAAP) for publicly accountable enterprises effective for fiscal years beginning on or after January 1, 2011. In this MD&A the term Canadian GAAP refers to Canadian GAAP before the adoption of IFRS. The financial statements for the year ended December 31, 2011, have been prepared in accordance with IFRS and IFRS 1, using accounting policies consistent with IFRS as issued by the International Accounting Standards Board (IASB) and interpretations of the International Financial Reporting Interpretations Committee (IFRIC). CPPI relies on the resources of the Partnership to ensure compliance with IFRS.

The accounting policies have been applied consistently to all periods presented in the financial statements. The policies applied in these financial statements are based on IFRS issued and effective as of February 6, 2012, the date the Board of Directors approved the statements.

#### **Impact of Adopting IFRS on the Company's Accounting Policies**

CPPI has changed certain accounting policies to be consistent with IFRS. As a result of the conversion to a corporation effective January 1, 2011, the items discussed below do not impact CPPI's Cash and Cash Equivalents, Total Assets, Total Liabilities, Total Shareholders' Equity or Net Income Before Income Taxes for 2011.

The impact of the application of these accounting policies on the comparative 2010 financial statements of the Fund is summarized as follows:

##### **(a) Fund Units**

Under the terms of the trust indenture, unitholders had a puttable option, whereby the Fund would have been required to redeem Fund units at the request of the unitholder and required the Fund to distribute all of the taxable income received from the Partnership.

Under Canadian GAAP the Fund units were classified as equity. Under IFRS, International Accounting Standard (IAS) 32 "Financial Instruments: Presentation" requires that the Fund units be classified as a financial liability prior to conversion to a corporation and the Fund's distributions be classified as a financing expense recorded in the statement of comprehensive income. The financial liability is recorded at amortized cost, with fair value being the best approximation of amortized cost, and changes in amortized cost recorded in the statement of comprehensive income (loss). Upon conversion to a corporation effective January 1, 2011, the Fund units were converted on a one-for-one basis into shares of CPPI and the shares are classified as equity with quarterly dividends treated as an equity distribution.

Impact on Balance Sheets of the Fund:

(thousands of dollars, except for per unit amounts)	As at December 31, 2010	As at January 1, 2010
Increase in fund unit liability	509,687	310,568
Reduction in equity	509,687	310,568
Unit market price for valuation	14.36	8.75

Impact on Statements of Comprehensive Income (Loss) of the Fund:

(thousands of dollars)	Year ended December 31, 2010
Increase in value of Fund units (revaluation loss)	199,119
Reclassification to financing expense (distributions declared)	91,573
Reduction in comprehensive income	290,692

(b) Deferred income tax rate

Under Canadian GAAP the Fund recorded temporary tax differences that were projected to reverse after 2010 based on Specified Investment Flow Through (SIFT) entity tax rates. However, IAS 12 "Income Taxes" requires that companies should use the undistributed rate for recording taxes. Therefore, under IFRS the rate to apply to temporary differences that are projected to reverse after 2010 would be the highest marginal personal tax rate rather than the SIFT rate. The highest marginal personal tax rate is the rate at which tax would be payable by the Fund should distributions not be declared (43.7%). Subsequent to January 1, 2011 as a result of the conversion of the Fund into a corporation, the temporary tax differences are to be measured at the substantively enacted corporate tax rate in effect at the date of reversal of the temporary differences.

Impact on Balance Sheets of the Fund:

(thousands of dollars, unaudited)	As at December 31, 2010	As at January 1, 2010
Increase in deferred tax liability	17,415	18,350
Reduction in equity	17,415	18,350

**FINANCIAL INSTRUMENTS**

CPPI's financial instruments consisted of cash and cash equivalents, distributions receivable from the Partnership, and amounts due to the Partnership. The fair values of these financial instruments approximated their carrying values due to the relatively short period to maturity of these instruments.

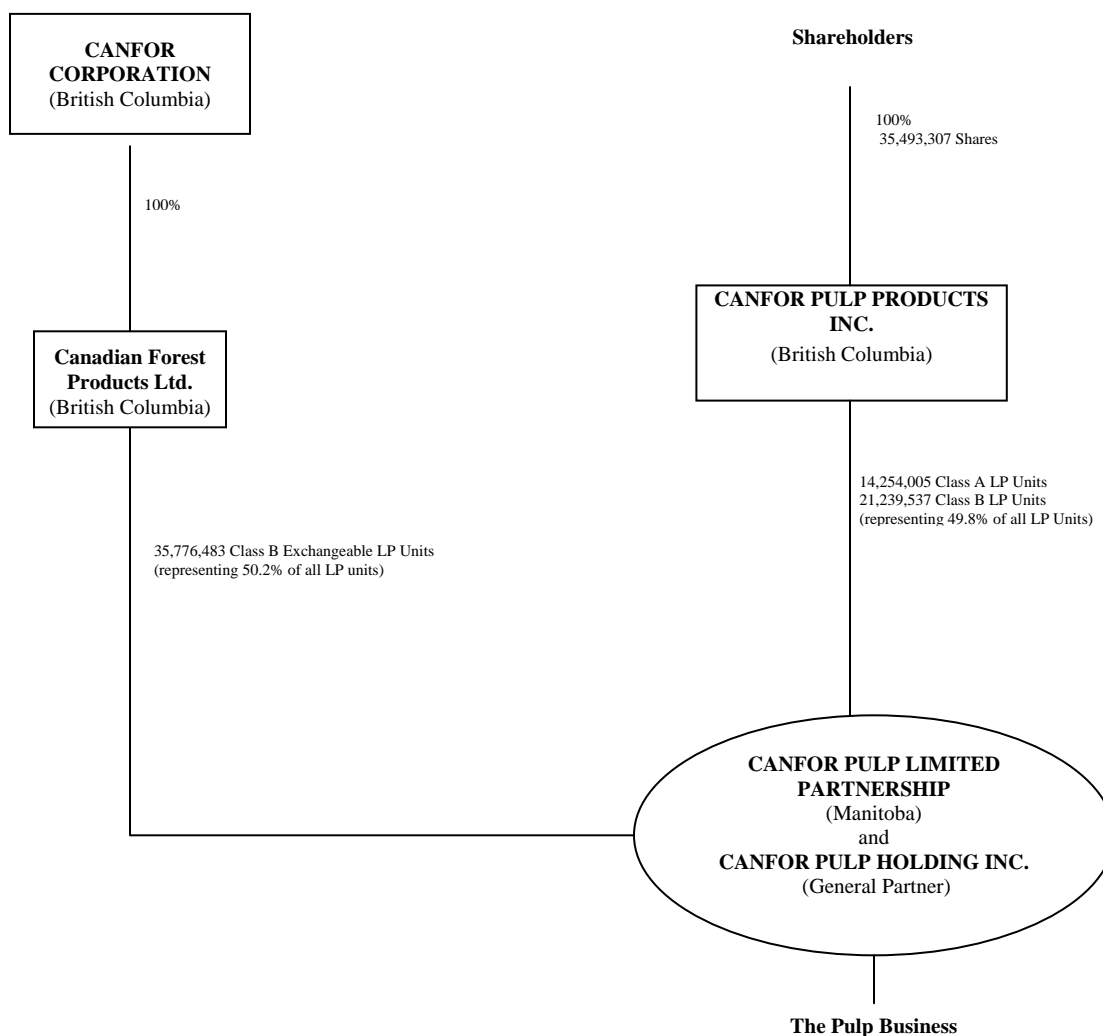
## CANFOR PULP LIMITED PARTNERSHIP

### Structure

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

At February 6, 2012, CPPI indirectly held a total of 14,254,005 Class A Limited Partnership Units and 21,239,537 Class B Limited Partnership Units, representing 49.8% of the Partnership and Canfor owns the remaining 50.2%. The Partnership is managed, on behalf of the limited partners, by Canfor Pulp Holding Inc., the General Partner.

### Ownership Structure





## The Partnership's Business and Strategic Objectives

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

The Partnership owns and operates three mills with annual capacity to produce over one million tonnes of northern softwood market kraft pulp, 90% of which is bleached to become NBSK pulp for sale to the market, and approximately 140,000 tonnes of kraft paper.

### 2011 HIGHLIGHTS

- Reported net income of \$138.6 million or \$1.94 per Partnership unit on sales of \$941.0 million.
- Generated EBITDA of \$218.2 million.
- Generated distributable cash of \$131.6 million or \$1.85 per Partnership unit.
- Completed a capital program totaling \$139.1 million, of which \$56.0 million was funded by the Partnership, and the remainder from government programs.

### Selected Annual Information

(millions of dollars except volumes and per unit amounts, unaudited)	2011	2010	2009 <sup>2</sup>
<b>Sales volume - major products</b>			
Pulp - thousands of metric tonnes	978.5	1,039.0	1,044.6
Paper - thousands of metric tonnes	127.6	144.7	135.0
<b>Sales by segment</b>			
Pulp	802.9	857.2	690.0
Paper	136.6	142.6	122.5
Unallocated	1.5	1.3	1.0
Total sales	941.0	1,001.1	813.5
<b>Operating income</b>			
Pulp	154.9	199.0	11.7
Paper	9.2	0.6	10.6
Unallocated costs	(13.6)	(15.9)	(10.3)
Total operating income	150.5	183.7	12.0
<b>EBITDA</b>			
Pulp	218.4	261.4	57.9
Paper	13.2	3.9	13.9
Unallocated costs	(13.4)	(15.6)	(10.0)
Total EBITDA	218.2	249.7	61.8
<b>Net income</b>	138.6	179.0	13.4
<b>Net income per Partnership unit, basic and diluted</b>	\$ 1.94	\$ 2.51	\$ 0.19
<b>Total assets</b>	791.2	853.3	837.6
<b>Total long-term debt</b>	111.9	109.4	115.1
<b>Distributable cash</b>	131.6	207.1	30.5
<b>Distributions declared</b>	149.7	183.9	18.6
<b>Distributions declared per unit</b>	\$ 2.10	\$ 2.58	\$ 0.26
<b>Average exchange rate (US\$/Cdn\$)<sup>1</sup></b>	1.011	0.971	0.876

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

<sup>2</sup> Presented under previous Canadian GAAP. See Partnership's disclosure on pages 23 – 25.

## Reconciliation of Net Income to EBITDA

The following table reconciles the Partnership's net income from continuing operations, as reported in accordance with GAAP, to EBITDA:

(millions of dollars, unaudited)	2011	2010
<b>Net income</b>	<b>\$ 138.6</b>	\$ 179.0
Add (deduct):		
Amortization	66.8	66.1
Interest expense	8.0	7.8
Foreign exchange loss (gain) on long-term debt	2.5	(5.7)
Loss (gain) on derivative financial instruments	1.6	(1.5)
Foreign exchange loss (gain) on working capital	(1.0)	4.0
Loss (gain) on disposal of fixed assets	0.9	(0.2)
Other expense	0.8	0.2
<b>EBITDA</b>	<b>\$ 218.2</b>	\$ 249.7
<b>EBITDA per Partnership unit</b>	<b>\$ 3.06</b>	\$ 3.50

## 2011 Compared to 2010

Net income and EBITDA for 2011 decreased by \$40.4 million and by \$31.5 million respectively over 2010. The decrease in 2011 results were primarily attributable to lower earnings from the pulp segment due to lower shipment volumes, the impact of the extended maintenance outage at the Northwood Pulp Mill and lower realized pulp prices in Canadian dollar terms. The reduction in pulp segment earnings were partially offset by improved paper segment earnings and higher energy sales.

Non-operating charges, included in net income of the Partnership totaled \$11.9 million in 2011, which represents an increase of \$7.2 million when compared to 2010. The increase in non-operating charges is primarily the result of a foreign exchange loss on translation of US dollar denominated long-term debt and a loss on derivative financial instruments, partially offset by a foreign exchange gain on working capital.

## DISTRIBUTABLE CASH AND CASH DISTRIBUTIONS

(millions of dollars, unaudited)	2011	2010
<b>CALCULATION OF DISTRIBUTABLE CASH</b>		
<b>Cash flow from operations before working capital changes</b>	<b>\$ 212.1</b>	246.2
Deduct:		
Capital expenditures – net <sup>1</sup>	(56.0)	(12.6)
Major maintenance amortization	(16.5)	(18.7)
Interest	(8.0)	(7.8)
<b>Distributable cash</b>	<b>\$ 131.6</b>	207.1
Distributable cash – per Partnership unit	\$ 1.85	2.91
<b>Cash distributions declared (paid and payable)</b>	<b>\$ 149.7</b>	\$ 183.9
Cash distributions declared – per Partnership unit	\$ 2.10	2.58

Note: <sup>1</sup> Presented net of government funding and excludes major maintenance capital.

Approximately \$17 million in undistributed cash was carried forward from 2010 to fund a portion of the anticipated higher level of capital expenditures in 2011.

The Board of the General Partner determines the level of cash distributions based on the level of projected sustainable cash flow from operations before changes in non-cash working capital less anticipated capital expenditures and interest expense. The Board considers business risks and uncertainties which could impact those projections. It is projected that normal seasonal fluctuations in working capital will be funded from cash resources or the revolving short-term credit facility.

## OPERATING RESULTS BY BUSINESS SEGMENT

### Pulp

(millions of dollars unless otherwise noted, unaudited)	2011	2010
Sales	802.9	857.2
EBITDA	218.4	261.4
EBITDA margin	27%	30%
Operating income	154.9	199.0
Average NBSK pulp list price – (US\$ per tonne, delivered to USA)	977	960
Average NBSK pulp list price – (Cdn\$ per tonne, delivered to USA)	966	989
Production – pulp (000 mt)	996.7	1,032.0
Shipments – Partnership produced pulp (000 mt)	978.5	1,039.0
<i>Marketed on behalf of HSLP &amp; Canfor (000 mt)</i>	210.1	457.8

Note: <sup>1</sup> HSLP (Howe Sound Pulp Limited Partnership) sales agency agreement was terminated effective October 1, 2010.

For the year ended December 31, 2011, operating income of \$154.9 million was \$44.1 million lower than in 2010. The decline in operating results was attributable to higher unit manufacturing costs, lower shipment volumes and lower realized prices in Canadian dollar terms, partially offset by higher energy sales. The maintenance outage at the Northwood Pulp Mill was extended to complete the installation of the recovery boiler and precipitator upgrade. This reduced production in 2011 by approximately 65,000 tonnes impacting unit manufacturing costs and shipment volumes.

- Unit manufacturing costs increased 5% when compared to the prior year due primarily to the impact of the extended outage at the Northwood Pulp Mill and related maintenance costs, and higher chemical and energy costs. Chemical costs increased 11% due to higher related global commodity prices. Fibre costs in 2011 were unchanged when compared to 2010.
- Market pulp production decreased 35,300 tonnes, primarily due to the extended maintenance outage at the Northwood Pulp Mill.
- Pulp shipment volumes decreased approximately 60,500 tonnes compared to 2011. The reduction was due in part to the extended maintenance outage at the Northwood Pulp Mill and some rebuilding of pulp inventory to a target range in 2011 from the low levels at the end of 2010.
- Realized pulp prices in Canadian dollar terms decreased 1% due primarily to the 4% strengthening of the Canadian dollar averaging \$1.011 US/Cdn, (2010 – \$0.971), partially offset by slightly higher NBSK US list prices and a shift in volumes to higher margin geographic regions and customers.
- North American NBSK US list prices averaged US\$977 per tonne compared to US\$960 per tonne in 2010.
- Energy sales under the Partnership's Energy Purchase Agreement (EPA) with BC Hydro increased \$1.5 million.

### Operations

NBSK market pulp production during 2011 was 35,300 tonnes lower than in 2010. The lower production was mainly attributable to an extended maintenance outage at the Northwood Pulp Mill, and a 1% decrease in the average daily production rate in 2011. The Intercontinental Pulp Mill set an annual production record in 2011 exceeding the previous record set in 2010 by 3%.

## Markets – Pulp

The 2011 year began with pulp inventories held by producers and customers at low levels allowing successive price increases through the first half of the year. The second half of the year was characterized by increasing inventory levels and softening demand resulting in downward pressure on prices.

Pulp and Paper Products Council (PPPC) reported decreased global demand for printing and writing papers of 2% while tissue demand is projected to have increased 3% for full year 2011 as compared to 2010. PPPC reported an increase in shipments of bleached softwood sulphate pulp of 3% in 2011 with increased shipments to Asia offset by reductions in Europe and North America.

At the end of December 2011, World 20<sup>1</sup> producers of bleached softwood pulp inventories were at 36 days of supply. By comparison, December 2010 inventories were at 25 days of supply and June 2011 was at 28 days of supply. Market conditions are generally considered balanced when inventories are in the 27-30 days of supply range.

Producers were successful at implementing price increases through the first half of 2011. North American US list prices peaked in June 2011 at US\$1040 per tonne from US\$960 per tonne in January 2011. Downward pressure was exerted on pricing in the second half of 2011 with softening demand and increasing producer inventories with North American US list prices ending the year at US\$890 per tonne.

Note: <sup>1</sup> World 20 data is based on twenty producing countries representing 80% of world chemical market pulp capacity and is based on information compiled and prepared by the Pulp and Paper Products Council.

## Outlook – Pulp

The global softwood pulp market is projected to remain soft through the first quarter of 2012. There is ample supply as historically there is minimal scheduled maintenance downtime during the winter months. However, current pricing at or below cash costs of some NBSK producers may reduce the risk of further price erosion. Global softwood pulp demand is projected to remain flat in 2012 on slowed growth from China and declining production of graphic papers in mature markets. European demand may be somewhat influenced by the ability of Europe to manage through the current debt crisis in certain countries.

A scheduled maintenance outage is planned at the Intercontinental Pulp Mill in the second quarter of 2012 with an estimated 11,000 tonnes of reduced production. In addition a maintenance outage is planned at the Prince George Pulp Mill which will be extended to complete the final project under the Green Transformation Program, and subject to Board approval, a partial rebuild of the recovery boiler. This will result in a total of approximately 17,000 tonnes of reduced production at the Prince George Pulp Mill, of which 5,000 tonnes falls in the second quarter with the balance of 12,000 tonnes in the third quarter of 2012. A scheduled maintenance outage at the Northwood Pulp Mill is planned for the fourth quarter of 2012 with an estimated 8,000 tonnes of reduced production.

## Paper

(millions of dollars unless otherwise noted, unaudited)	2011	2010
Sales	136.6	142.6
EBITDA	13.2	3.9
EBITDA margin	10%	3%
Operating income	9.2	0.6
Production – paper (000 mt)	136.5	136.7
Shipments – paper (000 mt)	127.6	144.7

The 2011 operating results for the paper segment improved \$8.6 million when compared to 2010. The improvement was primarily attributable to a 9% increase of realized paper prices in Canadian dollar terms partially offset by lower shipment volumes. Paper shipments decreased by 12% when compared to 2010 primarily due to a reduction in demand from the US and higher than normal shipment levels in 2010.

## Operations

The paper division produced 136,500 tonnes in 2011, slightly below the record of 136,700 tonnes set in 2010.

## Markets

Global Kraft paper demand slowed through the latter half of 2011 in all regions. American Forest and Paper Association reported that US total Kraft paper shipments for December decreased 7.5% as compared to December 2010. The Paper Shipping Sack Manufacturers' Association shipping sack statistics for December 2011 revealed that the industry paper consumption was 4% less than November and 10% less than December 2010 and down 8% for the full year. Prices for all grades decreased about 6% in North America in the fourth quarter. Export prices were also lower overall with some pricing higher than the domestic market.

The Partnership's prime paper shipments in 2011 were down 13% from 2010 with prime bleached shipments down 9% from 2010. The reduction in shipments was primarily due to a reduction in demand from the US and higher than normal shipment levels in 2010.

### Outlook – Kraft Paper

Kraft paper demand improved somewhat in December 2011 and is projected to continue to improve through the first quarter of 2012. Prices have stabilized and are projected to be steady through the first quarter of 2012. Roll paper inventories are projected to have peaked at the end of the year and are currently about 30% higher than normal. Inventories are projected to remain high through the first quarter.

### Non-Segmented Costs

(millions of dollars, unaudited)	2011	2010
Net unallocated costs	13.6	15.9
Interest expense, net	8.0	7.8
Foreign exchange loss (gain) on long-term debt	2.5	(5.7)
Loss (gain) on derivative financial instruments	1.6	(1.5)
Foreign exchange loss (gain) on working capital	(1.0)	4.0
Other expense	0.8	0.1
	25.5	20.6

### Net Unallocated Costs

Unallocated costs, comprised principally of general and administrative expenses, for 2011 of \$13.6 million were \$2.3 million lower than the same period a year ago. The reduced costs were primarily attributable to lower accruals for performance based incentive plans and a reduction in payments to industry associations, partially offset by higher consulting costs.

### Other Non-segmented Items

The foreign exchange loss on long-term debt was the result of translating the US\$110.0 million debt at the year-end exchange rate.

The foreign exchange gain on working capital of \$1.0 million resulted from translating US dollar balances at period-end exchange rates.

The net loss of \$1.6 million on derivative financial instruments recorded in 2011 relates to the settlement of maturing contracts during the year and the revaluation to market of outstanding contracts at the end of the year for natural gas swaps and US dollar forward contracts.

The declining price of natural gas in 2011 resulted in a loss for the year of \$2.6 million on settlement of contracts. The natural gas swaps are used to fix the price on a portion of the Partnership's future natural gas requirements. A loss for the year of \$0.8 million was recorded on the settlement of US dollar forward contracts, which were used to mitigate the impact of currency fluctuations on US dollar working capital. This loss was offset by the foreign exchange gain on working capital of \$1.0 million.

A net gain of \$1.8 million was recorded in the year on outstanding derivative financial instruments relating to a revaluation to market of outstanding natural gas swaps and outstanding US dollar forward contracts at December 31, 2011.

## SUMMARY OF FINANCIAL POSITION

The following table summarizes the Partnership's financial position as at the end of and for the following years:

(millions of dollars, except for ratios, unaudited)	2011	2010
Ratio of current assets to current liabilities	2.03	1.90
Ratio of net debt to partners' equity <sup>1</sup>	0.25	0.09
<hr/>		
Increase (decrease) in cash and cash equivalents	(66.2)	50.7
Comprised of cash flow from (used in):		
Operating activities	199.0	241.7
Financing activities	(188.8)	(158.1)
Investing activities	(76.4)	(32.9)

Note: <sup>1</sup> Net debt consists of long-term debt and operating loans, net of cash and cash equivalents.

## Changes in Financial Position

For the year, cash generated from operating activities of \$199.0 million compared to \$241.7 million in 2010. The decrease was primarily due to reductions in cash generated from operations and working capital. The lower cash generated from operations was primarily attributable to lower shipment volumes, the impact of the extended maintenance outage at the Northwood Pulp Mill and lower realized pulp prices in Canadian dollar terms. The reduction in cash generated from working capital was primarily the result of increased volumes of pulp and paper finished goods and chip inventories in 2011 as compared to 2010, which were partially offset by a reduction in trade receivable balances as a result of discounting letters of credit related to agency sales for Taylor Pulp in 2011.

The cash used in financing activities of \$188.8 million represents distributions paid to the limited partners, namely Canfor and CPPI, and \$7.8 million in financing expense.

The cash used in investing activities in the year was comprised of \$41.3 million in sustaining and discretionary capital expenditures, \$27.2 million in major maintenance expenditures and \$87.6 million relating to expenditures under the Green Transformation Program (the Program), partially offset by \$75.6 million of funds received for claims under the Program, \$3.5 million in funds received under other grant programs and \$0.6 million in interest income.

## FINANCIAL REQUIREMENTS AND LIQUIDITY

### *Long-term Debt*

At December 31, 2011 the Partnership had outstanding long-term debt of \$111.9 million (2010 – \$109.4 million, US\$110.0 million for both 2011 and 2010) in the form of unsecured US dollar private placement notes (the Notes). The Notes bear interest at 6.41% and are repayable in full on their maturity date of November 30, 2013.

### *Operating Loans*

The Partnership has a \$40.0 million bank credit facility with a maturity date of November 30, 2013, of which \$0.5 million was utilized at December 31, 2011 for a standby letter of credit issued for general business purposes. In addition, the Partnership has a separate facility with a maturity date of November 30, 2013, to cover the \$10.4 million standby letter of credit issued to BC Hydro under the Energy Purchase Agreement. The Partnership also has an undrawn \$30.0 million bridge loan credit facility with a maturity date of December 31, 2012 to fund timing differences between expenditures and reimbursements for projects funded under the Green Transformation Program. Interest and other costs of the bank credit facility are at prevailing market rates.

### *Cash Management*

The Partnership manages cash resources to fund current and future operations through management of its capital structure in conjunction with cash flow forecasting, including anticipated investing and financing activities. The Partnership uses the bank credit facility to meet short-term working capital requirements. The Partnership also reviews on an ongoing basis, the level of distributions, capital expenditures and timing of scheduled major maintenance outages and may adjust these periodically to manage cash resources.

The Partnership periodically discounts letters of credit on outstanding trade receivables to reduce borrowing costs, to reduce credit and foreign currency exposure, and to increase short-term liquidity.

### *Debt Covenants*

The Notes and bank credit agreements each contain similar financial covenants including a maximum allowable debt:EBITDA leverage ratio and minimum required EBITDA:interest coverage ratio. The Partnership remained in compliance with all covenants at December 31, 2011 and throughout the year.

### *Pulp and Paper Green Transformation Program*

The Partnership was allocated \$122.2 million under the Canadian Federal Government Pulp and Paper Green Transformation Program (the Program). The Program is designed as a reimbursement of funds to be spent on qualifying energy and environmental capital projects. As of December 31, 2011 the Partnership has expended the full Program allocation of \$122.2 million with an additional \$33.2 million of Partnership funded expenditures for a total of \$155.4 million on qualifying expenditures under the Program. During 2011, the Partnership received reimbursements for capital and operating expenditures totaling \$82.4 million with the balance of \$19.7 million receivable as at December 31, 2011. These projects are expected to provide economic and environmental benefits to the Partnership's operations.

### *Commitments*

The Partnership is committed to the following operating leases for property, plant and equipment. At December 31, 2011 and 2010, the future minimum lease payments under these operating leases were as follows:

(millions of dollars)	As at December 31, 2011	As at December 31, 2010
Within one year	1.7	2.4
Between one and five years	1.7	2.7
After five years	-	-
<b>Total</b>	<b>3.4</b>	<b>5.1</b>

Other contractual obligations not included in the preceding table are:

- The Partnership has an Energy agreement with BC Hydro which provides for the sale of power production that exceeds an amended commitment of the cogeneration project at the Prince George Pulp and Paper Mill. Under the agreement, the Partnership is required to post a standby letter of credit as security in annually decreasing amounts as a minimum required amount of electricity is generated. As of December 31, 2011, the Partnership had no repayment obligation under the terms of the agreement and a standby letter of credit in the amount of \$10.4 million was issued to BC Hydro as security for future power generation commitments.
- Obligations to pay pension and other post-employment benefits, for which a liability of \$94.8 million was recorded at December 31, 2011 (2010 – \$79.8 million). The Partnership has funded and unfunded defined benefit plans, as well as a defined contribution plan, that provide pension and other retirement and post-employment benefits to all salaried employees and to its hourly employees that are covered under collective agreements. The regular Salary Pension Plan (SPP) is a registered pension plan and as such, requires funding of future obligations.

- The Partnership's asset retirement obligations represent estimated undiscounted future payments of \$7.2 million to remediate the landfills at the end of their useful lives. Payments relating to landfill closure costs are expected to occur at periods ranging from 7 to 40 years which have been discounted at risk free rates ranging from 1.5% to 2.5%. The estimated fair value is \$3.1 million (2010 – \$3.1 million) and the amount is included in long-term provisions.
- Contractual commitments relating to the construction of capital assets totaled \$6.2 million at December 31, 2011 (2010 – \$6.5 million).

#### *Pension Obligations*

The Partnership is currently committed to annual payments in relation to its main salary pension plan of approximately \$7.6 million for the next four years, or until such a time as a new funding valuation is completed. Of this amount, approximately \$2.7 million will relate to current service costs of active employees.

#### **RELATED PARTY TRANSACTIONS**

The Partnership purchased wood chips and hog fuel from Canfor sawmills in the amount of \$122.2 million in 2011 (2010 – \$126.2 million). The Partnership also purchased wood chips from Lakeland Mills Ltd., in which Canfor owns a one-third interest in the amount of \$11.5 million in 2011 (2010 – \$6.1 million). Purchased wood chips and hog fuel are included in manufacturing and product costs.

Effective July 1, 2006, the Partnership entered into a services agreement under which Canfor provides certain business and administrative services to the Partnership. Total value of the services provided in 2011 was \$3.3 million (2010 – \$3.0 million), included in manufacturing and product costs and selling and administration costs.

Effective July 1, 2006, the Partnership entered into an incidental services agreement with Canfor, under which the Partnership provides certain business and administrative services to Canfor. Total value of the services provided in 2011 was \$2.0 million (2010 – \$1.7 million), included in manufacturing and product costs and selling and administration costs.

The Partnership markets bleached chemi-thermo mechanical pulp production from Canfor's Taylor Pulp Mill (Taylor) for which it earned commissions totaling \$1.9 million in 2011 (2010 – \$1.7 million), included in sales. The Partnership also purchased chemi-thermo mechanical pulp from Taylor for resale totaling \$0.4 million in 2011 (2010 – \$1.5 million). The Partnership sold NBSK pulp to Taylor for packaging use totaling \$3.0 million in 2011 (2010 – \$3.0 million). In respect of the products marketed and services provided for Taylor, the Partnership held balances of \$3.2 million in accounts receivable - trade (2010 – \$22.2 million) and \$7.6 million in accounts payable (2010 – \$23.6 million) to Canfor at December 31, 2011.

Under the agreements for the marketing of production from Taylor, the Partnership assumes the customer credit risk. Accordingly, the Partnership records on its balance sheet the accounts receivable from the customer and the accounts payable to Canfor for sales made under those agreements.

In October of 2010, Canfor sold its 50% ownership of Howe Sound Pulp and Paper Limited Partnership (HSLP). Until this time, the Partnership marketed the NBSK pulp produced by HSLP, for which it earned commissions totaling \$1.8 million in 2010, included in sales. In respect of the products marketed and service provided for HSLP, the Partnership held balances of \$1.0 in accounts receivable and \$8.9 million in accounts payable to Canfor at December 31, 2010. As a result of the sale of HSLP by Canfor, the Partnership's agreement to market HSLP pulp was terminated by the buyer and as compensation the Partnership received a contract termination fee of \$1.3 million from HSLP, included in selling and administration costs in 2010.

At December 31, 2011, a total of \$10.6 million (2010 – \$12.0 million) was outstanding as accounts payable to Canfor in respect of purchases of wood chips, hog fuel, services and amounts paid on behalf of the Partnership. At December 31, 2011 a total of \$0.9 million (2010 – \$0.4 million) was payable to Lakeland Mills Ltd. for wood chips.

The Partnership performs all accounting, treasury, legal and administrative functions for CPPI pursuant to a support agreement. The value of these services for the year ended December 31, 2011 was \$1.1 million, with an outstanding balance of \$0.1 million recorded in accounts receivable from CPPI at December 31, 2011.



These transactions occurred in the normal course of operations and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

During 2011, the Partnership declared distributions totaling \$149.7 million to its limited partners. Distributions to Canfor were \$75.2 million, of which \$71.3 million was paid, with the balance of \$3.9 million recorded in accounts payable as at December 31, 2011. Distributions to the Fund were \$74.5 million, of which \$70.6 million was paid, with the balance of \$3.9 million recorded in accounts payable as at December 31, 2011. For the year ended December 31, 2010, the Partnership declared distributions totaling \$183.9 million to its limited partners. Distributions to Canfor were \$92.3 million, of which \$72.6 million was paid, with the balance of \$19.7 million recorded in accounts payable as at December 31, 2010. Distributions to the Fund were \$91.6 million, of which \$72.1 million was paid, with the balance of \$19.5 million recorded in accounts payable as at December 31, 2010.

#### SELECTED QUARTERLY PARTNERSHIP FINANCIAL INFORMATION

(millions of dollars unless otherwise noted, unaudited)	Q4 2011	Q3 2011	Q2 2011	Q1 2011	Q4 2010	Q3 2010	Q2 2010	Q1 2010
<b>Sales and Income</b>								
Sales	212.7	233.9	242.1	252.3	266.1	247.9	247.6	239.5
Operating income	15.8	35.7	49.1	49.9	46.1	52.5	52.1	33.0
EBITDA	37.8	49.6	64.1	66.7	62.3	68.7	69.4	49.3
Net income	15.8	23.9	48.2	50.7	47.4	55.0	43.6	33.0
<b>Per Partnership unit (dollars) <sup>1</sup></b>								
Net income, basic and diluted	\$0.22	\$0.33	\$0.68	\$0.71	\$0.67	\$0.77	\$0.61	\$0.46
<b>Statistics</b>								
Pulp shipments (000 mt)	231.0	240.2	242.0	265.3	272.3	246.0	252.3	268.4
Paper shipments (000 mt)	30.2	32.1	32.7	32.6	39.0	33.6	34.4	37.7
<b>Average exchange rate (US\$/Cdn\$) <sup>2</sup></b>								
	0.977	1.020	1.033	1.014	0.987	0.962	0.973	0.961
<b>Average NBSK pulp list price – (US\$ per tonne, delivered to USA)</b>								
	920	993	1,025	970	967	1,000	993	880
<b>Per Partnership unit (dollars) <sup>1</sup></b>								
Distributable cash per unit <sup>3</sup>	(\$0.04)	\$0.37	\$0.75	\$0.77	\$0.68	\$0.78	\$0.88	\$0.57
Distributions declared per unit	\$0.33	\$0.30	\$0.69	\$0.78	\$1.05	\$0.69	\$0.52	\$0.32

Notes: <sup>1</sup> Based on Partnership units outstanding at December 31, 2011 (71,270,025) for all periods.

<sup>2</sup> Source – Bank of Canada (average noon rate for the year).

<sup>3</sup> Results for the Partnership are presented under IFRS.

<sup>4</sup> For further details on the Partnership's distributable cash see the disclosure on page 10.

Sales are primarily influenced by changes in market pulp prices, sales volumes and fluctuations in Canadian dollar exchange rates. Operating income, net income and EBITDA are primarily impacted by: the level of sales; freight costs; fluctuations of fibre, chemical, and energy prices; level of spending and the timing of scheduled maintenance downtime; and production curtailments. Net income is also impacted by fluctuations in Canadian dollar exchange rates, the market price of natural gas, the revaluation to the year-end rate of US dollar denominated working capital balances and long-term debt, and revaluation of outstanding natural gas swaps and US dollar forward contracts.

## FOURTH QUARTER 2011 RESULTS COMPARED TO FOURTH QUARTER 2010

### Overview:

EBITDA for the fourth quarter of 2011 was \$37.8 million, \$24.5 million lower when compared to the fourth quarter of 2010. The decline was primarily attributable to lower realized pulp prices, higher unit manufacturing costs, lower shipment volumes of the Partnership's pulp and paper products and higher unallocated costs, partially offset by higher realized paper prices.

### Pulp

(millions of dollars unless otherwise noted, unaudited)	Q4 2011	Q4 2010
Sales	179.1	224.7
EBITDA	36.8	62.3
EBITDA margin	21%	28%
Operating income	16.1	47.0
Average NBSK pulp list price – (US\$ per tonne, delivered to USA)	920	967
Average NBSK pulp list price – (Cdn\$ per tonne, delivered to USA)	942	980
Production – pulp (000 mt)	245.7	261.4
Shipments – Partnership-produced pulp (000 mt)	231.0	272.3
Marketed on behalf of HSLP <sup>1</sup> & Canfor (000 mt)	44.3	58.8

Note: <sup>1</sup> HSLP (Howe Sound Pulp Limited Partnership) sales agency agreement was terminated effective October 1, 2010.

Pulp segment operating income of \$16.1 million decreased \$30.9 million due primarily to lower NBSK US list price, lower shipment volumes and higher unit manufacturing costs.

- Realized pulp prices in Canadian dollar terms decreased 6% due primarily to lower North American NBSK US list prices which averaged US\$920 per tonne compared to US\$967 per tonne in the prior period.
- Market pulp production decreased 15,700 tonnes, primarily due to completion of the extended maintenance outage at the Northwood Pulp Mill in the fourth quarter of 2011.
- Unit manufacturing costs increased 6% when compared to the prior year quarter due to the extended outage at the Northwood Pulp Mill, higher chemical costs and accelerated amortization related to end-of-life assets replaced during the Northwood recovery boiler upgrade project, all of which were partially offset by lower fibre cost.
- Sales volume decreased 41,200 tonnes as a result of softening global demand and reduced tonnage available for sale due to the extended maintenance outage at the Northwood Pulp Mill.

### Paper

(millions of dollars unless otherwise noted, unaudited)	Q4 2011	Q4 2010
Sales	33.5	40.9
EBITDA	4.6	2.1
EBITDA margin	14%	5%
Operating income	3.3	1.3
Production – paper (000 mt)	33.5	34.7
Shipments – paper (000 mt)	30.2	39.0

Operating income of the paper segment for the fourth quarter of 2011 was \$2.0 million higher than the same period last year. The improved results were due to a 6% increase in realized paper prices in Canadian dollar terms, partially offset by lower shipment volumes. The increase in paper prices were due to price increases through the first three quarters of 2011 as paper makers pushed to maintain margins with the substantial increase in global pulp prices through mid 2011. Sales volumes decreased in the fourth quarter of 2011 due to weakening demand and higher than normal shipments in the prior year quarter.

## Non-Segmented Costs

(millions of dollars, unaudited)	Q4 2011	Q4 2010
Unallocated costs, net	3.6	2.2
Interest expense, net	2.1	1.9
Foreign exchange gain on long-term debt	(2.4)	(3.9)
Foreign exchange loss on working capital	1.3	2.8
Gain on derivative financial instruments	(1.5)	(2.3)
Other expense	0.5	0.2
	3.6	0.9

### *Unallocated Costs, net*

Unallocated costs, comprised principally of general and administrative expenses, totaled \$3.6 million in the fourth quarter of 2011 compared to \$2.2 million in the fourth quarter of 2010. The lower unallocated costs in the fourth quarter of 2010 were primarily attributable to a one-time fee received in respect of the termination of the agency sales agreement with Howe Sound Limited Partnership (HSLP) due to the sale by Canfor of their ownership interest in HSLP.

### *Other Non-segmented Items*

The foreign exchange gain on long-term debt of \$2.4 million resulted from translating the US\$110 million debt at period-end exchange rates.

The foreign exchange loss on working capital of \$1.3 million resulted from translating US dollar balances at period-end exchange rates.

The net gain of \$1.5 million on derivative financial instruments recorded in the fourth quarter of 2011 results from the settlement of maturing contracts during the quarter and the revaluation to market of outstanding contracts at the end of the quarter for US dollar forward contracts and natural gas swaps. The natural gas swaps are used to fix the price on a portion of the Partnership's future natural gas requirements, while the US dollar forward contracts are used to hedge the impact of currency fluctuations on US dollar working capital.

More detailed analysis of the fourth quarter 2011 results can be found in the Fourth Quarter 2011 press release dated February 6, 2012.

## RISKS AND UNCERTAINTIES RELATED TO THE BUSINESS AND INDUSTRY

### **Cyclicality of Product Prices**

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

### **Currency Exchange Risk**

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

## **Dependence on Canfor**

Approximately 54% of the fibre currently used by the Partnership is derived from the Fibre Supply Agreement with Canfor. The Partnership's financial results could be materially adversely affected if Canfor is unable to provide the current volume of wood chips as a result of mill closures, whether temporary or permanent.

## **Raw Material Costs**

The principal raw material utilized by the Partnership in its manufacturing operations is wood chips. The Partnership's Fibre Supply Agreement with Canfor contains a pricing formula that currently results in the Partnership paying market price for wood chips and contains provisions to adjust the pricing to reflect market conditions. The current pricing under the agreement expires August 31, 2012, and is being reviewed and may be amended as necessary to ensure it is reflective of market conditions. Prices for wood chips are not within the Partnership's control and are driven by market demand, product availability, environmental restrictions, logging regulations, the imposition of fees or other restrictions on exports of lumber into the US and other matters. The Partnership is not always able to increase the selling prices of its products in response to increases in raw material costs.

## **Competitive Markets**

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

## **Dependence on Key Customers**

In 2011, the Partnership's top five customers accounted for approximately 33% of its pulp sales. The Partnership is therefore dependent on these customers. In the event that the Partnership cannot maintain these customer relationships or the demand from these customers is diminished for any reason in the future, there is a risk that the Partnership would be forced to find alternative markets in which to sell its pulp, which in turn, could result in lower prices or increased distribution costs thereby adversely affecting its sales margins and distributable cash.

## **Increased Production Capacity**

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

## **Maintenance Obligations and Facility Disruptions**

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

## **Governmental Regulation**

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

change in their interpretation or enforcement, or the discovery of currently unknown conditions, may give rise to unexpected expenditures or liabilities.

### **Capital Requirements**

The pulp and paper industries are capital intensive, and the Partnership regularly incurs capital expenditures to expand its operations, maintain its equipment, increase its operating efficiency and comply with environmental laws. The Partnership's total capital expenditures during 2011 were approximately \$139.1 million of which approximately \$77.4 million was incurred under qualifying projects under the Canadian Federal government's Green Transformation Program (the Program) and \$5.7 million funded under other government programs. The Partnership anticipates available cash resources and cash generated from operations will be sufficient to fund its operating needs and capital expenditures.

### **Work Stoppages**

Any labour disruptions and any costs associated with labour disruptions at the Partnership's mills could have a material adverse effect on the Partnership's production levels and results of operations. The Partnership's collective agreements with the CEP and PPWC expire on April 30, 2012. Any future inability to negotiate acceptable contracts could result in a strike or work stoppage by the affected workers and increased operating costs as a result of higher wages or benefits paid to unionized workers.

### **Native Land Claims**

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

### **Transportation Services**

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

### **Environmental Laws, Regulations and Compliance**

The Partnership is subject to a wide range of general and industry-specific laws and regulations relating to the protection of the environment, including those governing air emissions, wastewater discharges, the storage, management and disposal of hazardous substances and wastes, the cleanup of contaminated sites, landfill operation and closure obligations, and health and safety matters. These laws and regulations require the Partnership to obtain authorizations from and comply with the authorization requirements of the appropriate governmental authorities, which have considerable discretion over the terms and timing of permits.

The Partnership has incurred, and expects to continue to incur, capital, operating and other expenditures complying with applicable environmental laws and regulations and as a result of environmental remediation on asset retirement obligations. The provision for these future environmental remediation expenditures was \$3.1 million as of December 31, 2011 (see note 11 of the accompanying consolidated financial statements). It is possible that the Partnership could incur substantial costs, such as civil or criminal fines, sanctions and enforcement actions, cleanup and closure costs, and third-party claims for property damage and personal injury as a result of violations of, or liabilities under, environmental laws and regulations. The amount and timing of environmental expenditures is difficult to predict, and, in some cases, the Partnership's liability may exceed forecasted amounts. The discovery of additional contamination or the imposition of additional cleanup obligations at the Partnership's or third-party sites may result in significant

additional costs. Any material expenditure incurred could adversely impact the Partnership's financial condition or preclude the Partnership from making capital expenditures that would otherwise benefit the Partnership's business. Enactment of new environmental laws or regulations or changes in existing laws or regulations, or interpretation thereof, could have a significant impact on the Partnership.

### **Pension Obligations**

The Partnership in participation with Canfor has several defined benefit plans, which provide pension benefits to certain salaried employees. Benefits are based on a combination of years of service and final average salary. The cash payments required to fund the plan are determined by actuarial valuation completed at least once every three years, with the most recent actuarial valuation for the largest plan being completed as at December 31, 2010.

The funded surplus (deficit) of each defined benefit plan is calculated as the difference between the fair market value of plan assets and an actuarial estimate of future liabilities. Any deficit in the registered plans determined following an actuarial valuation must be funded in accordance with regulatory requirements, normally over 5 or 15 years. Some of the unregistered plans are also partially funded.

Through its pension funding requirements, the Partnership through Canfor, is exposed to the risk of fluctuating market values for the securities making up the plan assets, and to changes in prevailing interest rates which determine the discount rate used in calculating the estimated future liabilities.

For the main Salary Pension Plan, a one percentage point decrease in the rate of return on plan assets over one year would increase the funded deficit by an estimated \$0.7 million. A one percentage point decrease in the discount rate used in calculating the actuarial estimate of future liabilities would increase the funded deficit by an estimated \$9.0 million. These changes would only impact the Partnership's funding requirements in years where a new actuarial funding valuation was performed and approval for a change in annual funding contributions was obtained from the regulator.

### **Sensitivities**

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

(millions of dollars, unaudited)	Impact on annual Net income
Canadian dollar – US \$0.01 change per Canadian dollar	\$ 6
NBSK pulp – US \$10 change per tonne	7
Natural gas cost - \$1 change per gigajoule	4
Chip cost - \$2 change per tonne	5

### **CRITICAL ACCOUNTING ESTIMATES**

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts recorded in the financial statements. On an ongoing basis, management reviews its estimates, including those related to asset useful lives for amortization, impairment of long-lived assets, pension and other employee future benefit plans and asset retirement obligations, based upon currently available information. While it is reasonably possible that circumstances may arise which cause actual results to differ from these estimates, management does not believe it is likely that any such differences will materially affect the Partnership's financial condition.

The Partnership reviewed the carrying values of the pulp and paper finished goods inventories as at December 31, 2011. The Partnership estimates the net realizable value of the finished goods inventories based on actual and forecasted sales orders. Based on these estimates there is no requirement to write-down the Partnership's finished goods inventories, which are carried at cost at December 31, 2011.

On an ongoing basis, management reviews the asset retirement obligations in respect of useful lives and landfill closure costs. The obligations represent estimated undiscounted future payments of \$7.2 million. Payments relating to landfill closure costs are expected to occur at periods ranging from 7 to 40 years which have been discounted at risk free rates ranging from 1.5% to 2.5%.

## **FINANCIAL INSTRUMENTS**

Periodically, the Partnership considers the use of derivative instruments to reduce its exposure to risks associated with fluctuations in foreign exchange rates, pulp prices, and natural gas prices.

For the year ended December 31, 2011 the Partnership recorded a net loss on derivative financial instruments of \$1.6 million (2010 – net gain of \$1.5 million) relating to the settlement of maturing contracts during the year and the revaluation to market of outstanding contracts at the end of the year, for natural gas swaps and US dollar forward contracts.

For the year ended December 31, 2011 the Partnership recorded losses of \$2.6 million (2010 – \$3.7 million) relating to the settlement of maturing natural gas swaps as a charge to non-operating income. At December 31, 2011 the Partnership's outstanding commodity swaps hedging future natural gas purchases have all been settled.

For the year ended December 31, 2011 the Partnership recorded a net loss of \$0.8 million (2010 – net gain of \$4.2 million) on settlement of maturing US dollar forward contracts as a credit to non-operating income. At December 31, 2011 the Partnership had outstanding US dollar forward contracts of \$56.0 million extending to April 2012. At December 31, 2011 the unrealized gain of \$0.3 million (2010 – 1.1 million) on these outstanding US dollar forward contracts was recorded as an asset in other accounts receivable.

## **OUTSTANDING UNITS**

At February 6, 2012, there were 71,270,025 Limited Partnership Units outstanding, of which 35,493,542 units (consisting of 14,254,005 Class A Limited Partnership Units and 21,239,537 Class B Limited Partnership Units) were owned by CPPI and 35,776,483 Class B Exchangeable Limited Partnership Units were owned indirectly by Canfor. The Class B Exchangeable Limited Partnership Units are exchangeable for an equivalent number of CPPI shares pursuant to the terms of an amended exchange agreement (Exchange Agreement) dated January 1, 2011 between Canfor, CPPI, the Partnership and the General Partner.

## **DISCLOSURE CONTROLS AND INTERNAL CONTROLS OVER FINANCIAL REPORTING**

The Partnership has established disclosure controls and procedures to ensure that information disclosed in this MD&A and the related financial statements was properly recorded, processed, summarized and reported to the Board and the Audit Committee. The Partnership's chief executive officer (CEO) and chief financial officer (CFO) evaluated the effectiveness of these disclosure controls and procedures for the year ended December 31, 2011, and have concluded that they were operating effectively.

The CEO and CFO acknowledge responsibility for the design of internal controls over financial reporting (ICFR), and confirmed that there were no changes in these controls that occurred during the most recent year ended December 31, 2011 which materially affected, or are reasonably likely to materially affect, the Partnership's ICFR. Based upon their evaluation of these controls for the year ended December 31, 2011, the CEO and CFO have concluded that these controls were operating effectively.

## **CHANGE IN ACCOUNTING POLICIES**

### **Transition to and Initial Adoption of IFRS**

IFRS became Canadian GAAP for publicly accountable enterprises effective for fiscal years beginning on or after January 1, 2011. The financial statements for the year ended December 31, 2011, have been prepared in accordance with IFRS, and IFRS 1, using accounting policies consistent with IFRS as issued by the IASB and IFRIC.

The accounting policies have been applied consistently to all periods presented in the financial statements. The policies applied in these financial statements are based on IFRS issued and effective as of February 6, 2012, the date the Board of Directors approved the statements.

## Impact of Adopting IFRS on the Partnership's Accounting Policies

The Partnership has changed certain accounting policies to be consistent with IFRS. The following summarizes the significant changes to the Partnership's accounting policies on adoption of IFRS.

### (a) Major Maintenance

IAS 16 requires major inspections and overhauls to be accounted as a separate component of Property, Plant and Equipment (PP&E) if the component is used for more than one reporting period. This treatment is only intended for major expenditures that occur at regular intervals over the life of the asset as costs of routine repairs and maintenance will continue to be expensed as incurred. The regularly scheduled major maintenance outages required on the Partnership's plant and equipment qualify for treatment under this standard with the expenditures being classified as property, plant and equipment.

#### Impact on Consolidated Balance Sheets

(millions of dollars)	As at December 31, 2010	As at January 1, 2010
Increase in property, plant and equipment	13.9	20.7
Reduction in prepaid expenses and other assets	10.8	15.3
Reduction in other long-term assets	3.1	5.4

#### Impact on Consolidated Statements of Comprehensive Income

(millions of dollars)	Twelve months ended December 31, 2010
Increase in amortization expense	18.7
Reduction in manufacturing and product costs	18.7

#### Impact on Consolidated Statements of Cash Flows

(millions of dollars)	Twelve months ended December 31, 2010
Increase in net cash from operations	14.6
Reduction in cash from investing activities	14.6
Net change in cash and cash equivalents	-

### (b) Employee Future Benefits

Actuarial gains and losses are permitted under IAS 19, Employee Benefits, to be recognized directly in other comprehensive income rather than through net income. Actuarial gains and losses have been recognized in other comprehensive income.

IAS 19 requires the past service cost element of defined benefit plans to be expensed on an accelerated basis, with vested past service costs expensed immediately and unvested past service costs recognized on a straight-line basis until the benefits become vested. Under Canadian GAAP, past service costs were generally amortized on a straight-line basis over the expected average remaining service period of active employees under the plan. Vested past service costs have been expensed immediately under IFRS.

Under Canadian GAAP, certain gains and losses which were unrecognized at the time of adopting the current Canadian accounting standard were permitted to be amortized over a period under transitional provisions of the current standard. Under IFRS the transitional provisions have been recognized on the transition date.



## Impact on Consolidated Balance Sheets

(millions of dollars)	As at December 31, 2010	As at January 1, 2010
Increase in post employment benefits obligation	26.8	17.0
Reduction in other long-term assets	14.0	11.2
Reduction in Partners' equity	40.8	28.2

## Impact on Consolidated Statements of Comprehensive Income

(millions of dollars)	Twelve months ended December 31, 2010
Decrease in employee benefits expense	1.0
Reduction in other comprehensive income	13.6