POTLATCH CORP
Form 10-Q
July 30, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended June 30, 2007

Or

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

Commission file number 1-32729

POTLATCH CORPORATION

(Exact name of registrant as specified in its charter)

Delaware **(State or other jurisdiction of** **incorporation or organization)**	**82-0156045** **(I.R.S. Employer** **Identification No.)**
601 West Riverside Ave., Suite 1100 **Spokane, Washington** **(Address of principal executive offices)**	**99201** **(Zip Code)**

(509) 835-1500

Registrant s telephone number, including area code

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨

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

The number of shares of common stock of the registrant outstanding as of June 30, 2007 was 39,033,538.

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POTLATCH CORPORATION AND CONSOLIDATED SUBSIDIARIES

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Part I

ITEM 1.

Financial Statements

Potlatch Corporation and Consolidated Subsidiaries

Statements of Operations and Comprehensive Income

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

	Quarter Ended June 30		Six Months Ended June 30	
	2007	**2006**	**2007**	**2006**
Revenues	$ 414,714	$ 413,293	$ 800,920	$ 814,517
Costs and expenses:				
Depreciation, depletion and amortization	19,320	19,327	38,672	38,979
Materials, labor and other operating expenses	325,985	358,815	661,730	691,731
Selling, general and administrative expenses	20,987	21,673	41,878	44,995
Restructuring charge (Note 5)	35		2,832	
	366,327	399,815	745,112	775,705
Earnings from continuing operations before interest and taxes	48,387	13,478	55,808	38,812
Interest expense	(7,340)	(7,323)	(14,891)	(14,682)
Interest income	596	295	897	1,097
Earnings from continuing operations before taxes	41,643	6,450	41,814	25,227
Provision (benefit) for taxes (Note 4)	6,250	(1,795)	983	(52,332)
Earnings from continuing operations	35,393	8,245	40,831	77,559
Discontinued operations (Note 6):				
Loss from discontinued operations (including gain (loss) on disposal of $55, $-, $(35,774), and $-)	(1,396)	(6,346)	(39,443)	(10,406)
Income tax provision (benefit)	47	(507)	(2,786)	(977)
	(1,443)	(5,839)	(36,657)	(9,429)
Net earnings	$ 33,950	$ 2,406	$ 4,174	$ 68,130
Other comprehensive income, net of tax				
Defined benefit pension and other postretirement benefit plans:				
Amortization of actuarial loss included in net periodic cost, net of tax of $899, $-, $2,015, and $-	$ 1,407	$	$ 3,153	$
Amortization of prior service credit included in net periodic cost, net of tax of $(230), $-, $(268), and $-	(360)		(419)	
Other comprehensive income, net of tax	1,047		2,734	

Comprehensive income	$ 34,997	$ 2,406	$ 6,908	$ 68,130
Earnings per common share from continuing operations (Note 8):				
Basic	$ 0.91	$ 0.21	$ 1.05	$ 2.27
Diluted	0.90	0.21	1.04	2.26
Loss per common share from discontinued operations:				
Basic	$ (0.04)	$ (0.15)	$ (0.94)	$ (0.28)
Diluted	(0.04)	(0.15)	(0.93)	(0.27)
Net earnings per common share:				
Basic	$ 0.87	$ 0.06	$ 0.11	$ 1.99
Diluted	0.87	0.06	0.11	1.98
Distributions per common share (annual rate)(1)	1.96	1.96	1.96	1.96
Average shares outstanding (in thousands):				
Basic	39,027	38,681	38,989	34,159
Diluted	39,242	38,819	39,232	34,336

(1) Distributions for 2006 reflect the annualized rate of our first quarter 2006 distribution, after adjusting for the issuance of approximately 9.1 million shares of common stock in connection with a special earnings and profits distribution of $15.15 per common share paid on March 31, 2006. Actual distributions per common share were $0.49, $0.49, $0.98 and $1.14 for the quarters ended June 30, 2007 and 2006, and six months ended June 30, 2007 and 2006, respectively.

Certain 2006 amounts have been reclassified to conform to the 2007 presentation.

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

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Potlatch Corporation and Consolidated Subsidiaries

Condensed Balance Sheets

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

	June 30, 2007	December 31, 2006
ASSETS		
Current assets:		
Cash	$ 6,754	$ 7,759
Restricted cash (Note 7)		6,673
Short-term investments	31,394	21,564
Receivables, net	108,638	135,105
Inventories (Note 10)	165,906	168,816
Prepaid expenses	18,653	16,602
Total current assets	331,345	356,519
Land, other than timberlands	8,549	8,554
Plant and equipment, at cost less accumulated depreciation	523,759	562,387
Timber, timberlands and related deposits, net	382,579	391,577
Pension assets	127,140	118,355
Other assets (Note 7)	35,496	20,215
	$ 1,408,868	$ 1,457,607
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current installments on long-term debt	$ 3,209	$ 6,157
Accounts payable and accrued liabilities	179,699	190,107
Total current liabilities	182,908	196,264
Long-term debt	321,285	321,474
Liability for pensions and other postretirement benefits	287,257	289,791
Other long-term obligations	16,777	19,059
Deferred taxes	48,627	53,160
Stockholders equity	552,014	577,859
	$ 1,408,868	$ 1,457,607
Stockholders equity per common share	$ 14.14	$ 14.88
Working capital	$ 148,437	$ 160,255
Current ratio	1.8:1	1.8:1

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

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Potlatch Corporation and Consolidated Subsidiaries

Condensed Statements of Cash Flows

Unaudited (Dollars in thousands)

	Six Months Ended June 30, 2007	Six Months Ended June 30, 2006
CASH FLOWS FROM CONTINUING OPERATIONS		
Net earnings	$ 4,174	$ 68,130
Adjustments to reconcile net earnings to net operating cash flows:		
Loss from discontinued operations	3,674	9,429
Loss on disposal of discontinued operations	32,983	
Depreciation, depletion and amortization	38,672	38,979
Proceeds from sales deposited with a like-kind exchange intermediary	(14,829)	
Non-cash cost of real estate sold	403	110
Deferred taxes	(3,495)	(53,331)
Equity-based compensation expense	2,839	1,942
Employee benefit plans	(7,565)	(1,464)
Other	385	2,215
Working capital changes	17,099	42,011
Excess tax benefit from share-based payment arrangements	(2,192)	(528)
Income tax benefit related to stock issued in conjunction with stock compensation plans	958	1,086
Net cash provided by operating activities from continuing operations	73,106	108,579
CASH FLOWS FROM INVESTING		
Decrease (increase) in short-term investments	(9,830)	43,240
Additions to plant and properties	(33,097)	(25,806)
Deposits on timberlands	(54,021)	
Other, net	(173)	(3,813)
Net cash provided by (used for) investing activities from continuing operations	(97,121)	13,621
CASH FLOWS FROM FINANCING		
Change in book overdrafts	(3,319)	5,564
Issuance of common stock	3,654	5,479
Issuance of treasury stock		513
Repayment of long-term debt	(3,137)	(2,336)
Distributions to common stockholders	(38,244)	(127,133)
Excess tax benefit from share-based payment arrangements	2,192	528
Other, net	(1,654)	(196)
Net cash used for financing activities from continuing operations	(40,508)	(117,581)
Cash flows from continuing operations	(64,523)	4,619
Cash flows of discontinued operations:		
Operating cash flows	153	(3,271)
Investing cash flows	63,365	(1,509)
Financing cash flows		
Decrease in cash	(1,005)	(161)
Cash at beginning of period	7,759	6,133

Cash at end of period	$ 6,754	$ 5,972

Net interest payments (net of amounts capitalized) for the six months ended June 30, 2007 and 2006 were $14.9 million and $14.7 million, respectively. Net income tax payments for the six months ended June 30, 2007 and 2006 were $14.4 million and $0.6 million, respectively.

Not included in additions to plant and properties for the six months ended June 30, 2007, are non-cash transactions totaling $50.2 million for the purchase of timberlands.

Certain 2006 amounts have been reclassified to conform to the 2007 presentation.

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

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Potlatch Corporation and Consolidated Subsidiaries

Notes to Consolidated Financial Statements

Unaudited (Dollars in thousands)

NOTE 1.

General

The accompanying Condensed Balance Sheets at June 30, 2007 and December 31, 2006, the Statements of Operations and Comprehensive Income for the quarters and six months ended June 30, 2007 and 2006, and the Condensed Statements of Cash Flows for the six months ended June 30, 2007 and 2006, have been prepared in conformity with accounting principles generally accepted in the United States of America. We believe that all adjustments necessary for a fair statement of the results of such interim periods have been included. On March 30, 2007, we entered into a definitive agreement with a private equity tree farm investment fund for the sale of our hybrid poplar tree farm in Boardman, Oregon. The sale was completed in May 2007. As a result, the Boardman operation was classified as discontinued operations in the financial statements for the quarter and six months ended June 30, 2007. Comparative amounts for 2006 have been reclassified to conform to the 2007 presentation. Except for an adjustment to the carrying value of the Boardman operation, made in conjunction with the sale announcement and pursuant to Financial Accounting Standards Board, or FASB, Statement of Financial Accounting Standards, or SFAS, No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, all adjustments were of a normal recurring nature. There were no material nonrecurring adjustments.

We adopted FASB Staff Position, or FSP, AUG AIR-1, Accounting for Planned Major Maintenance Activities, on January 1, 2007. Adoption of this FSP did not have an effect on our annual 2006 financial condition and results of operations. However, prior to adoption of this FSP, we used the accrue-in advance method to recognize planned major maintenance costs for interim reporting periods. Upon adoption of FSP AUG AIR-1, we began recording major maintenance expenses as incurred. For comparative purposes, results for the quarter and six months ended June 30, 2006, have been revised to reflect the retrospective application of this FSP. The effect of this change on our Statement of Operations and Comprehensive Income for the quarter and six months ended June 30, 2006, respectively, were increases in materials, labor and other operating expenses of $9.1 million and $4.3 million, and decreases in both earnings from continuing operations and net earnings of $5.6 million ($.14 per diluted common share) and $2.6 million ($.08 per diluted common share). Substantially all of this revision was related to our Pulp and Paperboard segment.

This Quarterly Report on Form 10-Q should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2006, as filed with the Securities and Exchange Commission on February 23, 2007.

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

NOTE 2.

Recent Accounting Pronouncements

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

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities. This Statement permits a company to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. SFAS No. 159 is effective as of the beginning of a company s first fiscal year that begins after November 15, 2007. We are currently reviewing this Statement to determine what effect, if any, it will have on our financial condition and results of operations.

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NOTE 3.

REIT Conversion

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

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

NOTE 4.

Income Taxes

As a REIT, generally we are not subject to federal corporate income taxes on ordinary taxable income and capital gains income from real estate investments that we distribute to our stockholders. If certain requirements are met, only our taxable REIT subsidiaries are subject to corporate-level income taxes. We are, however, subject to corporate taxes on built-in gains (the excess of fair market value over tax basis at January 1, 2006) on sales of real property (other than timber) held by the REIT at January 1, 2006, and sold during the first ten years following the REIT conversion.

For the three months ended June 30, 2007, an income tax provision of $6.3 million related to continuing operations was recorded, compared to an income tax benefit of $1.8 million recorded for the three months ended June 30, 2006. The income tax provision for the second quarter of 2007 was largely due to pre-tax operating income for Potlatch TRS. The income tax benefit for the second quarter of 2006 was a result of a pre-tax operating loss for Potlatch TRS.

For the six months ended June 30, 2007, an income tax provision of $1.0 million related to continuing operations was recorded, compared to an income tax benefit of $52.3 million recorded for the same period in 2006. The income tax provision for the first half of 2007 was largely due to pre-tax operating income for Potlatch TRS. The income tax benefit for the first half of 2006 included the reversal of $51.2 million of deferred tax liabilities due to our REIT conversion.

Our federal income tax returns have been examined, and we have reached final settlement, for all tax years through 1994. Examinations for the years 1995 through 2004 have been completed, and agreement has been reached with the Internal Revenue Service regarding tax issues for those years. In the opinion of management, adequate provision had been made at June 30, 2007 for income taxes that might be due as a result of the agreement, and any assessments will not have a material effect on our consolidated earnings.

We adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, on January 1, 2007. Adoption did not result in our recording an adjustment for unrecognized tax benefits on that date.

We reflect accrued interest related to tax obligations, as well as penalties, in our provision for income taxes. During the quarters ended June 30, 2007 and 2006, we included approximately $0.2 million and $0.4 million in interest, respectively. For the six months ended June 30, 2007 and 2006, we included approximately $0.4 million and $0.9 million in interest, respectively. At June 30, 2007 and December 31, 2006, we had approximately $2.1 million and $1.6 million, respectively, accrued for the payment of interest.

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NOTE 5.

Restructuring Charge

In January 2007, we recorded a pre-tax charge of $2.8 million associated with a restructuring within our Resource segment. The charge represented estimated severance benefit costs for 35 employees. An additional charge of less than $0.1 million related to this restructuring was recorded in the second quarter of 2007. As of June 30, 2007, approximately $2.5 million related to this charge had been paid.

NOTE 6.

Discontinued Operations

On March 30, 2007, we entered into a definitive agreement with a private equity tree farm investment fund for the sale of our hybrid poplar tree farm in Boardman, Oregon, for $65 million in cash. The sale was completed in May 2007. We applied a large portion of the proceeds from this sale to our acquisition in the first quarter of 2007 of 76,000 acres of timberlands in Wisconsin through a tax-efficient Internal Revenue Code section 1031 like-kind exchange.

As a result of the sale, we recorded an after-tax charge of $33.0 million for the six months ended June 30, 2007. The charge represented estimated costs associated with the adjustment of the carrying value of the assets involved in the sale to fair market value, as well as approximately $0.3 million in severance benefits and approximately $0.2 million in transaction and other costs associated with the sale. For the quarter and six months ended June 30, 2007, after-tax operating losses of $1.5 million and $3.7 million, respectively, which were previously included in the operating results of our Resource segment, are classified as discontinued operations in the Statements of Operations and Comprehensive Income, as required by SFAS No. 144. We recorded after-tax losses from discontinued operations of $5.8 million and $9.4 million for the quarter and six months ended June 30, 2006, respectively. Revenues for the hybrid poplar tree farm, which were previously included in our Resource segment revenues, were $0.8 million and $2.5 million for the quarter and six months ended June 30, 2007, respectively, and $2.2 million and $4.2 million for the quarter and six months ended June 30, 2006, respectively.

NOTE 7.

Like-Kind Exchanges and Restricted Cash

In order to acquire and sell assets, primarily timberlands, in a tax-efficient manner, we enter into like-kind exchange, or LKE, tax-deferred transactions. There are two main types of LKE transactions: forward transactions, in which property is sold and the proceeds are reinvested by acquiring similar property; and reverse transactions, in which property is acquired and similar property is subsequently sold by us. Both forward and reverse transactions must be completed within prescribed time periods under Internal Revenue Code section 1031.

We use a qualified LKE intermediary to facilitate LKE transactions. Proceeds from forward LKE transactions are held by the intermediary and are classified as restricted cash because the funds must be reinvested in similar properties. If the acquisition of suitable LKE properties is not completed within 180 days of the sale of the company-owned property, the proceeds are distributed to us by the intermediary and are reclassified as available cash and applicable taxes are recognized. Proceeds from reverse LKE transactions are not restricted because the funds are not subject to risk, earn interest and are available upon demand; therefore, these proceeds are included in cash. In the case of a reverse transaction in which we have not yet completed LKE sales of company-owned land to match with property purchased on our behalf by the intermediary, the amount associated with the property purchased on our behalf but not yet matched with LKE sales is classified as a long-term asset and included in Timber, timberlands and related deposits, net on our Condensed Balance Sheets and as Deposits on timberlands in the investing activities section of our Condensed Statements of Cash Flows. Amounts deposited with a third party towards the potential future purchase of property that are not matched with LKE sales are also included in Timber, timberlands and related deposits, net on our Condensed Balance Sheets and as Deposits on timberlands in our Condensed Statements of Cash Flows.

At June 30, 2007, we had $14.8 million of proceeds from land sales that were deposited with a LKE intermediary and classified as restricted cash in Other assets on the Condensed Balance Sheet and as a non-cash adjustment to operating earnings on the Condensed Statement of Cash Flows. We had $10.5 million of deposits on timberlands included in Timber, timberlands and related deposits, net on our Condensed Balance Sheet at June 30, 2007. There were no amounts classified as restricted cash or deposits on timberlands at June 30, 2006.

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NOTE 8.

Earnings per Common Share

Earnings per common share from continuing operations are computed by dividing earnings from continuing operations by the weighted average number of common shares outstanding in accordance with SFAS No. 128, Earnings Per Share. The following table reconciles the number of common shares used in the basic and diluted earnings per share from continuing operations calculations:

	Quarter Ended June 30		Six Months Ended June 30	
(Dollars in thousands - except per-share amounts)	**2007**	**2006**	**2007**	**2006**
Earnings from continuing operations	$ 35,393	$ 8,245	$ 40,831	$ 77,559
Basic average common shares outstanding	39,027,412	38,681,493	38,988,519	34,158,522
Incremental shares due to:				
Common stock options	86,125	69,827	92,175	91,679
Performance shares	117,772	68,146	139,048	85,155
Restricted stock units	11,144		12,734	858
Diluted average common shares outstanding	39,242,453	38,819,466	39,232,476	34,336,214
Basic earnings per common share from continuing operations	$ .91	$ .21	$ 1.05	$ 2.27
Diluted earnings per common share from continuing operations	$ .90	$ .21	$ 1.04	$ 2.26

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

	Six Months Ended June 30
(Dollars in thousands - except per-share amounts)	**2006**
Earnings from continuing operations	$ 77,559
Diluted earnings per share from continuing operations	
As reported	$ 2.26
Pro forma	$ 2.00

For the quarter ended June 30, 2007, 3,000 performance shares were excluded from the computation of diluted earnings per share because their effect was anti-dilutive. For the quarter and six months ended June 30, 2007, options to purchase 190,101 shares of common stock were excluded from the computation of diluted earnings per share because their effect was anti-dilutive. For the quarter ended June 30, 2006, 36,328 performance shares, 27,051 restricted stock units and options to purchase 503,931 shares of common stock were excluded from the computation of diluted earnings per share because their effect was anti-dilutive. For the six months ended June 30, 2006, 36,328 performance shares, 24,401 restricted stock units and options to purchase 315,653 shares of common stock were excluded from the computation of diluted earnings per share because their effect was anti-dilutive.

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NOTE 9.

Equity-Based Compensation

At June 30, 2007, we had four stock incentive plans, the 1989, 1995, 2000 and 2005 plans, under which stock option, performance share or restricted stock unit grants were outstanding. All of these plans have received stockholder approval. We were originally authorized to issue up to 1.5 million shares, 1.7 million shares, 1.4 million shares and 1.6 million shares under our 1989 Stock Incentive Plan, 1995 Stock Incentive Plan, 2000 Stock Incentive Plan and 2005 Stock Incentive Plan, respectively. At June 30, 2007, no shares were available for future use under the 1989 and 1995 Stock Incentive Plans, while approximately 75,000 and 972,000 shares were authorized for future use under the 2000 and 2005 Stock Incentive Plans, respectively. All exercises of stock options or distributions of performance shares or restricted stock were made through issuance of new shares after January 31, 2006. Prior to that date, treasury shares were utilized.

During the quarter ended June 30, 2007, we recorded equity-based compensation expense of $1.3 million, of which $1.2 million related to performance shares and $0.1 million related to restricted stock units. For the six months ended June 30, 2007, equity-based compensation expense of $2.8 million was recorded, of which $2.6 million and $0.2 million related to performance shares and restricted stock units, respectively. For the quarter ended June 30, 2006, we recorded equity-based compensation expense of $1.1 million, of which $1.0 million related to performance shares and $0.1 million related to restricted stock units. We recorded equity-based compensation expense of $1.9 million for the six months ended June 30, 2006, of which $1.7 million and $0.2 million related to performance shares and restricted stock units, respectively. All outstanding stock options were fully vested prior to January 1, 2006. The net income tax benefit recognized in the Statements of Operations and Comprehensive Income for equity-based compensation expense totaled $0.5 million and $0.5 million for the quarters ended June 30, 2007 and 2006, respectively, and $1.1 million and $0.8 million for the six months ended June 30, 2007 and 2006, respectively.

In addition to our four stock incentive plans, directors of the company can each elect to defer compensation in the form of stock units. Compensation expense or income is recorded during each reporting period based on a combination of deferred compensation and the increase or decrease in the value of the company s common stock. During the quarter and six months ended June 30, 2007, we recorded director deferred income of $0.2 million and expense of $0.1 million, respectively. For the quarter and six months ended June 30, 2006, we recorded director deferred income of $0.1 million and expense of $1.2 million, respectively.

As required by SFAS No. 123 (Revised 2004), Share-Based Payment, $2.2 million and $0.5 million of cash flows as of June 30, 2007 and 2006, respectively, representing the realized tax benefit related to the excess of the deductible amount over the compensation cost recognized, has been classified as a financing cash inflow and an operating cash outflow in the Condensed Statements of Cash Flows.

STOCK OPTIONS

All outstanding stock options were granted with an exercise price equal to the market price on the date of grant, are fully exercisable after two years and expire not later than 10 years from the date of grant. No new stock options were granted in 2006 or 2007, as we believe that performance shares provide a superior incentive to stock options for employees in a REIT.

A summary of outstanding stock options and changes during the six month period ended June 30, 2007, is presented below:

	Shares	Weighted Avg. Exercise Price	Aggregate Intrinsic Value (in thousands)
Outstanding at January 1	875,425	$ 26.16	
Shares exercised	(137,518)	26.57	$ 2,783
Outstanding and exercisable at June 30	737,907	26.08	12,520

There were no unvested stock options outstanding during the six months ended June 30, 2007. The total intrinsic value of stock options exercised for the six month period ended June 30, 2006 was $2.7 million.

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The following table summarizes information about stock options outstanding at June 30, 2007:

	Options Outstanding and Exercisable		
Range of Exercise Prices	Number Outstanding at June 30, 2007	WeightedAvg. Remaining Contractual Life	Weighted Avg. Exercise Price
$15.8849 to $19.0779	100,127	5.06 years	$ 17.41
$21.3279 to $27.5226	447,679	3.38 years	24.58
$32.0957 to $35.4393	190,101	4.78 years	34.18
$15.8849 to $35.4393	737,907	3.97 years	26.08

Cash received from stock option exercises for the six months ended June 30, 2007 and 2006 was $3.7 million and $6.0 million, respectively. The actual tax benefit realized for the tax deductions from option exercises totaled $0.1 million, $0.4 million, $1.0 million and $1.0 million for the quarters ended June 30, 2007 and 2006, and the six months ended June 30, 2007 and 2006, respectively.

PERFORMANCE SHARES

Performance share awards granted under the plans have a three-year performance period, and shares will be issued at the end of the period if the performance measure is met. The performance measure is a comparison of the percentile ranking of our total shareholder return compared to the total shareholder return performance of a selected peer group of forest products companies. The number of performance shares actually issued, as a percentage of the amounts initially granted, could range from 0% 200%. Performance shares granted under the program may not be voted until issued. If performance share awards are paid out at the end of the three-year performance measurement period, the recipients will receive distribution equivalents at the time of payment equal to the distributions that would have been paid on the shares earned had the recipient owned the shares during the three-year period.

Due to the adoption of SFAS No. 123 (Revised 2004), the fair value of all performance share awards after January 1, 2006, is estimated by using an independent third party using a Monte Carlo simulation model. For purposes of recognizing compensation expense, performance share awards granted prior to the adoption of SFAS No. 123 (Revised 2004) are valued at the market value of the company s common stock at the date of grant.

A summary of outstanding performance share awards and changes during the six month period ended June 30, 2007 is presented below:

	Shares	Weighted Avg. Grant Date Fair Value	Aggregate Intrinsic Value (in thousands)
Unvested shares outstanding at January 1	329,358	$ 51.62	
Granted	3,000	59.59	
Forfeited	(12,604)	49.68	
Unvested shares outstanding at June 30	319,754	51.77	$ 12,603

As of June 30, 2007, there was $8.3 million of total unrecognized compensation cost related to non-vested performance share awards. The cost is expected to be recognized over a weighted average period of 1.7 years.

RESTRICTED STOCK UNITS

Our 2005 Stock Incentive Plan also allows for awards to be issued in the form of restricted stock units, or RSUs. During 2006 and 2007, certain of our officers were granted RSU awards, which accrue distribution equivalents based on distributions paid during the RSU vesting period. These distribution equivalents will be converted into additional RSUs that will vest in the same manner as the underlying RSUs to which they relate. The terms of the awards state that 20% of the RSUs vest on each of the first and second anniversaries of the awards, with the remaining 60% vesting on the third anniversary.

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A summary of outstanding RSU awards and changes during the six month period ended June 30, 2007, is presented below:

	Shares	Weighted Avg. Grant Date Fair Value	Aggregate Intrinsic Value (in thousands)
Unvested shares outstanding at January 1	28,401	$ 50.32	
Granted	2,000	47.84	
Vested	(4,880)	53.00	
Unvested shares outstanding at June 30	25,521	49.62	$ 1,099

For restricted stock awards granted during the period, the fair value of each share was estimated on the date of grant using the grant date market price. The total fair value of share awards vested during the period was $0.3 million, using the grant date market price.

As of June 30, 2007, there was $0.9 million of total unrecognized compensation cost related to non-vested RSU awards. The cost is expected to be recognized over a weighted average period of 1.7 years.

NOTE 10.

Inventories

Inventories at the balance sheet dates consist of:

(Dollars in thousands)	June 30, 2007	December 31, 2006
Raw materials	$ 66,420	$ 77,915
Finished goods	99,486	90,901
	$ 165,906	$ 168,816

NOTE 11.

Pension and Other Postretirement Benefit Plans

The table below details the components of net periodic costs (benefit):

Quarters ended June 30:

	Pension Benefit Plans		Other Postretirement Benefit Plans	
(Dollars in thousands)	2007	2006	2007	2006
Service cost	$ 3,002	$ 3,119	$ 531	$ 696
Interest cost	8,567	8,251	3,566	4,019
Expected return on plan assets	(15,605)	(15,355)		

Amortization of prior service cost (credit)	548	511	(1,138)	(642)
Amortization of actuarial loss	1,304	1,426	1,002	1,980
Net periodic cost (benefit)	$ (2,184)	$ (2,048)	$ 3,961	$ 6,053

Six months ended June 30:

(Dollars in thousands)	Pension Benefit Plans 2007	Pension Benefit Plans 2006	Other Postretirement Benefit Plans 2007	Other Postretirement Benefit Plans 2006
Service cost	$ 6,004	$ 6,025	$ 1,247	$ 1,392
Interest cost	17,134	16,574	7,645	8,038
Expected return on plan assets	(31,210)	(30,531)		
Amortization of prior service cost (credit)	1,095	1,025	(1,782)	(1,283)
Amortization of actuarial loss	2,608	2,825	2,560	3,959
Net periodic cost (benefit)	$ (4,369)	$ (4,082)	$ 9,670	$ 12,106

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Of the $1.0 million reported as Other comprehensive income, net of tax, on our Statement of Operations and Comprehensive Income for the quarter ended June 30, 2007, $1.1 million and $(0.1) million related to our defined benefit pension and other postretirement benefit plans, respectively. Of the $2.7 million reported as Other comprehensive income, net of tax, on our Statement of Operations and Comprehensive Income for the six months ended June 30, 2007, $2.2 million and $0.5 million related to our defined benefit pension and other postretirement benefit plans, respectively.

As discussed in the notes to our financial statements for the year ended December 31, 2006, no minimum contributions to our qualified pension plans are estimated for 2007 due to the funded status of those plans at December 31, 2006. However, we estimate contributions will total approximately $1.7 million in 2007 for our non-qualified plan. As of June 30, 2007, $0.8 million of contributions had been made. No change to the original estimate is anticipated. We do not anticipate funding our other postretirement benefit plans in 2007 except to pay benefit costs as incurred during the year by plan participants.

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NOTE 12.

Segment Information

(Dollars in thousands)	Quarter Ended June 30 2007	Quarter Ended June 30 2006	Six Months Ended June 30 2007	Six Months Ended June 30 2006
Segment Revenues				
Resource	$ 72,438	$ 66,598	$ 131,704	$ 129,786
Real Estate	8,563	2,031	8,656	2,671
Wood Products				
Lumber	92,221	107,671	180,929	213,068
Plywood	14,080	15,368	27,716	29,795
Particleboard	5,676	5,012	10,592	9,210
Other	12,496	10,628	24,407	22,434
	124,473	138,679	243,644	274,507
Pulp and Paperboard				
Paperboard	142,711	132,130	273,487	264,663
Pulp	26,111	15,317	46,235	30,807
Other	318	294	580	613
	169,140	147,741	320,302	296,083
Consumer products	105,933	117,142	216,185	216,677
	480,547	472,191	920,491	919,724
Elimination of intersegment revenues	(65,833)	(58,898)	(119,571)	(105,207)
Total consolidated revenues	$ 414,714	$ 413,293	$ 800,920	$ 814,517
Intersegment revenues or transfers				
Resource	$ 45,881	$ 44,874	$ 78,300	$ 76,633
Wood Products	5,273	3,688	10,685	7,187
Pulp and Paperboard	14,647	10,311	30,529	21,335
Consumer Products	32	25	57	52
Total	$ 65,833	$ 58,898	$ 119,571	$ 105,207
Operating Income (Loss)				
Resource	$ 19,937	$ 16,110	$ 33,097	$ 34,552
Real Estate	7,374	1,491	7,007	1,980
Wood Products	6,388	3,622	8,578	11,065
Pulp and Paperboard	17,005	(5,396)	10,976	(2,395)
Consumer Products	4,092	6,984	8,867	13,873
Eliminations	4,026	1,050	8,973	1,720
	58,822	23,861	77,498	60,795
Corporate	(17,179)	(17,411)	(35,684)	(35,568)

Earnings from continuing operations before taxes	$ 41,643	$ 6,450	$ 41,814	$ 25,227

Certain 2006 amounts have been reclassified to conform to the 2007 presentation.

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ITEM 2.

Management s Discussion and Analysis of Financial Condition and Results of Operations

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION

This report contains, in addition to historical information, certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, including without limitation, statements regarding future revenues, cash flows, distributions, compliance with REIT tax rules, costs, manufacturing output, capital expenditures, timber harvest levels, future land sales, like-kind exchanges and tax consequences, and other timber supply issues. Words such as anticipate, expect, will, intend, plan, target, project, believe, seek, estimate, and similar expressions are intended to identify such forward-looking statements. These forward-looking statements reflect management s current views regarding future events based on estimates and assumptions, and are therefore subject to known and unknown risks and uncertainties and are not guarantees of future performance. Our actual results of operations could differ materially from those expressed or implied by forward-looking statements contained in this report. Important factors that could cause or contribute to such differences include, but are not limited to:

- changes in timber harvest levels on our lands
- changes in timber prices
- changes in timberland values
- changes in policy regarding governmental timber sales
- changes in the United States and international economies
- changes in exchange rates between the U.S. dollar and other currencies
- changes in the level of construction activity
- changes in tariffs, quotas and trade agreements involving wood products
- changes in worldwide demand for our products
- changes in worldwide production and production capacity in the forest products industry
- competitive pricing pressures for our products
- unanticipated manufacturing disruptions

changes in general and industry-specific environmental laws and regulations

unforeseen environmental liabilities or expenditures

weather conditions

changes in raw material, energy and other costs

the ability to satisfy complex rules in order to remain qualified as a REIT

changes in tax laws that could reduce the benefits associated with REIT status

Forward-looking statements contained in this report present management s views only as of the date of this report. Except as required under applicable law, we do not intend to issue updates concerning any future revisions of management s views to reflect events or circumstances occurring after the date of this report.

OVERVIEW

Potlatch is a real estate investment trust, or REIT, with approximately 1.5 million acres of timberlands in Arkansas, Idaho, Minnesota and Wisconsin. Through our wholly-owned taxable subsidiary, Potlatch TRS, we also operate 13 manufacturing facilities that produce lumber and panel products and bleached pulp products, including paperboard and tissue. We also conduct a real estate sales and development business through Potlatch TRS. We completed our conversion to a REIT effective January 1, 2006. As a REIT, we expect to be better able to compete for timberland acquisitions against other tax-advantaged entities.

As discussed in Note 6 on page 7, on March 30, 2007, we entered into a definitive agreement with a private equity tree farm investment fund for the sale of our hybrid poplar tree farm in Boardman, Oregon, for $65 million in cash. The sale was completed in the second quarter of 2007.

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As of June 30, 2007, our business was organized into five segments:

The Resource segment consists of substantially all of our timberlands, as well as those assets necessary to manage these timberlands. The primary business of the segment is the management of our timberlands to optimize the value of all possible revenue-producing opportunities while at the same time adhering to our strict standards of stewardship responsibilities. Management activities include, but are not limited to, planting trees, harvesting trees, building and maintaining roads, development of management plans, recreation lease management, and monitoring contract compliance. For the first six months of 2007, Resource segment revenues were $131.7 million, representing approximately 14% of our net revenues from continuing operations, before elimination of intersegment revenues. Intersegment revenues were $78.3 million for the period.

In January 2007, we completed the acquisition of 76,000 acres of prime timberland in Wisconsin for $64.5 million from Tomahawk Timberlands, LLC, and Tomahawk Highlands, LLC. This was our first significant purchase of timberland in more than a decade. The purchase of the Wisconsin timberlands was matched with sales of our own lands, primarily the hybrid poplar tree farm in Boardman, Oregon, for Internal Revenue Code section 1031 like-kind exchange purposes.

The activities of the Real Estate segment, formerly known as the Land Sales and Development segment, consist of the sale of selected non-strategic timberland real estate, including sales of land for higher and better use purposes, and the acquisition of timberlands. Results for this segment depend on the timing of closing of transactions for properties we identify as having higher and better use values. Real Estate segment revenues for the first six months of 2007 were $8.7 million, which represented approximately 1% of our net revenues from continuing operations. The segment did not have intersegment revenues during the period.

The Wood Products segment manufactures lumber, plywood, and particleboard at eight mills located in Arkansas, Idaho, Michigan and Minnesota. The segment s products are largely commodity products, which are sold to wholesalers primarily for use in home building and other construction activity. Wood Products segment revenues were $243.6 million for the first six months of 2007, representing approximately 26% of our net revenues from continuing operations, before elimination of intersegment revenues. Intersegment revenues were $10.7 million for the period.

The Pulp and Paperboard segment manufactures bleached paperboard used in packaging and bleached softwood market pulp. The Pulp and Paperboard segment operates two pulp and paperboard mills located in Arkansas and Idaho. Pulp and Paperboard segment revenues were $320.3 million for the first six months of 2007, representing approximately 35% of our net revenues from continuing operations, before elimination of intersegment revenues. Intersegment revenues were $30.5 million for the period.

The Consumer Products segment manufactures tissue products primarily sold on a private label basis to major grocery store chains. The segment operates two tissue mills with related converting facilities in Idaho and Nevada, and one additional tissue converting facility located in Illinois. Consumer Products segment revenues were $216.2 million for the first six months of 2007, representing approximately 24% of our net revenues from continuing operations, before elimination of intersegment revenues. The segment did not have significant intersegment revenues during the period.

FACTORS INFLUENCING OUR RESULTS OF OPERATIONS AND CASH FLOWS

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

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

Our results of operations and cash flow are also affected by changes in timber availability at the local and national level. Increases in timber supply could adversely affect the prices that we receive for timber. Our timberland ownership is currently concentrated in Arkansas, Idaho, Minnesota and Wisconsin. In Arkansas and Minnesota, most timberlands are privately owned. Historically, increases in timber prices have often resulted in substantial increases in harvesting on private timberlands, including lands not previously made available for commercial timber operations, causing a short-term increase in supply that has tended to moderate price increases. In Idaho, where a greater proportion of timberland is publicly owned, any substantial increase in timber harvesting from these lands could significantly reduce timber prices, which could harm our results of operations. For more than twenty years, environmental concerns and other factors have limited timber sales by federal agencies, which historically had been major suppliers of timber to the United States forest products industry, particularly in the West. Any reversal of policy that substantially increases public timber sales could materially adversely affect our results of operations and cash flow. On a local level, timber supplies can fluctuate depending upon factors such as changes in weather conditions and harvest strategies of local forest products industry participants, as well as occasionally high timber salvage efforts due to unusual pest infestations or fires.

Changes in harvest levels on our timberlands also may have a significant impact on our results of operations, due in part to the low cost basis of our timber from timberlands we acquired many years ago. Over the long term, we manage our timberlands on a sustainable yield basis to achieve a balance between timber growth and timber harvests. From time to time, however, we may choose, consistent with our environmental commitments, to harvest timber at levels above or below our estimate of sustainability for various reasons. For example, for several years prior to 2005, we had been harvesting timber in Idaho at a level below the estimated long-term sustainable harvest level. Beginning in 2005, due to an imbalance in timber ages on our Idaho timberlands, we began to significantly increase the timber harvest level on our Idaho timberlands in order to improve the long-term productivity and sustainability of these timberlands. In 2006, the harvest level on our Idaho timberlands was approximately 19% higher than the 2005 harvest level. For approximately five to ten years, we expect annual harvest levels on our Idaho timberlands to be as much as 25% higher than the 2005 harvest level. We also anticipate that, as a result of this period of increased timber harvest activity, the annual harvest levels on our existing Idaho timberlands will subsequently decrease to a level below the sustainable harvest level for a period of time, before increasing again to achieve the optimal long-term sustainable harvest level. On a short-term basis, our timber harvest levels may be impacted by factors such as demand for timber and harvesting capacity. For example, in 2006 we deferred the harvest of Arkansas timber by approximately 200,000 tons due to weak markets. In 2007, however, due to rebounds in prices, we expect to significantly increase the harvest of timber from our Arkansas timberlands primarily to offset the 2006 deferred harvest. We also experience seasonally lower harvest activity during the winter and early spring due to weather conditions. Longer term, our timber harvest levels may also be affected by purchases of additional timberlands, sales of existing timberlands and changes in estimates of long-term sustainable yield because of genetic improvements and other silvicultural advances, as well as by natural disasters, regulatory constraints and other factors beyond our control.

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

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

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Our manufacturing businesses are capital intensive, which leads to high fixed costs and generally results in continued production as long as prices are sufficient to cover variable costs. These conditions have contributed to substantial price competition, particularly during periods of reduced demand. Some of our competitors may currently be lower-cost producers in some of the businesses in which we operate, and accordingly these competitors may be less adversely affected than we are by price decreases. For the periods presented in this Form 10-Q, no downtime was taken at any of our facilities due to an inability to cover variable costs. The profitability of our manufacturing segments depends largely on our ability to operate our manufacturing facilities efficiently and at or near full capacity. Our operating results can be adversely affected if market demand does not justify operating at these levels or if our operations are inefficient or suffer significant interruption for any reason.

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

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

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

Changes in our timberland holdings and manufacturing capacity, primarily as a result of capital spending programs or asset purchases and dispositions, have affected our results of operations in recent periods. In January 2007, we purchased approximately 76,000 acres of timberlands in Wisconsin. In May 2007, we completed the sale of our hybrid poplar tree farm in Boardman, Oregon. These changes have affected or will affect our levels of net revenues and expenses, as well as the comparability of our operating results from period to period.

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

Among the reasons for our REIT conversion is that we will be better able to compete for acquisitions of timberlands against other entities that use tax-efficient structures. It is uncertain whether any timberland acquisitions we make will perform in accordance with our expectations. In addition, we anticipate financing acquisitions through Internal Revenue Code section 1031 like-kind exchanges, cash from operations, borrowings under our credit facility, or proceeds from equity or debt offerings. Our inability to finance future acquisitions on favorable terms or the failure of any acquisition to perform as we expect could harm our results of operations.

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CRITICAL ACCOUNTING POLICIES

Our principal accounting policies are discussed on pages 51-56 of our Annual Report on Form 10-K for the year ended December 31, 2006. The preparation of financial statements in accordance with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported financial position and operating results of the company. Management believes the accounting policies discussed below represent the most complex, difficult and subjective judgments it makes in this regard.

Long-lived assets. Due to the capital-intensive nature of our industry, a significant portion of our total assets are invested in our manufacturing facilities and timber and timberlands. Also, the cyclical patterns of our businesses cause cash flows to fluctuate by varying degrees from period to period. As a result, long-lived assets are a material component of our financial position with the potential for material change in valuation if assets are determined to be impaired. We account for impairment of long-lived assets in accordance with SFAS No. 144, which requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable, as measured by its undiscounted estimated future cash flows. We use our operational budgets to estimate future cash flows. Budgets are inherently uncertain estimates of future performance due to the fact that all inputs (revenues, costs, capital spending) are subject to frequent change for many different reasons, as previously described in Factors Influencing Our Results of Operations and Cash Flows. Because of the number of variables involved, the interrelationship between the variables and the long-term nature of the impairment measurement, sensitivity analysis of individual variables is not practical. Budget estimates are adjusted periodically to reflect changing business conditions and operations are reviewed, as appropriate, for impairment using the most current data available. To date, this process has not resulted in an impairment charge for any of the assets associated with our continuing operations.

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

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

- harvest cycles can vary by geographic region and by species of timber;
- weather patterns can affect annual harvest levels;
- environmental regulations and restrictions may limit our ability to harvest certain timberlands;
- changes in harvest plans may occur;
- scientific advancement in seedlings and timber growing technology may affect future harvests;
- land sales and acquisitions affect volumes available for harvest; and
- major forest fire events or pest infestations can significantly affect future harvest levels.

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

Restructuring charges and discontinued operations. In January 2007, we recorded a charge for a restructuring of our Resource segment. On March 30, 2007, we entered into a definitive agreement to sell our hybrid poplar tree farm in Boardman, Oregon. The sale was completed in the second quarter of 2007. These events required us to record estimates of liabilities for employee benefits and other costs at the time of the events. In making these judgments, we considered contractual obligations, legal liabilities and possible incremental costs incurred as a result of restructuring transactions to determine the liability. Our estimated liabilities could differ materially from actual costs incurred, with resulting adjustments to future period earnings for any differences.

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Environmental liabilities. We record accruals for estimated environmental liabilities that are not within the scope of SFAS No. 143, Accounting for Asset Retirement Obligations and FASB Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations, in accordance with SFAS No. 5, Accounting for Commitments and Contingencies. These estimates reflect assumptions and judgments as to the probable nature, magnitude and timing of required investigation, remediation and monitoring activities. In making these estimates, we consider, among other things, the activities we have conducted at any particular site, information obtained through consultation with applicable regulatory authorities and third-parties, and our historical experience at other sites that are judged to be comparable. We must also consider the likelihood of changes in governmental regulations, advancements in environmental technologies, and changing legal standards regarding liability. Due to the numerous uncertainties and variables associated with these assumptions and judgments, and changes in governmental regulations and environmental technologies, our accruals are subject to substantial uncertainties and our actual costs could be materially more or less than the estimated amounts.

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

Note 12 to our 2006 Form 10-K consolidated financial statements included information for the three years ended December 31, 2006, 2005 and 2004 on the components of pension and OPEB expense and the underlying actuarial assumptions used to calculate periodic expense, as well as the funded status for our pension and OPEB plans as of December 31, 2006 and 2005. Note 11, Pension and Other Postretirement Benefit Plans, on pages 11-12 of this Form 10-Q, includes information on the components of pension and OPEB expense for the quarters and six months ended June 30, 2007 and 2006.

The discount rate used in the determination of pension benefit obligations and pension expense is based on high-quality fixed income investment interest rates. At December 31, 2006, we calculated obligations using a 5.85% discount rate. The discount rates used at December 31, 2005 and 2004 were 5.60% and 5.90%, respectively. To determine the expected long-term rate of return on pension assets, we employ a process that analyzes historical long-term returns for various investment categories, as measured by appropriate indices. These indices are weighted based upon the extent to which plan assets are invested in the particular categories in arriving at our determination of a composite expected return. The assumed long-term rate of return on pension plan assets used for the three-year period ended December 31, 2006, was 9.5%. Over the past 29 years, the period we have actively managed pension assets, our actual average annual return on pension plan assets has been approximately 11.5%.

Total periodic pension plan income in 2006 was $8.1 million. An increase in the discount rate or the expected return on plan assets, all other assumptions remaining the same, would increase pension plan income, and conversely, a decrease in either of these measures would decrease plan income. As an indication of the sensitivity that pension income has to the discount rate assumption, a 25 basis point change in the discount rate would affect annual plan income by approximately $1.4 million. A 25 basis point change in the assumption for expected return on plan assets would affect annual plan income by approximately $1.6 million. The actual rates on plan assets may vary significantly from the assumption used because of unanticipated changes in financial markets.

No minimum pension contributions to our qualified plans are required for 2007 due to the funded status of those pension plans at December 31, 2006. However, we estimate contributions will total approximately $1.7 million in 2007 for our non-qualified plan. We do not anticipate funding our OPEB plans in 2007 except to pay benefit costs as incurred during the year by plan participants.

For our OPEB plans, expense for 2006 was $24.2 million. The discount rate used to calculate OPEB obligations was 5.85% at December 31, 2006, and 5.60% and 5.90% at December 31, 2005 and 2004, respectively. The assumed health care cost trend rate used to calculate OPEB obligations and expense for 2006 was an 11% increase over the previous year, with the rate of increase scheduled to decline one percent annually to a long-term ultimate rate increase assumption of 6% for 2011 and thereafter.

As an indication of the sensitivity that OPEB expense has to the discount rate assumption, a 25 basis point change in the discount rate would affect annual plan expense by approximately $0.8 million. A 1% change in the assumption for health care cost trend rates would have affected 2006 plan expense by approximately $1.9 - $2.2 million and the total postretirement obligation by approximately $25.3 - $29.9 million. The actual rates of health care cost increases may vary significantly from the assumption used because of unanticipated changes in health care costs.

Periodic pension and OPEB expense are included in Materials, labor and other operating expenses and Selling, general and administrative expenses in the Statements of Operations and Comprehensive Income. The expense is allocated to all business segments. In accordance with SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R), which we adopted on December 31, 2006, long-term assets are recorded at June 30, 2007, and December 31, 2006, for overfunded plans and liabilities are recorded at June 30, 2007, and December 31, 2006, for underfunded plans. The funded status of a benefit plan is measured as the difference between plan assets at fair value and the benefit obligation. For underfunded plans, the estimated liability to be payable in the next twelve months is recorded as a current liability, with the remaining portion recorded as long-term. See Note 12 to our 2006 Form 10-K consolidated financial statements for further discussion.

RESULTS OF OPERATIONS

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

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

Quarter Ended June 30, 2007, Compared to Quarter Ended June 30, 2006

The following table sets forth period-to-period changes in items included in our Statements of Operations and Comprehensive Income for the quarters ended June 30, 2007 and 2006.

	Quarter Ended June 30		
(Dollars in thousands)	**2007**	**2006**	**Increase (Decrease)**
Revenues	$ 414,714	$ 413,293	$ 1,421
Costs and expenses:			
Depreciation, depletion and amortization	19,320	19,327	(7)
Materials, labor and other operating expenses	325,985	358,815	(32,830)
Selling, general and administrative expenses	20,987	21,673	(686)
Restructuring charge	35		35
Earnings from continuing operations before interest and taxes	48,387	13,478	34,909
Interest expense	(7,340)	(7,323)	(17)
Interest income	596	295	301
Provision (benefit) for taxes	6,250	(1,795)	8,045
Earnings from continuing operations	35,393	8,245	27,148
Discontinued operations, net of tax	(1,443)	(5,839)	4,396
Net earnings	$ 33,950	$ 2,406	$ 31,544
Other comprehensive income, net of tax	$ 1,047	$	$ 1,047
Comprehensive income	$ 34,997	$ 2,406	$ 32,591

Certain 2006 amounts have been reclassified to conform to the 2007 presentation.

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Revenues Compared to the second quarter of 2006, total revenues for the second quarter of 2007 were virtually unchanged. Resource segment revenues increased $4.8 million to $26.6 million for the second quarter of 2007, primarily due to increased sales of logs to external customers for the Northern and Southern regions. Real Estate revenues were $8.6 million in the second quarter of 2007, compared to $2.0 million for the second quarter of 2006. The increased revenues in the second quarter of 2007 were due to increased sales of properties identified as non-strategic through our stratification process. Revenues for Wood Products were $119.2 million for the second quarter of 2007, a decrease of $15.8 million compared to the second quarter of 2006 due largely to lower selling prices and decreased shipments for lumber. The decreased lumber shipments were due to the reduction of daily operations from three shifts to two shifts at our Prescott and Warren, Arkansas, sawmills in the fourth quarter of 2006 in order to optimize operating efficiencies at each mill. Pulp and Paperboard revenues increased to $154.5 million for the second quarter of 2007, compared to $137.4 million for the second quarter of 2006, primarily due to higher selling prices and increased shipments. Consumer Products revenues were $105.9 million for the second quarter of 2007, a decrease of $11.2 million compared to second quarter 2006 revenues of $117.1 million, due to decreased shipments for consumer tissue products, which were partially offset by higher selling prices.

Depreciation, depletion and amortization Depreciation, depletion and amortization of $19.3 million in the second quarter of 2007 was unchanged compared to the same period in 2006.

Materials, labor and other operating expenses For the second quarter of 2007, materials, labor and other operating expenses were $326.0 million, or $32.8 million lower than the second quarter of 2006 due primarily to decreased lumber and consumer tissue shipments, lower log costs for the Wood Products segment and lower maintenance costs for the Pulp and Paperboard segment. These favorable comparisons were partially offset by higher wood fiber costs and increased pulp and paperboard shipments for the Pulp and Paperboard segment, and higher pulp costs for the Consumer Products segment.

Selling, general and administrative expenses Selling, general and administrative expenses were $21.0 million for the second quarter of 2007, compared to $21.7 million for the second quarter of 2006.

Restructuring charge In January 2007, we recorded a pre-tax charge of $2.8 million associated with a restructuring within our Resource segment. The charge represented estimated severance benefit costs for 35 employees. An additional charge of less than $0.1 million related to this restructuring was recorded in the second quarter of 2007.

Interest expense Interest expense of $7.3 million in the second quarter of 2007 was unchanged compared to the same period in 2006.

Interest income Compared to the second quarter of 2006, interest income for the second quarter of 2007 increased $0.3 million to $0.6 million.

Provision (benefit) for taxes For the quarter ended June 30, 2007, we recorded an income tax provision of $6.3 million related to our continuing operations, which was largely due to pre-tax income from Potlatch TRS. We recorded an income tax benefit of $1.8 million in the second quarter of 2006 due primarily to a pre-tax loss from Potlatch TRS.

Earnings from continuing operations We recorded earnings from continuing operations of $35.4 million for the three months ended June 30, 2007, compared to $8.2 million for the three months ended June 30, 2006. The favorable comparison was due largely to higher earnings for all of our operating segments except Consumer Products in the 2007 quarter.

Discontinued operations For the second quarter of 2007, we recorded an after-tax loss of $1.4 million for our hybrid poplar tree farm in Boardman, Oregon. The sale of the tree farm, which was announced in the first quarter, was completed during the second quarter. In the second quarter of 2006, the Boardman operation recorded a loss of $5.8 million.

Other comprehensive income, net of tax Beginning in 2007, due to our adoption of SFAS No. 158, we are required to record comprehensive income or loss related to our defined benefit pension and other postretirement benefit plans for each reporting period when net gains or losses, or prior service costs or credits existing at the date of initial application of the Statement, are amortized as components of net periodic pension cost. As a result, we recorded other comprehensive income, net of tax, of $1.0 million for the second quarter of 2007.

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DISCUSSION OF BUSINESS SEGMENTS

The Resource segment reported operating income of $19.9 million for the second quarter of 2007, an increase of $3.8 million compared to $16.1 million reported for the same period of 2006. Segment revenues were $72.4 million for the second quarter of 2007, compared to $66.6 million for the second quarter of 2006. The higher revenues were due primarily to increased log sales volumes for our Northern region and higher log selling prices for our Southern region. Expenses for the segment were $52.5 million for the second quarter of 2007, compared to $50.5 million in the second quarter of 2006. The higher expenses were primarily due to costs associated with increased fee timber harvests in our Northern and Southern regions in the second quarter of 2007.

The Real Estate segment reported operating income of $7.4 million for the second quarter of 2007, compared to operating income of $1.5 million for the same period in 2006. Revenues for the segment were $8.6 million for the second quarter of 2007, compared to $2.0 million for the same period in 2006. The higher revenues in the second quarter of 2007 for the segment were due to an increase in sales of properties identified as non-strategic through our stratification process. A total of 7,472 acres of land were sold in the second quarter of 2007, compared to 2,017 acres of combined land and conservation easements sold in 2006. There were no conservation easement sales in the second quarter of 2007. Results for the segment depend on the timing of closing of transactions for properties we identify as having higher and better use values. As a result of our assessment of our lands, which was completed in late 2006, we identified 250,000 to 300,000 acres of our land as having values that are potentially greater than for timberland. Sales of these lands are expected to occur within the next ten years, with the goal of utilizing like-kind exchange transactions for tax efficiency, thus maximizing cash flows. We expect to sell a total of 15,000 to 20,000 acres in 2007. Real Estate segment expenses were $1.2 million in the second quarter of 2007, compared to $0.5 million for the same quarter of 2006.

The Wood Products segment reported operating income of $6.4 million for the second quarter of 2007, $2.8 million higher than the $3.6 million recorded in the second quarter of 2006. Revenues for the segment were $124.5 million, compared to $138.7 million for the second quarter of 2006. Lumber revenues were $92.2 million in the second quarter of 2007, down from $107.7 million for the same period in 2006. The lower revenues were due to lower selling prices and decreased shipments, which were primarily the result of our Prescott and Warren, Arkansas, lumber mills reducing their daily operations from three shifts to two shifts in the fourth quarter of 2006 in order to optimize operating efficiencies at each mill. Plywood revenues decreased to $14.1 million for the second quarter of 2007, compared to $15.4 million for the second quarter of 2006. The decrease was due to lower selling prices, which were partially offset by a slight increase in shipments. Particleboard revenues were $5.7 million for the second quarter of 2007, compared to $5.0 million for the same period in 2006. The increase was due to higher selling prices. Other revenues for the segment, which consist primarily of by-products such as chips, were $12.5 million for the second quarter of 2007, compared to $10.6 million for the second quarter of 2006. Segment expenses were $118.1 million for the second quarter of 2007, $17.0 million lower than expenses of $135.1 million for the second quarter of 2006. The decrease in expenses was primarily due to decreased lumber shipments and lower log costs.

The Pulp and Paperboard segment reported operating income of $17.0 million for the second quarter of 2007, compared to an operating loss of $5.4 million for the second quarter of 2006. Revenues for the segment were $169.1 million for the second quarter of 2007, up from $147.7 million for the second quarter of 2006. Paperboard revenues increased to $142.7 million in the second quarter of 2007, from $132.1 million in the second quarter of 2006. The increase was due to higher selling prices and increased shipments. Pulp revenues were $26.1 million for the second quarter of 2007, $10.8 million higher than the $15.3 million recorded in the same period of 2006. The increase in pulp revenues was due to significantly higher selling prices and increased shipments. Expenses for the segment were $152.1 million for the second quarter of 2007, compared to $153.1 million for the same period in 2006. The slight decrease in expenses was due primarily to lower maintenance costs, which were partially offset by significantly higher wood fiber costs and increased shipments of paperboard and pulp. Maintenance costs were lower in the 2007 quarter due to a planned major maintenance outage at our Lewiston pulp and paperboard operation during the second quarter of 2006. There were no major maintenance outages at our pulp and paperboard operations in the second quarter of 2007. The higher wood fiber costs were largely attributable to very high chip prices in 2007 for our Lewiston, Idaho, pulp and paperboard operation resulting mainly from sawmill curtailments in the West.

The Consumer Products segment reported operating income of $4.1 million for the second quarter of 2007, versus $7.0 million for the second quarter of 2006. Revenues for the segment were $105.9 million in the second quarter of 2007, compared to $117.1 million recorded in the second quarter of 2006. The lower revenues were due to decreased shipments, partially offset by higher selling prices. Segment expenses were $101.8 million for the second quarter of 2007, compared to $110.2 million for the second quarter of 2006. Segment expenses were lower due largely to decreased shipments, which were partially offset by increased pulp costs.

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Six Months Ended June 30, 2007, Compared to Six Months Ended June 30, 2006

The following table sets forth period-to-period changes in items included in our Statements of Operations and Comprehensive Income for the six months ended June 30, 2007 and 2006.

	Six Months Ended June 30		
(Dollars in thousands)	**2007**	**2006**	**Increase (Decrease)**
Revenues	$ 800,920	$ 814,517	$ (13,597)
Costs and expenses:			
Depreciation, depletion and amortization	38,672	38,979	(307)
Materials, labor and other operating expenses	661,730	691,731	(30,001)
Selling, general and administrative expenses	41,878	44,995	(3,117)
Restructuring charge	2,832		2,832
Earnings from continuing operations before interest and taxes	55,808	38,812	16,996
Interest expense	(14,891)	(14,682)	(209)
Interest income	897	1,097	(200)
Provision (benefit) for taxes	983	(52,332)	53,315
Earnings from continuing operations	40,831	77,559	(36,728)
Discontinued operations, net of tax	(36,657)	(9,429)	(27,228)
Net earnings	$ 4,174	$ 68,130	$ (63,956)
Other comprehensive income, net of tax	$ 2,734	$	$ 2,734
Comprehensive income	$ 6,908	$ 68,130	$ (61,222)

Certain 2006 amounts have been reclassified to conform to the 2007 presentation.

Revenues Total revenues from continuing operations of $800.9 million for the six months ended June 30, 2007, were $13.6 million lower than the $814.5 million recorded for the same period in 2006. Resource segment revenues were $53.4 million for the first six months of 2007, relatively unchanged from revenues of $53.2 million for the first six months of 2006. Slightly higher sales of logs to external customers for the Southern region were offset by slightly lower log sales to external customers for the Northern region. Real Estate revenues were $8.7 million in the first half of 2007, $6.0 million higher than the first half of 2006 due to increased sales in the first half of 2007 of properties identified as non-strategic through our stratification process. Revenues for Wood Products were $233.0 million for the first six months of 2007, compared to $267.3 million for the same period in 2006. The decrease was due largely to lower selling prices and decreased shipments for lumber. The decreased lumber shipments were due to the reduction of daily operations from three shifts to two shifts at our Prescott and Warren, Arkansas, sawmills in the fourth quarter of 2006 in order to optimize operating efficiencies at each mill. Pulp and Paperboard revenues increased to $289.8 million for the first six months of 2007, compared to $274.7 million for the first six months of 2006, primarily due to higher selling prices and increased shipments of pulp to external customers. Consumer Products revenues were $216.1 million for the first half of 2007, virtually unchanged from revenues of $216.6 million for the first half of 2006 due to higher selling prices in 2007 being offset by decreased shipments for consumer tissue products.

Depreciation, depletion and amortization For the six months ended June 30, 2007, depreciation, depletion and amortization totaled $38.7 million, compared to $39.0 million recorded in the first six months of 2006.

Materials, labor and other operating expenses Materials, labor and other operating expenses were $661.7 million for the first six months of 2007, compared to $691.7 million recorded in the first six months of 2006. The decrease was due primarily to decreased shipments of lumber, paperboard and consumer tissue products. Higher wood fiber costs and increased pulp shipments for the Pulp and Paperboard segment, combined with higher pulp costs for the Consumer Products segment, partially offset the favorable comparison.

Selling, general and administrative expenses For the six months ended June 30, 2007, selling, general and administrative expenses were $41.9 million, compared to $45.0 million recorded for the same period in 2006. The decrease was due primarily to lower compensation-related expenses in 2007.

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Restructuring charge In January 2007, we recorded a pre-tax charge of $2.8 million associated with a restructuring within our Resource segment. An additional charge of less than $0.1 million related to this restructuring was recorded in the second quarter of 2007. The charge represented estimated severance benefit costs for 35 employees. As of June 30, 2007, approximately $2.5 million related to this charge had been paid.

Interest expense Interest expense totaled $14.9 million for the first six months of 2007, compared to $14.7 million for the same period in 2006.

Interest income For the six months ended June 30, 2007, interest income was $0.9 million, compared to $1.1 million recorded for the first six months of 2006.

Provision (benefit) for taxes For the six months ended June 30, 2007, we recorded an income tax provision of $1.0 million related to our continuing operations, which was due to pre-tax income for Potlatch TRS. We recorded an income tax benefit of $52.3 million for the first six months of 2006, which was largely due to the reversal of $51.2 million in timber-related deferred tax liabilities that were no longer necessary as a result of our REIT conversion.

Earnings from continuing operations In the first half of 2007, we recorded earnings from continuing operations of $40.8 million, compared to $77.6 million for the first half of 2006. The unfavorable comparison was due to the reversal of the deferred tax liabilities in 2006, as discussed above, partially offset by higher earnings for our Pulp and Paperboard and Real Estate segments in 2007.

Discontinued operations For the first six months of 2007, we recorded an after-tax loss of $33.0 million related to sale of our Boardman, Oregon, hybrid poplar tree farm, which was completed during the second quarter. Excluding the loss on disposal, the Boardman operation recorded an after-tax operating loss of $3.7 million for the first six months 2007, compared to a loss of $9.4 million for the same period in 2006.

Other comprehensive income, net of tax Beginning in 2007, due to our adoption of SFAS No. 158, we are required to record comprehensive income or loss related to our defined benefit pension and other postretirement benefit plans for each reporting period when net gains or losses, or prior service costs or credits existing at the date of initial application of the Statement, are amortized as components of net periodic pension cost. As a result, we recorded other comprehensive income, net of tax, of $2.7 million for the first six months of 2007.

DISCUSSION OF BUSINESS SEGMENTS

The Resource segment reported operating income of $33.1 million for the first six months of 2007, compared to $34.6 million for the first six months of 2006. Segment revenues were $131.7 million for the first six months of 2007, compared to $129.8 million for the first six months of 2006. The slightly higher revenues were due primarily to increased log sales volumes for our Northern region and higher log selling prices for our Southern region, partially offset by lower log selling prices for the Northern region and decreased log sales volumes for the Southern region. Expenses for the segment were $98.6 million for the first six months of 2007, compared to $95.2 million in the first six months of 2006. The higher expenses were primarily due to costs associated with an increased fee timber harvest for our Southern region and a pre-tax restructuring charge of $2.8 million recorded in the first half of 2007.

The Real Estate segment reported operating income of $7.0 million for the first six months of 2007, compared to operating income of $2.0 million for the same period in 2006. Revenues for the segment were $8.7 million for the first six months of 2007, compared to $2.7 million for the same period in 2006. The higher revenues in the first half of 2007 for the segment were due to increased sales of properties identified as non-strategic through our stratification process. A total of 7,540 acres of land were sold in the first half of 2007, compared to 2,917 acres of combined land and conservation easements sold in 2006. There were no conservation easement sales in the first half of 2007. Real Estate segment expenses were $1.6 million in the first half of 2007, compared to $0.7 million for the same period in 2006.

The Wood Products segment reported operating income of $8.6 million for the first six months of 2007, $2.5 million lower than the $11.1 million recorded in the first six months of 2006. Revenues for the segment were $243.6 million, compared to $274.5 million for the first six months of 2006. Lumber revenues were $180.9 million in the first half of 2007, down from $213.1 million for the same period in 2006. Revenues were lower due to lower selling prices and decreased shipments, which were primarily the result of our Prescott and Warren, Arkansas, lumber mills reducing their daily operations from three shifts to two shifts in the fourth quarter of 2006 in order to optimize operating efficiencies at each mill. Plywood revenues decreased to $27.7 million for the first half of 2007, compared to $29.8 million for the first half of 2006. The decrease was due to lower selling prices, which were partially offset by

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increased shipments. Particleboard revenues were $10.6 million for the first six months of 2007, compared to $9.2 million for the same period in 2006. The increase was due to higher selling prices, partially offset by decreased shipments. Other revenues for the segment were $24.4 million for the first half of 2007, compared to $22.4 million for the first half of 2006. Segment expenses were $235.1 million for the first six months of 2007, $28.3 million lower than expenses of $263.4 million for the first six months of 2006. The decrease in expenses was primarily due to decreased lumber shipments and lower log costs.

The Pulp and Paperboard segment reported operating income of $11.0 million for the first half of 2007, compared to an operating loss of $2.4 million for the first half of 2006. Revenues for the segment were $320.3 million for the first half of 2007, up from $296.1 million for the first half of 2006. Paperboard revenues were $273.5 million in the first six months of 2007, compared to $264.7 million in the first six months of 2006. The increase was due to higher selling prices, partially offset by decreased shipments. Pulp revenues were $46.2 million for the first six months of 2007, $15.4 million higher than the $30.8 million recorded in the same period of 2006. The increase in pulp revenues was due to significantly higher selling prices and increased shipments. Expenses for the segment were $309.3 million for the first six months of 2007, compared to $298.5 million for the same period in 2006. The increased expenses were due primarily to significantly higher wood fiber costs and increased pulp shipments, which were partially offset by decreased paperboard shipments and decreased maintenance costs. The higher wood fiber costs were largely attributable to very high chip prices for our Lewiston, Idaho, pulp and paperboard operation in the first half of 2007 resulting mainly from sawmill curtailments in the West.

The Consumer Products segment reported operating income of $8.9 million for the first six months of 2007, versus $13.9 million for the first six months of 2006. Revenues for the segment were $216.2 million in the first half of 2007, compared to $216.7 million recorded in the first half of 2006. Revenues for the first half of 2007 were comparable to those in the same period in 2006 as a result of higher selling prices being offset by decreased shipments. Segment expenses were $207.3 million for the first six months of 2007, compared to $202.8 million for the first six months of 2006. Higher pulp costs were largely responsible for the increased segment expenses and were partially offset by decreased shipments.

LIQUIDITY AND CAPITAL RESOURCES

At June 30, 2007, our financial position included long-term debt of $324.5 million, including current installments on long-term debt of $3.2 million. Long-term debt at June 30, 2007 (including current installments) decreased $3.1 million from the balance at December 31, 2006 of $327.6 million due to normal repayments on maturing debt. Stockholders equity for the first six months of 2007 decreased by $25.8 million due to regular quarterly distributions to common stockholders of $38.2 million, partially offset by the issuance of $3.7 million of common stock related to the exercise of stock options and net earnings of $4.2 million. The ratio of long-term debt (including current installments) to stockholders equity was ..59 to 1 at June 30, 2007, compared to .57 to 1 at December 31, 2006.

Scheduled payments due on long-term debt during each of the five years subsequent to December 31, 2007, are as follows:

(Dollars in thousands)	
2008	$ 209
2009	100,410
2010	11
2011	5,011
2012	21,655

Working capital totaled $148.4 million at June 30, 2007, a decrease of $11.9 million from the December 31, 2006 balance of $160.3 million. The significant changes in the components of working capital are as follows:

Short-term investments increased $9.8 million due primarily to the investment of a portion of cash received from the sale of the hybrid poplar tree farm and net earnings of $4.2 million.

Receivables decreased by $26.5 million due primarily to a decrease in trade receivables associated with our Pulp and Paperboard segment. Net cash provided by operating activities from continuing operations for the first six months of 2007 totaled $73.1 million, compared with $108.6 million for the same period in 2006. The unfavorable comparison was largely due to lower earnings from continuing operations and a smaller amount of cash provided from working capital changes in the first half of 2007 compared to the same period in 2006.

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For the six months ended June 30, 2007, net cash used for investing activities was $97.1 million, compared to net cash provided by investing activities of $13.6 million for the first six months of 2006. In the first six months of 2007, we used $54.0 million for deposits on timberlands and $33.1 million for capital expenditures. The deposits on timberlands primarily included cash held by a like-kind exchange qualified intermediary for a portion of the Wisconsin timberlands purchased on our behalf by the intermediary, which was held until it was matched with the sale of the hybrid poplar tree farm to complete our like-kind exchange process for the purchase. Capital expenditures in the first six months of 2007 included $14.5 million in cash for the Wisconsin timberland purchase. The balance of capital expenditures in the first six months of 2007 was for forestland activities and various smaller projects designed to improve product quality and manufacturing efficiency. Cash was provided in the first six months of 2006 by a decrease in our short-term investments, partially offset by cash used primarily for capital expenditures.

Net cash used for financing activities totaled $40.5 million for the six months ended June 30, 2007, compared with cash used for financing activities of $117.6 million during the same period in 2006. The cash used for financing in the first six months of 2007 was due largely to regular quarterly cash distributions to common stockholders totaling $38.2 million. Cash used for financing activities in the first six months of 2006 was for distributions to common stockholders.

In connection with our REIT conversion, we increased our regular quarterly distributions from approximately $4.4 million in 2005 to approximately $19.0 million in 2006. In 2006, we funded our distributions using the cash flows from our REIT-qualifying timberland operations. In the future, any shortfall between cash available for distribution from REIT operations and anticipated future annual distributions to stockholders is expected to be funded through cash on hand, bank borrowings, Potlatch TRS distributions or a combination thereof. Our ability to fund distributions through bank borrowings is subject to our continued compliance with debt covenants, as well as the availability of borrowing capacity under our lending arrangements. If our operations do not generate sufficient cash flows and we are unable to borrow, we may be required to reduce our quarterly distributions. In addition, even if cash available for distribution from our REIT operations is sufficient on an annual basis to fund the entire distribution to stockholders, we anticipate that it will be necessary to utilize some short-term borrowing to fully fund distributions in the first half of each year as a result of the lower harvest activity during winter and early spring. Significant decreases in timber prices or other factors that have a materially adverse effect on the cash flows from our REIT operations could result in our inability to maintain the expected distribution rate.

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

Our current unsecured bank credit facility, which expires on December 22, 2008, provides for a revolving line of credit of up to $175 million, including a $35 million subfacility for letters of credit and a $10 million subfacility for swing line loans. Usage under either or both subfacilities reduces availability under the revolving line of credit. As of June 30, 2007, there were no borrowings outstanding under the revolving line of credit; however, approximately $10.3 million of the letter of credit subfacility was being used to support several outstanding letters of credit. Loans under the credit facility bear interest at LIBOR plus between 0.625% and 1.625% for LIBOR loans, and a base rate effectively equal to the bank s prime rate plus up to 0.625% for other loans. As of the date of this report, we are eligible to borrow under the credit facility at LIBOR plus 0.875%.

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

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The table below sets forth the most restrictive covenants in the credit facility and our status with respect to these covenants as of June 30, 2007.

	Covenant Requirement	Actual Ratio at June 30, 2007
Maximum Funded Indebtedness To Capitalization Ratio	55%	33.4%
Minimum Net Worth	80% of consolidated net worth at March 31, 2006 (1)	122.7%
Minimum Interest Coverage Ratio	2.75 to 1.00	6.50 to 1.00

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

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

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

We believe that our cash, cash flows from continuing operations and available borrowings under our credit facility will be sufficient to fund our operations, stockholder distributions, capital expenditures and debt service obligations for the next twelve months. We cannot assure, however, that our business will generate sufficient cash flow from operations or that we will be in compliance with the financial covenants in our credit facility so that future borrowings thereunder will be available to us. Thus, our ability to fund our operations and stockholder distributions will be dependent upon our future financial performance, which will be affected by general economic, competitive and other factors, including those discussed above under the heading Factors Influencing our Results of Operations and Cash Flows, many of which are beyond our control.

In October 2005, Standard & Poor s Ratings Services, or S&P, downgraded our senior unsecured debt from BB+ to BB. Since the first quarter of 2003, Fitch, Inc. has rated our senior unsecured debt at BB+. Fitch affirmed its rating on January 12, 2007, and raised its outlook to positive. Moody s Investors Service Inc. has rated our senior unsecured debt at Ba1 and our senior secured subordinated debt at Ba2 since October 2004. Moody s affirmed its ratings, with a stable outlook, in October 2005. The interest rate we pay on some of our debt is influenced by our credit ratings. See Item 3, Quantitative and Qualitative Disclosures About Market Risk below for additional information.

ITEM 3.

Quantitative and Qualitative Disclosures About Market Risk

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

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

As of June 30, 2007, there were no borrowings outstanding under our unsecured bank credit facility. The interest rates applied to borrowings under the credit facility are adjusted often and therefore react quickly to any movement in the general trend of market interest rates. We do not attempt to mitigate the effects of short-term interest rate fluctuations on our credit facility borrowings through the use of derivative financial instruments.

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

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

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

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

QUANTITATIVE INFORMATION ABOUT MARKET RISKS

(Dollars in thousands)

	Expected Maturity Date (as of June 30, 2007)						
	2007	**2008**	**2009**	**2010**	**2011**	**Thereafter**	**Total**
Long-term debt:							
Fixed rate	$ 3,002	$ 209	$ 100,410	$ 11	$ 5,011	$ 215,851	$ 324,494
Average interest rate	6.1%	6.9%	13.0%	6.5%	8.6%	6.9%	8.8%
Fair value at 6/30/07							$ 347,803

ITEM 4.

Controls and Procedures

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

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

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

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Part II

ITEM 1.

Legal Proceedings

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

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

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

ITEM 1A.

Risk Factors

There are no material changes from the risk factors previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2006. See Part I, Item 1A, Risk Factors.

ITEM 4.

Submission of Matters to a Vote of Security Holders

At the annual meeting of stockholders of the company held on May 7, 2007, the company s stockholders voted on two proposals as follows:

Proposal 1

Election of Directors

	Votes For	Votes Withheld
Michael J. Covey	35,945,398	1,280,273
Gregory L. Quesnel	36,589,483	636,188
Michael T. Riordan	36,575,283	650,388

Directors whose terms of office also continued after the annual meeting are Boh A. Dickey, William L. Driscoll, Ruth Ann M. Gillis, Jerome C. Knoll, John S. Moody, Lawrence S. Peiros, Judith M. Runstad and William T. Weyerhaeuser.

Proposal 2

Ratification of the Appointment of Independent Auditor

Votes For	36,319,806
Votes Against	789,595
Abstentions	116,270

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ITEM 6.

Exhibits

The exhibit index is located on page 32 of this Form 10-Q.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

POTLATCH CORPORATION
(Registrant)

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

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

Date: July 30, 2007

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POTLATCH CORPORATION AND CONSOLIDATED SUBSIDIARIES

EXHIBIT INDEX

EXHIBIT NUMBER	DESCRIPTION
(4)	Registrant undertakes to furnish to the Commission, upon request, any instrument defining the rights of holders of long-term debt.
10(u)[1]	Retirement Agreement with Chief Financial Officer.
10(v)[1]	Offer Letter, dated May 21, 2007, between Company and Eric J. Cremers.
(31)	Rule 13a-14(a)/15d-14(a) Certifications.
(32)	Furnished statements of the Chief Executive Officer and Chief Financial Officer under 18 U.S.C. Section 1350.

[1] Management contract or compensatory plan, contract or arrangement.