

GLATFELTER P H CO  
Form 10-Q  
August 08, 2007

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-Q**

**b QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

or

**o TRANSITION REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD**

from \_\_\_\_\_ to \_\_\_\_\_

For the quarterly period ended **June 30, 2007**

Commission file number **1-3560**

**P. H. Glatfelter Company**

(Exact name of registrant as specified in its charter)

**Pennsylvania**

(State or other jurisdiction of  
incorporation or organization)

**23-0628360**

(IRS Employer Identification No.)

**96 South George Street, Suite 500**

**York, Pennsylvania 17401**

(Address of principal executive offices)

**(717) 225-4711**

(Registrant's telephone number, including area code)

**N/A**

(Former name or former address, if changed since last report)

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 at least the past 90 days. Yes  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.  Large Accelerated  Accelerated  Non-Accelerated.

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

As of July 31, 2007, P. H. Glatfelter Company had 45,062,434 shares of common stock outstanding.

**P. H. GLATFELTER COMPANY**  
**REPORT ON FORM 10-Q**  
**for the QUARTERLY PERIOD ENDED**  
**JUNE 30, 2007**  
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**Table of Contents****PART I****Item 1 Financial Statements****CONDENSED CONSOLIDATED STATEMENTS OF INCOME****P. H. GLATFELTER COMPANY****CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(unaudited)

|  | <b>Three Months Ended</b> |             | <b>Six Months Ended</b> |             |
|--|---------------------------|-------------|-------------------------|-------------|
|  | <b>June 30</b>            |             | <b>June 30</b>          |             |
| <i>In thousands, except per share</i>                          | <b>2007</b>               | 2006        | <b>2007</b>             | 2006        |
| Net sales  | <b>\$ 288,091</b>         | \$ 279,720  | <b>\$ 569,080</b>       | \$ 440,326  |
| Energy sales net   | <b>2,424</b>              | 2,847       | <b>4,638</b>            | 5,304       |
| Total revenues   | <b>290,515</b>            | 282,567     | <b>573,718</b>          | 445,630     |
| Costs of products sold   | <b>261,715</b>            | 276,834     | <b>508,209</b>          | 419,632     |
| Gross profit   | <b>28,800</b>             | 5,733       | <b>65,509</b>           | 25,998      |
| Selling, general and administrative expenses                   | <b>23,776</b>             | 25,040      | <b>52,503</b>           | 41,737      |
| Shutdown and restructuring charges                             | <b>(63)</b>               | 6,657       | <b>162</b>              | 25,955      |
| Gains on dispositions of plant, equipment and timberlands, net | <b>(5,693)</b>            | (1,095)     | <b>(8,887)</b>          | (1,085)     |
| Gains from insurance recoveries                                |                           | (205)       |                         | (205)       |
| Operating income (loss)  | <b>10,780</b>             | (24,664)    | <b>21,731</b>           | (40,404)    |
| Non-operating income (expense)                                 |                           |             |                         |             |
| Interest expense   | <b>(7,424)</b>            | (7,170)     | <b>(14,761)</b>         | (10,563)    |
| Interest income  | <b>848</b>                | 1,126       | <b>1,589</b>            | 1,792       |
| Other net  | <b>(364)</b>              | (1,896)     | <b>267</b>              | (1,546)     |
| Total other income (expense)                                   | <b>(6,940)</b>            | (7,940)     | <b>(12,905)</b>         | (10,317)    |
| Income (loss) before income taxes                              | <b>3,840</b>              | (32,604)    | <b>8,826</b>            | (50,721)    |
| Income tax provision (benefit)                                 | <b>1,842</b>              | (11,882)    | <b>3,575</b>            | (18,134)    |
| Net income (loss)  | <b>\$ 1,998</b>           | \$ (20,722) | <b>\$ 5,251</b>         | \$ (32,587) |
| <b>Earnings (loss) per share</b>                               |                           |             |                         |             |
| Basic and diluted  | <b>\$ 0.04</b>            | \$ (0.46)   | <b>\$ 0.12</b>          | \$ (0.73)   |
| <b>Cash dividends declared per common share</b>                | <b>\$ 0.09</b>            | \$ 0.09     | <b>\$ 0.18</b>          | \$ 0.18     |
| <b>Weighted average shares outstanding</b>                     |                           |             |                         |             |
| Basic  | <b>45,040</b>             | 44,571      | <b>44,964</b>           | 44,392      |
| Diluted  | <b>45,373</b>             | 44,571      | <b>45,308</b>           | 44,392      |

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

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**Table of Contents****CONDENSED CONSOLIDATED BALANCE SHEETS**

**P. H. GLATFELTER COMPANY**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(unaudited)

| <i>In thousands</i>                         | <b>June 30<br/>2007</b> | December 31<br>2006 |
|---|-------------------------|---------------------|
| <b>Assets</b>                               |                         |                     |
| <b>Current assets</b>                       |                         |                     |
| Cash and cash equivalents                   | \$ 12,996               | \$ 21,985           |
| Accounts receivable net                     | 135,670                 | 128,255             |
| Inventories                                 | 188,621                 | 192,281             |
| Prepaid expenses and other current assets   | 37,019                  | 32,517              |
| Total current assets                        | 374,306                 | 375,038             |
| <b>Plant, equipment and timberlands net</b> | <b>520,762</b>          | 528,867             |
| <b>Other assets</b>                         | <b>322,752</b>          | 321,738             |
| Total assets                                | <b>\$ 1,217,820</b>     | 1,225,643           |
| <b>Liabilities and Shareholders Equity</b>  |                         |                     |
| <b>Current liabilities</b>                  |                         |                     |
| Current portion of long-term debt           | \$ 49,092               | \$ 19,500           |
| Short-term debt                             | 2,368                   | 2,818               |
| Accounts payable                            | 61,200                  | 70,966              |
| Dividends payable                           | 4,056                   | 4,035               |
| Environmental liabilities                   | 5,716                   | 5,489               |
| Other current liabilities                   | 85,658                  | 90,482              |
| Total current liabilities                   | 208,090                 | 193,290             |
| <b>Long-term debt</b>                       | <b>331,344</b>          | 375,295             |
| <b>Deferred income taxes</b>                | <b>174,787</b>          | 182,659             |
| <b>Other long-term liabilities</b>          | <b>109,082</b>          | 86,031              |
| Total liabilities                           | <b>823,303</b>          | 837,275             |
| <b>Commitments and contingencies</b>        |                         |                     |
| <b>Shareholders equity</b>                  |                         |                     |
| Common stock                                | 544                     | 544                 |
| Capital in excess of par value              | 43,463                  | 42,288              |

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|  |                     |           |
|--|---------------------|-----------|
| Retained earnings                          | <b>513,565</b>      | 519,489   |
| Accumulated other comprehensive loss       | <b>(24,931)</b>     | (32,337)  |
|  | <b>532,641</b>      | 529,984   |
| Less cost of common stock in treasury      | <b>(138,124)</b>    | (141,616) |
| Total shareholders' equity                 | <b>394,517</b>      | 388,368   |
| Total liabilities and shareholders' equity | <b>\$ 1,217,820</b> | 1,225,643 |

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

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**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**P. H. GLATFELTER COMPANY**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(unaudited)

|   | <b>Six Months Ended</b> |             |
|---|-------------------------|-------------|
|   | <b>June 30</b>          |             |
| <i>In thousands</i>   | <b>2007</b>             | <b>2006</b> |
| <b>Operating activities</b>   |                         |             |
| Net income (loss)   | \$ 5,251                | \$ (32,587) |
| Adjustments to reconcile to net cash provided (used) by operations:     |                         |             |
| Depreciation, depletion and amortization                                | 27,865                  | 24,645      |
| Pension income  | (6,421)                 | (7,965)     |
| Restructuring charges   | 162                     | 50,823      |
| Deferred income tax provision   | (66)                    | (8,817)     |
| (Gains) losses on dispositions of plant, equipment and timberlands, net | (8,887)                 | (1,095)     |
| Stock-based compensation  | 2,108                   | 965         |
| Change in operating assets and liabilities                              |                         |             |
| Accounts receivable   | (6,292)                 | (21,877)    |
| Inventories   | 5,053                   | (5,274)     |
| Other assets and prepaid expenses                                       | 83                      | (3,870)     |
| Accounts payable  | (9,962)                 | 5,417       |
| Other current liabilities   | 1,382                   | (24,378)    |
| Other   | 7,360                   | (8,335)     |
| Net cash (used) provided by operating activities                        | 17,636                  | (32,348)    |
| <b>Investing activities</b>   |                         |             |
| Purchases of plant, equipment and timberlands                           | (14,221)                | (25,250)    |
| Proceeds from disposals of plant, equipment and timberlands             | 9,448                   | 1,092       |
| Acquisition of Lydney mill and Chillicothe                              |                         | (151,605)   |
| Net cash used by investing activities                                   | (4,773)                 | (175,763)   |
| <b>Financing activities</b>   |                         |             |
| Net proceeds from revolving credit facility and other short term debt   | 784                     | 30,901      |
| Net (repayment of) proceeds from term loan facility                     | (16,400)                | 98,269      |
| Net proceeds from 7 <sup>1</sup> / <sub>8</sub> % note offering         |                         | 196,440     |
| Repayment of 6 <sup>7</sup> / <sub>8</sub> % notes                      |                         | (152,675)   |
| Payment of dividends  | (8,159)                 | (7,967)     |
| Proceeds from stock options exercised                                   | 1,086                   | 7,314       |
| Excess tax benefit of stock options exercised                           | 85                      | 814         |
| Net cash (used) provided by financing activities                        | (22,604)                | 173,096     |
| Effect of exchange rate changes on cash                                 | 752                     | 1,374       |
| Net decrease in cash and cash equivalents                               | (8,989)                 | (33,641)    |



|  |                  |           |
|--|------------------|-----------|
| Cash and cash equivalents at the beginning of period | <b>21,985</b>    | 57,442    |
| Cash and cash equivalents at the end of period       | <b>\$ 12,996</b> | \$ 23,801 |

**Supplemental cash flow information**

|               |                  |           |
|---------------|------------------|-----------|
| Cash paid for |                  |           |
| Interest      | <b>\$ 14,549</b> | \$ 11,648 |
| Income taxes  | <b>(1,637)</b>   | 17,057    |

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

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Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****P. H. GLATFELTER COMPANY AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

unaudited

**1. ORGANIZATION**

P. H. Glatfelter Company and subsidiaries ( Glatfelter ) is a manufacturer of specialty papers and engineered products. Headquartered in York, Pennsylvania, our manufacturing facilities are located in Spring Grove, Pennsylvania; Chillicothe and Fremont, Ohio; Lydney, Gloucestershire, the United Kingdom; Gernsbach, Germany; Scaër, France and the Philippines. Our products are marketed throughout the United States and in over 80 other countries, either through wholesale paper merchants, brokers and agents, or directly to customers.

**2. ACCOUNTING POLICIES**

**Principles of Consolidation** The consolidated financial statements include the accounts of Glatfelter and its wholly owned subsidiaries. All intercompany balances and transactions have been eliminated.

**Accounting Estimates** The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingencies as of the balance sheet date and the reported amounts of revenues and expenses during the reporting period. Management believes the estimates and assumptions used in the preparation of these consolidated financial statements are reasonable, based upon currently available facts and known circumstances, but recognizes that actual results may differ from those estimates and assumptions.

**Reclassifications** Certain reclassifications have been made to the prior year's balance sheet to conform to those classifications used in the current year. Such reclassifications had no impact on reported earnings, financial position, or cash flows for either period.

**3. RECENT PRONOUNCEMENTS**

Effective January 1, 2007, we adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 ( FIN 48 ). The Interpretation prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return. For those benefits to be recognized, a tax position must be more-likely-than-not to be sustained upon examination by taxing authorities. The amount recognized is measured as the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. The cumulative effect adjustment of \$3.0 million was recognized as an adjustment to retained earnings.

The following table provides a breakdown of the incremental effect of applying FIN 48 on individual line items in the consolidated balance sheet as of January 1, 2007:

| <i>In thousands</i>                       | Before<br>FIN 48 | Effect of<br>FIN 48 | After<br>adoption<br>of FIN 48 |
|---|------------------|---------------------|--------------------------------|
| Prepaid expenses and other current assets | \$ 32,517        | \$ 193              | \$ 32,710                      |
| Other current liabilities                 | 74,960           | (7,214)             | 67,746                         |
| Other long-term liabilities               | 86,031           | 21,690              | 107,721                        |
| Deferred income taxes                     | 182,659          | (11,309)            | 171,350                        |
| Retained earnings                         | 519,489          | (2,974)             | 516,515                        |

In September 2006, SFAS No. 157, Fair Value Measurements was issued. SFAS No. 157, which defines fair value, establishes a framework for measurement and requires expanded disclosures about the fair value measurements, is effective for us beginning January 1, 2008. We do not expect the adoption of SFAS No. 157 to have a material impact on our consolidated financial position or results of operations.

#### 4. ACQUISITIONS

**Lydney** On March 8, 2006, we entered into a definitive agreement to acquire, through Glatfelter-UK Limited ( GLT-UK ), a wholly-owned subsidiary, certain assets and liabilities of J R Crompton Limited ( Crompton ), a global supplier of wet laid non-woven products based in Manchester, United Kingdom. On February 7, 2006, Crompton was placed into Administration, the U.K. equivalent of bankruptcy.

Effective March 13, 2006, we completed our purchase of Crompton s Lydney mill and related inventory, located in Gloucestershire, UK for £37.5 million (US \$65.0 million) in cash in addition to \$4.2 million of transaction costs. The Lydney facility employs about 240 people, produces a broad portfolio of wet laid non-woven products, including tea and coffee filter papers, clean room wipes, lens tissue, dye filter paper, double-sided adhesive tape substrates and battery grid

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pasting tissue, and had 2005 revenues of approximately £43 million (US \$75 million). The purchase price was financed with existing cash balances and borrowings under our credit facility.

The following table summarizes the allocation of the purchase price to assets acquired and liabilities assumed:

*In thousands*

**Assets acquired:**

|                                      |           |
|--------------------------------------|-----------|
| Inventory                            | \$ 8,389  |
| Property and equipment               | 56,885    |
| Intangibles and other assets         | 9,325     |
|                                      | 74,599    |
| Less acquisition related liabilities | (5,374)   |
| Total                                | \$ 69,225 |

Although we do not expect future adjustments to occur, any such adjustments required to be made to the purchase price will be reflected in our results of operations in the applicable period in which such adjustment occurs. The amounts set forth above ascribed to intangible and other assets primarily consist of technology and trademarks.

The above allocation of purchase price includes \$0.8 million for five sets of claims to the Bristol, England Employment Tribunal for unfair dismissal and failure to consult with the union prior to staffing reductions and the sale of the Lydney mill. During the second quarter of 2007, we reached an agreement to settle such claims which together with associated legal fees resulted in an additional \$0.2 million charge to earnings.

**Chillicothe** On April 3, 2006, we completed our acquisition of Chillicothe, the carbonless business operations of NewPage Corporation, for \$83.3 million in cash, in addition to approximately \$5.9 million of transaction and other related costs. The Chillicothe assets consist of a paper making facility in Chillicothe, Ohio with annual production capacity approximating 400,000 tons-per-year and coating operations based in Fremont, Ohio with annual revenue of approximately \$440 million. The Chillicothe acquisition was financed with borrowings under our credit facility.

The following table summarizes the allocation of the purchase price to assets acquired and liabilities assumed:

*In thousands*

**Assets acquired:**

|  |           |
|--|-----------|
| Accounts receivable  | \$ 43,618 |
| Inventory  | 91,580    |
| Property and equipment   | 1,959     |
| Prepaid pension and other assets   | 11,416    |
| Intangibles customer relationships   | 6,074     |
|  | 154,647   |
| Less acquisition related liabilities including accounts payable and accrued expenses | (65,430)  |
| Total  | \$ 89,217 |

Although we do not expect future adjustments to occur, any such adjustments required to be made to the purchase price will be reflected in our results of operations in the applicable period in which such adjustment occurs.

**Pro-Forma Financial Information** The information necessary to provide certain pro forma financial data for the Chillicothe acquisition relative to net income and earnings per share is not readily available due to the nature of the accounting and reporting structure of the acquired operation prior to the acquisition date. Pro forma consolidated net

sales for the six months ended June 30, 2006 was approximately \$546.2 million assuming the acquisition occurred at the beginning of the respective period.

This unaudited pro forma financial information above is not necessarily indicative of what the operating results would have been had the acquisition been completed at the beginning of the respective period nor is it indicative of future results.

**5. NEENAH FACILITY SHUTDOWN**

In connection with our agreement to acquire the Chillicothe operations, we committed to a plan to permanently close the Neenah, WI facility. Production at this facility ceased effective June 30, 2006 and certain products previously manufactured at the Neenah facility have been transferred to Chillicothe.

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The results of operations in the first six months of 2006 include the following pre-tax charges related to the Neenah shutdown:

| <i>In thousands</i>                                       | Six Months<br>Ended<br>June 30,<br>2006 |
|---|---|
| Accelerated depreciation                                  | \$ 22,457                               |
| Inventory write-down                                      | 2,411                                   |
| Severance and benefit continuation                        | 6,592                                   |
| Pension curtailments and other retirement benefit charges | 7,675                                   |
| Contract termination costs                                | 11,386                                  |
| Other   | 222                                     |
| Total   | \$ 50,743                               |

The Neenah shutdown resulted in the elimination of approximately 200 positions that had been supporting our Specialty Papers business unit. Approximately \$24.9 million of the Neenah shutdown related charges are recorded as part of costs of products sold in the accompanying statements of income. The amounts accrued for severance and benefit continuation are recorded as other current liabilities in the accompanying consolidated balance sheets.

With the exception of the severance and benefit continuation amounts and contract termination costs, substantially all other amounts accrued represent either accelerated non-cash asset write-downs or costs expected to be paid for from the Company's overfunded pension plan.

As part of the Neenah shutdown, we terminated our long-term steam supply contract, as provided for within the contract, resulting in termination fee of approximately \$11.4 million as of the end of the second quarter 2006.

During the first six months of 2007, we increased our reserve for costs associated with the shutdown by \$0.2 million and made payments totaling \$1.2 million; thus, the remaining reserve balance was \$1.9 million at June 30, 2007.

## 6. GAIN ON DISPOSITIONS OF PLANT, EQUIPMENT AND TIMBERLANDS

During the first six months of 2007 and 2006, we completed sales of timberlands which are summarized by the following table:

| <i>Dollars in thousands</i> | Acres | Proceeds | Gain     |
|-----------------------------|-------|----------|----------|
| 2007                        | 3,588 | \$ 9,435 | \$ 9,066 |
| 2006                        | 261   | 1,078    | 1,066    |

In accordance with terms of our credit facility, we are required to use the proceeds from timberland sales to reduce amounts outstanding under our term loan.

## 7. EARNINGS PER SHARE

The following table sets forth the details of basic and diluted earnings per share (EPS):

| <i>In thousands, except per share</i> | <b>Three Months Ended<br/>June 30</b> |             |
|---------------------------------------|---------------------------------------|-------------|
|                                       | <b>2007</b>                           | 2006        |
| Net (loss) income                     | <b>\$ 1,998</b>                       | \$ (20,722) |

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|  |                |           |
|--|----------------|-----------|
| Weighted average common shares outstanding used in basic EPS   | <b>45,040</b>  | 44,571    |
| Common shares issuable upon exercise of dilutive stock options, restricted stock awards and performance awards | <b>333</b>     |           |
| Weighted average common shares outstanding and common share equivalents used in diluted EPS                    | <b>45,373</b>  | 44,571    |
| Earnings (loss) per share Basic and diluted  | <b>\$ 0.04</b> | \$ (0.46) |

|  | <b>Six Months Ended<br/>June 30</b> |             |
|--|-------------------------------------|-------------|
|  | <b>2007</b>                         | 2006        |
| <i>In thousands, except per share</i>  |                                     |             |
| Net (loss) income  | <b>\$ 5,251</b>                     | \$ (32,587) |
| Weighted average common shares outstanding used in basic EPS   | <b>44,964</b>                       | 44,392      |
| Common shares issuable upon exercise of dilutive stock options, restricted stock awards and performance awards | <b>344</b>                          |             |
| Weighted average common shares outstanding and common share equivalents used in diluted EPS                    | <b>45,308</b>                       | 44,392      |
| Earnings (loss) per share Basic and diluted  | <b>\$ 0.12</b>                      | \$ (0.73)   |

Approximately 525,150 and 522,150 of potential common shares have been excluded from the computation of diluted earnings per share for the three month and six month periods ended June 30, 2007, respectively due to their anti-dilutive nature. Approximately 679,440 and 650,205 of potential common shares were excluded from the computation of

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diluted earnings per share for the three month and six month periods ended June 30, 2006, respectively.

**8. INCOME TAXES**

Income taxes are recognized for the amount of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in our consolidated financial statements or tax returns. The effects of income taxes are measured based on enacted tax laws and rates.

Effective January 1, 2007, we adopted FIN 48. Subsequent to the adoption of this standard, we had \$21.5 million of gross unrecognized tax benefits. If recognized, approximately \$17.8 million would be recorded as a component of income tax expense, thereby affecting our effective tax rate. There have been no significant changes to these amounts during 2007.

We, or one of our subsidiaries, file income tax returns with the United States Internal Revenue Service, as well as various state and foreign authorities. The following table summarizes tax years that remain subject to examination by major jurisdiction:

| Jurisdiction   | Open Tax Year           |      |                               |      |
|----------------|-------------------------|------|-------------------------------|------|
|                | Examination in progress |      | Examination not yet initiated |      |
| United States  |                         |      |                               |      |
| Federal        |                         | N/A  | 2003                          | 2006 |
| State          |                         | 2004 | 2002                          | 2006 |
| Germany (1)    |                         | N/A  | 2003                          | 2006 |
| France         | 2003                    | 2005 |                               | 2006 |
| United Kingdom |                         | N/A  |                               | 2006 |
| Philippines    | 2004                    | 2006 |                               | N/A  |

(1) includes provincial or similar local jurisdictions, as applicable

The amount of income taxes we pay is subject to ongoing audits by federal, state and foreign tax authorities, which often result in proposed assessments. Management performs a comprehensive review of its global tax positions on a quarterly basis and accrues amounts for uncertain tax positions. Based on these reviews and the result of discussions and resolutions of matters with certain tax authorities and the closure of tax years subject to tax audit, reserves are adjusted as necessary. However, future results may include favorable or unfavorable adjustments to our estimated tax liabilities in the period the assessments are determined or resolved or as such statutes are closed. While it is possible that the amounts of unrecognized benefit with respect to uncertain tax positions could change significantly within the next twelve months, such adjustments, if any, are not expected to have a material effect on our consolidated financial position.

We recognize interest and penalties related to uncertain tax positions as income tax expense. Interest and penalty expense totaled \$0.3 million and \$0.1 million for the first six months of 2007 and the second quarter of 2007, respectively. Accrued interest and penalties were \$0.7 million and \$1.0 million as of January 1, 2007 and June 30, 2007, respectively.

**9. STOCK-BASED COMPENSATION**

During the first six months of 2007, we issued 225,400 Stock Only Stock Appreciation Rights ( SOSAR ) to members of executive management. Under terms of the SOSAR, which vest ratably over a three year period, the recipients received the right to receive a payment in shares of common stock having a fair market value equal to the amount of appreciation, if any, in the fair market value of one share of common stock from the date of grant of a SOSAR to the date of its exercise. The SOSARs had a grant date fair value, estimated using the Black-Scholes valuation model, of \$5.00 per right, and an aggregate value of \$1.1 million. In addition, 122,023 Restricted Stock Units ( RSU ) were issued in 2007 with a weighted-average grant date fair value of \$15.26 per unit and an aggregate value of \$1.9 million. The RSUs vest over a period ranging from three years to five years.



During the first six months of 2007 and 2006, we recognized stock-based compensation expense totaling \$2.1 million and \$1.0 million, respectively.

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**Table of Contents****10. RETIREMENT PLANS AND OTHER POST-RETIREMENT BENEFITS**

The following table provides information with respect to the net periodic costs of our pension and post retirement medical benefit plans.

| <i>In thousands</i>                | <b>Three Months Ended<br/>June 30</b> |            |
|------------------------------------|---------------------------------------|------------|
|                                    | 2007                                  | 2006       |
| <b>Pension Benefits</b>            |                                       |            |
| Service cost                       | \$ 2,331                              | \$ 1,650   |
| Interest cost                      | 5,627                                 | 5,402      |
| Expected return on plan assets     | (11,703)                              | (11,846)   |
| Amortization of prior service cost | 589                                   | 433        |
| Amortization of unrecognized loss  | 244                                   | 117        |
|                                    | (2,912)                               | (4,244)    |
| Curtailment charge                 |                                       | 1,372      |
| Net periodic benefit income        | \$ (2,912)                            | \$ (2,872) |
| <b>Other Benefits</b>              |                                       |            |
| Service cost                       | \$ 538                                | \$ 449     |
| Interest cost                      | 743                                   | 780        |
| Expected return on plan assets     | (223)                                 |            |
| Amortization of prior service cost | (275)                                 | (167)      |
| Amortization of unrecognized loss  | 262                                   | 329        |
| Net periodic benefit cost          | \$ 1,045                              | \$ 1,391   |

| <i>In thousands</i>                | <b>Six Months Ended<br/>June 30</b> |            |
|------------------------------------|-------------------------------------|------------|
|                                    | 2007                                | 2006       |
| <b>Pension Benefits</b>            |                                     |            |
| Service cost                       | \$ 4,787                            | \$ 2,679   |
| Interest cost                      | 10,918                              | 9,648      |
| Expected return on plan assets     | (23,735)                            | (21,766)   |
| Amortization of prior service cost | 1,199                               | 916        |
| Amortization of unrecognized loss  | 406                                 | 558        |
|                                    | (6,425)                             | (7,965)    |
| Curtailment charge                 |                                     | 4,403      |
| Net periodic benefit income        | \$ (6,425)                          | \$ (3,562) |

**Other Benefits**

|                                    |                 |          |
|------------------------------------|-----------------|----------|
| Service cost                       | <b>\$ 1,013</b> | \$ 754   |
| Interest cost                      | <b>1,517</b>    | 1,434    |
| Expected return on plan assets     | <b>(446)</b>    |          |
| Amortization of prior service cost | <b>(517)</b>    | (375)    |
| Amortization of unrecognized loss  | <b>523</b>      | 648      |
|                                    | <b>2,090</b>    | 2,461    |
| Special termination charge         |                 | 3,273    |
| Net periodic benefit cost          | <b>\$ 2,090</b> | \$ 5,734 |

As discussed in Note 5, in the first quarter of 2006, we recorded special termination charges in connection with the curtailment of pension benefits and termination of certain post retirement benefits related to the Neenah facility shutdown.

During the fourth quarter of 2006, we transferred \$12.2 million from our qualified pension plan assets to a post-retirement sub-account pursuant to Section 420 of the Internal Revenue Code. Such amounts are to be used to satisfy certain post-retirement health care benefits.

## 11. COMPREHENSIVE INCOME

The following table sets forth comprehensive income and its components:

| <i>In thousands</i>                                   | <b>Three Months Ended<br/>June 30</b> |             |
|---|---------------------------------------|-------------|
|   | <b>2007</b>                           | 2006        |
| Net income (loss)                                     | <b>\$ 1,998</b>                       | \$ (20,722) |
| Foreign currency translation adjustment               | <b>4,569</b>                          | 1,383       |
| Additional pension liability amortization, net of tax | <b>533</b>                            |             |
| Comprehensive income (loss)                           | <b>\$ 7,100</b>                       | \$ (19,339) |

| <i>In thousands</i>                                   | <b>Six Months Ended<br/>June 30</b> |             |
|---|-------------------------------------|-------------|
|   | <b>2007</b>                         | 2006        |
| Net income (loss)                                     | <b>\$ 5,251</b>                     | \$ (32,587) |
| Foreign currency translation adjustment               | <b>6,359</b>                        | 3,294       |
| Additional pension liability amortization, net of tax | <b>1,047</b>                        |             |
| Comprehensive income (loss)                           | <b>\$ 12,657</b>                    | \$ (29,293) |

## 12. INVENTORIES

Inventories, net of reserves, were as follows:

| <i>In thousands</i>     | <b>June 30,<br/>2007</b> | December<br>31,<br>2006 |
|-------------------------|--------------------------|-------------------------|
| Raw materials           | <b>\$ 40,594</b>         | \$ 38,539               |
| In-process and finished | <b>99,723</b>            | 107,811                 |
| Supplies                | <b>48,304</b>            | 45,931                  |

|       |                   |            |
|-------|-------------------|------------|
| Total | <b>\$ 188,621</b> | \$ 192,281 |
|-------|-------------------|------------|

**13. LONG-TERM DEBT**

Long-term debt is summarized as follows:

| <i>In thousands</i>                                 | <b>June 30,<br/>2007</b> | December<br>31,<br>2006 |
|---|--------------------------|-------------------------|
| Revolving credit facility, due April 2011           | <b>\$ 66,836</b>         | \$ 64,795               |
| Term loan, due April 2011                           | <b>79,600</b>            | 96,000                  |
| 7 <sup>1</sup> / <sub>8</sub> % Notes, due May 2016 | <b>200,000</b>           | 200,000                 |
| Note payable SunTrust, due March 2008               | <b>34,000</b>            | 34,000                  |
| Total long-term debt                                | <b>380,436</b>           | 394,795                 |
| Less current portion <sup>(1)</sup>                 | <b>(49,092)</b>          | (19,500)                |
| Long-term debt, excluding current portion           | <b>\$ 331,344</b>        | \$ 375,295              |

<sup>(1)</sup> Includes \$34 million Note payable SunTrust. Refer to the separate discussion of intentions to extend this instrument's maturity.

Our revolving credit facility provides for up to \$200 million of aggregate borrowings on an unsecured basis. Our term loan requires quarterly repayments of principal outstanding that began on March 31, 2007 with the final principal payment due on April 2, 2011. In addition, if certain prepayment events occur, such as a sale of assets or the incurrence of additional indebtedness in excess of \$10.0 million in the aggregate, we must repay a specified

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portion of the term loan within five days of the prepayment event.

Borrowings under the credit agreement bear interest, at our option, at either (a) the bank's base rate described in the credit agreement as the greater of the prime rate or the federal funds rate plus 50 basis points, or (b) the EURO rate based generally on the London Interbank Offer Rate, plus an applicable margin that varies from 67.5 basis points to 137.5 basis points according to our corporate credit rating determined by S&P and Moody's.

The 7<sup>1</sup>/<sub>8</sub>% Senior Note agreement contains a cross-default clause that provides if there were to be an event of default under the credit agreement discussed earlier, we would also be in default under the 7<sup>1</sup>/<sub>8</sub>% Senior Notes.

Our outstanding debt obligations include a \$34 million Note Payable to SunTrust Financial (the Note Payable), all of which is presented in the accompanying condensed consolidated financial statements as currently payable as of June 30, 2007. The Note Payable bears interest at a fixed rate of 3.82% for five years through March 2008, at which time we can elect to renew the obligation. The Note Payable relates to the March 2003 sale of approximately 25,500 acres of timberlands for which we received as consideration a \$37.9 million 10-year interest bearing note receivable from the timberland buyer. The note receivable is recorded as Other assets in the accompanying consolidated balance sheet. We pledged this note as collateral under the Note Payable. The debt agreement underlying this obligation provides for an extension of the maturity of the Note Payable for up to five years assuming certain conditions are satisfied, all of which we believe to be, or will be, complied with. We intend to utilize the debt maturity extension clauses provided for in the original note agreement to extend the maturity of the Note Payable to March 2013.

P. H. Glatfelter Company guarantees debt obligations of all its subsidiaries. All such obligations are recorded in these consolidated financial statements.

As of June 30, 2007 and December 31, 2006, we had \$14.1 million and \$8.1 million in letters of credit issued to us by financial institutions. The letters of credit are for the benefit of government agencies in the Fox River environmental matter and certain state workers compensation insurance agencies in conjunction with our self-insurance program. No amounts were outstanding under the letters of credit. We bear the credit risk on this amount to the extent that we do not comply with the provisions of certain agreements. Outstanding letters of credit reduce amounts available under our revolving credit facility.

In June 2007, we negotiated an amendment to our credit agreement (the Amended Credit Agreement) which, among other items increased the maximum leverage ratio for each fiscal quarter beginning June 30, 2007 and through and including March 31, 2008. The Amended Credit Agreement contains a number of customary covenants for financings of this type that, among other things, restrict our ability to: i) dispose of or create liens on assets; ii) transfer assets between borrowing or guaranteeing subsidiaries and non guaranteeing subsidiaries; iii) incur additional indebtedness; iv) repay other indebtedness; or v) make acquisitions and engage in mergers or consolidations. We are also required to comply with specified financial tests and ratios, each as defined in the Amended Credit Agreement, including a consolidated minimum net worth test and a maximum debt to earnings before interest, taxes, depreciation and amortization (EBITDA) ratio. A breach of these requirements, of which there were none at June 30, 2007, would give rise to certain remedies under the Amended Credit Agreement, among which are the termination of the agreement and accelerated repayment of the outstanding borrowings plus accrued and unpaid interest under the credit facility. In addition, the 7<sup>1</sup>/<sub>8</sub>% Notes contain a cross default provision that in the event of a default under the credit agreement, the Notes would become currently due.

**14. COMMITMENTS, CONTINGENCIES AND LEGAL PROCEEDINGS**

**Ecusta Division Matters** At June 30, 2007, we had reserves for various matters associated with our former Ecusta Division. Summarized below is the activity in these reserves during the period indicated:

| <i>In thousands</i>   | Ecusta                   |                  |       |          |
|-----------------------|--------------------------|------------------|-------|----------|
|                       | Environmental<br>Matters | Workers'<br>Comp | Other | Total    |
| Balance, Jan. 1, 2007 | \$ 7,202                 | \$ 1,409         |       | \$ 8,611 |
| Payments              | (437)                    | (195)            |       | (632)    |

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|                        |          |          |           |
|------------------------|----------|----------|-----------|
| Balance, June 30, 2007 | \$ 6,765 | \$ 1,214 | \$ 7,979  |
| Balance, Jan. 1, 2006  | \$ 8,105 | \$ 1,913 | \$ 3,300  |
| Payments               | (478)    | (152)    | (630)     |
| Other Adjustments      | 16       |          | 16        |
| Balance, June 30, 2006 | \$ 7,643 | \$ 1,761 | \$ 3,300  |
|                        |          |          | \$ 12,704 |

With respect to the reserves set forth above as of June 30, 2007, \$1.2 million is recorded under the caption "Other current liabilities" and \$6.8 million is recorded under the caption "Other long-term liabilities" in the accompanying condensed consolidated balance sheets.

The following discussion provides more details on each of these matters.

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**Background Information** In August 2001, pursuant to an acquisition agreement (the *Acquisition Agreement*), we sold the assets of our Ecusta Division to four related entities, consisting of Purico (IOM) Limited, an Isle of Man limited liability company ( *Purico* ), RF&Son Inc. ( *RF* ), RFS US Inc. ( *RFS US* ) and RFS Ecusta Inc. ( *RFS Ecusta* ), each of which is a Delaware corporation (collectively, the *Buyers* ).

In August 2002, the Buyers shut down the manufacturing operation of the pulp and paper mill in Pisgah Forest, North Carolina, which was the most significant operation of the Ecusta Division. On October 23, 2002, RFS Ecusta and RFS US (the *Debtors* ) separately filed for bankruptcy under Chapter 11 of the U.S. Bankruptcy Code. The bankruptcy cases were later converted to Chapter 7 proceedings. Effective August 8, 2003, the assets of RFS Ecusta and RFS US, which substantially consist of the pulp and paper mill and related real property, were sold to several third parties unrelated to the Buyers (the *New Buyers* ).

**Ecusta Environmental Matters** Beginning in April 2003, government authorities, including the North Carolina Department of Environment and Natural Resources ( *NCDENR* ), initiated discussions with us and the New Buyers regarding, among other environmental issues, certain landfill closure liabilities associated with the Ecusta mill and its properties. The discussions focused on NCDENR's desire to establish a plan and secure financial resources to close three landfills located at the Ecusta facility and to address other environmental matters at the facility. During the third quarter of 2003, the discussions ended with NCDENR's conclusion to hold us responsible for the closure of three landfills. Accordingly, we established reserves approximating \$7.6 million representing estimated closure costs. In March 2004 and September 2005, the NCDENR issued us separate orders requiring the closure of two of the three landfills at issue. We have completed the closure of these two landfills and are in the process of closing the third.

In October 2004, one of the New Buyers entered into a Brownfields Agreement with the NCDENR relating to the Ecusta mill, pursuant to which the New Buyers were to be held responsible for certain specified environmental issues at the Ecusta Facility.

In September 2005, NCDENR sought our participation, pursuant to a proposed consent order, in the evaluation and potential remediation of environmentally hazardous conditions at the former Ecusta mill site. In January 2006, NCDENR modified its proposed consent order to include us and the company (the *Prior Owner* ) from whom our predecessor, Ecusta Corporation, purchased the Ecusta mill. NCDENR and the United

States Environmental Protection Agency ( *USEPA* ) have indicated that if neither party enters into a consent order USEPA intends to list the mill site on the National Priorities List and pursue assessment and remediation of the site under the Comprehensive Environmental Responsibility, Compensation and Liability Act (more commonly known as *Superfund* ). In addition to calling for the assessment, closure, and post-closure monitoring and maintenance of the third landfill for which we since have been directed to close, the proposed consent order would impose an obligation to assess and remediate the following:

- i. mercury and certain other contamination on and around the site;
- ii. potentially hazardous conditions existing in the sediment and water column of the site's water treatment and aeration and sedimentation basin (the *ASB* ); and
- iii. contamination associated with two additional landfills on the site that were not used by us.

With respect to the concerns set forth above (collectively, the *NCDENR matters* ), we contend that the Prior Owner is responsible for any mercury contamination at the Ecusta Facility and that the New Buyers, as owner and operator of the ASB, are responsible for addressing any issues associated with the ASB, including closure, and that the New Buyers, in a May 2004 agreement, expressly agreed to indemnify and hold us harmless from certain environmental liabilities, which include most, if not all, of the NCDENR matters. We continue to have discussions with NCDENR and USEPA concerning our potential responsibilities and appropriate remedial actions, if any, which may be necessary.

The Prior Owners of the site have filed a declaratory judgment action in the US District Court that seeks a determination by the Court that, under the Purchase Agreement pursuant to which the Ecusta Facility was conveyed to Glatfelter, Glatfelter is obligated to indemnify the Prior Owners for any costs related to the remediation of mercury contamination at the Ecusta Facility. In response, Glatfelter has filed an answer denying that it is responsible for such

costs and a counterclaim against the Prior Owners alleging, among others things, fraud and negligent misrepresentation by the Prior Owner regarding mercury contamination. We continue to evaluate potential legal claims we may have with respect to Prior Owners and other parties with respect to any remediation of hazardous substance that may be ultimately required at the Ecusta Facility.

As a result of NCDENR's September 2005 communication with us and our assessment of the range of likely outcomes of the NCDENR Matters and the New

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Buyers Matters, our results of operations for 2005 included a \$2.7 million charge to increase our reserve for estimated costs associated with the Ecusta environmental matters. The addition to the reserve includes estimated operating costs associated with the obligations of the New Buyer discussed above, estimated costs to perform an assessment of certain risks posed by the presence of mercury, further characterization of sediment in the ASB and treatment of other contamination. Since this initial accrual, no further changes have been made.

The 2005 reserves relating to additional environmental assessment activities were premised, in part, on the belief that it might be mutually beneficial to us and NCDENR if we were to agree to perform the assessment activities, without accepting responsibility for any subsequently required remediation. While it now appears clear that NCDENR and USEPA will not accept such an arrangement, it is uncertain in the absence of a consent order i) what actions will be taken by the agencies; ii) against whom any such actions may be taken; and iii) when any additional remediation would be required to be performed.

In addition, it is unclear how the liability for any required assessment or remediation will be apportioned among the Prior Owner, Glatfelter, the Buyers and the New Buyers. We are also in negotiations with potential buyers of the Ecusta Facility (the Potential Buyers ) and the New Buyers concerning the division of assessment and remediation obligations for known and suspected contamination at the Ecusta Facility and certain off-site areas between us and the Potential Buyers. However, the outcome of these negotiations is uncertain. For the foregoing reasons, in part, our recorded reserve does not include costs associated with further remediation activities that we may be required to perform, the range of which we are currently unable to estimate; however, they could be significant.

We are evaluating options presented to us by the Potential Buyers, including proposals for Glatfelter, the Prior Owner and the Potential Buyers to jointly contribute to the cost to remediate any on-site contamination. To date we believe we are adequately reserved to participate in such an arrangement at the level currently proposed; however, there are no assurances that we will reach agreement with the Potential Buyers and the Prior Owner on the terms of such an arrangement. We are uncertain as to what additional Ecusta-related claims, including, among others, environmental matters, government oversight and government past costs, if any, may be asserted against us

It is possible that the New Buyers may not have sufficient cash flow from their operations to satisfy certain ongoing obligations to NCDENR and us and, their ability to do so may be dependent on their ability to sell the Ecusta Facility. Specifically, the New Buyers are obligated (i) to treat leachate and stormwater runoff from the landfills, which we are currently required to manage, and (ii) to pump and treat contaminated groundwater in the vicinity of a former caustic building at the site. If the New Buyers should default on these obligations, it is possible that NCDENR will require us to make appropriate arrangements for these obligations and to be responsible for the remediation of certain contamination on and around the site (collectively, the New Buyers Matters ). We continue to discuss with the New Buyers and the Potential Buyers the need for assurances that the New Buyers or the Potential Buyers, or both, will fulfill the New Buyers obligations for the New Buyers Matters.

Notwithstanding a potential sale of the property, and with respect to alleged mercury contamination at the site, i) the extent of mercury contamination is unknown; ii) it is unclear who will be required to remediate this contamination; and iii) the ultimate costs to remedy such contamination are not reasonably estimable based on information currently available to us. Accordingly, no amounts to address such contamination have been included in our reserve discussed above. If we are required to perform additional remediation at the Ecusta Facility, additional charges would be required, and such amounts could be material.

**Workers Compensation** Prior to 2003, we established reserves related to potential workers compensation claims associated with the former Ecusta Division, which at that time were estimated to total approximately \$2.2 million. In the fourth quarter of 2005, the North Carolina courts issued a ruling that held us liable for workers compensation claims of certain employees injured during their employment at the Ecusta facility prior to our sale of the Division. Since this ruling, we have made payments as indicated in the reserve analysis presented earlier in this Note 14.

**Fox River Neenah, Wisconsin** We have previously reported with respect to environmental claims arising out of the presence of polychlorinated biphenyls ( PCBs ) in sediments in the lower Fox River and in the Bay of Green Bay, downstream from our Neenah, Wisconsin facility.

The governmental authorities are pursuing responsible parties for the costs to remediate the contaminated areas of the Fox River, satisfy Natural Resource Damage claims, and reimburse the governments for past costs. The areas of the lower Fox River and in the Bay of Green Bay in which PCB contamination exists are commonly referred to as Operable Unit 1 ( OU1 ), which consists of Little Lake Butte des Morts, the portion of the river that is closest to our Neenah facility, Operable Unit 2 ( OU2 ), which is the portion of the river between dams

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at Appleton and Little Rapids, and Operable Units 3 through 5 ( OU3 5 ), an area approximately 20 miles downstream from our Neenah facility.

The following table summarizes the potential range of costs to satisfy total claims associated with the Fox River matter based on the best available estimates. Such amounts are not necessarily indicative of our share of responsibility:

| <i>In millions</i>       | <b>Low</b> | <b>High</b> |
|--------------------------|------------|-------------|
| OU1                      | \$ 80      | \$ 137      |
| OU2                      |            |             |
| OU3 OU5                  | 227        | 487         |
| Natural Resource Damages | 176        | 333         |

The high end of the range for OU1 set forth above assumes dredging of contamination as opposed to the use of alternative remedies. With respect to OU1, approximately \$55 million has been spent to date to remediate portions of the site. The accompanying Condensed Consolidated Balance Sheets as of June 30, 2007 includes a reserve of \$10.9 million for our share of potential liability to complete the remediation of OU1, reflecting a \$6.0 million addition in the first quarter of 2007 to our reserve. We do not have any other reserves recorded for the Fox River matter.

The following provides an in depth discussion of each of the Fox River matters.

**Background**

We acquired the Neenah facility in 1979 as part of the acquisition of the Bergstrom Paper Company. In part, this facility used wastepaper as a source of fiber. At no time did the Neenah facility utilize PCBs in the pulp and paper making process, but discharges to the Fox River from the facility which may have contained PCBs from wastepaper may have occurred from 1954 to the late 1970s. Any PCBs that the Neenah facility discharged into the Fox River resulted from the presence of PCBs in NCR®-brand carbonless copy paper in the wastepaper that was received from others and recycled.

As described below, various state and federal governmental agencies have formally notified nine potentially responsible parties ( PRPs ), including us, that they are potentially responsible for response costs and natural resource damages ( NRDs ) arising from PCB contamination in the lower Fox River and in the Bay of Green Bay, under the Comprehensive Environmental Response, Compensation and Liability Act ( CERCLA ) and other statutes. The other identified PRPs are NCR Corporation, Appleton Paper Inc., Georgia Pacific Corp. (formerly Fort Howard Corp. and Fort James), WTM I Company ( WTM I , a subsidiary of Chesapeake Corp.), Riverside Paper Corporation, U.S. Paper Mills Corp. (a subsidiary of Sonoco Products Company), Sonoco Products Company, and Menasha Corporation.

CERCLA establishes a two-part liability structure that makes responsible parties liable for (1) response costs associated with the remediation of a release of hazardous substances and (2) NRDs related to that release. Courts have interpreted CERCLA to impose joint and several liabilities on responsible parties for response costs, subject to equitable allocation in certain instances. Prior to a final settlement by all responsible parties and the final cleanup of the contamination, uncertainty regarding the application of such liability will persist.

The following summarizes the status of our potential exposure:

**Response Actions**

**OU1 and OU2** On January 7, 2003, the Wisconsin Department of Natural Resources (the Wisconsin DNR ) and the Environmental Protection Agency ( EPA ) issued a Record of Decision ( ROD ) for the cleanup of OU1 and OU2. Subject to extenuating circumstances and alternative solutions provided for in the ROD, the ROD requires the removal of approximately 784,000 cubic yards of sediment from OU1 and no active remediation of OU2. The ROD also requires the monitoring of the two operable units. On July 1, 2003, WTM I Company entered into an Administrative Order on Consent ( AOC ) with EPA and the Wisconsin DNR regarding the implementation of the Remedial Design for OU1.

In the first quarter of 2004, the United States District Court for the Eastern District of Wisconsin approved a consent decree regarding OU1 ( the OU1 Consent Decree ). Under terms of the OU1 Consent Decree, Glatfelter and WTM I Company each agreed to pay approximately \$27 million, of which \$25.0 million from each was placed in escrow to fund response work at OU-1 ( OU-1Escrow Account ). The remaining amount that the parties agreed to pay under the Consent Decree includes payments for NRD and NRD assessment and other past costs incurred by the governments. In addition, EPA placed \$10 million from another source into escrow for the OU1 cleanup. As a result of these contributions, the total amount of funds available for remediation totaled \$60 million.

As of June 30, 2007, the escrow account balance together with additional amounts to be contributed totaled \$25 million. Our portion of the escrow account totaled approximately \$9.9 million, of which \$3.9 million is recorded in the accompanying Consolidated Balance Sheet under the caption Prepaid expenses and other current assets and \$6.0 million of which we have yet to fund. As of June 30, 2007, our reserve for environmental liabilities, substantially all of which is for OU1 remediation activities, totaled \$10.9 million.

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The terms of the OU1 Consent Decree and the underlying escrow agreement restrict the use of the funds to qualifying remediation activities or restoration activities at the lower Fox River site. The response work is being managed and/or performed by Glatfelter and WTM I, with governmental oversight, and funded by the amounts placed in escrow. Beginning in mid 2004, Glatfelter and WTM I have performed activities to remediate OU1, including, among others, construction of de-watering and water-treatment facilities, dredging of portions of OU1, dewatering of the dredged materials, and hauling of the dewatered sediment to an authorized disposal facility. Since the start of these activities, approximately 200,000 cubic yards of contaminated sediment has been dredged.

The terms of the OU1 Consent Decree include provisions to be followed should the escrow account be depleted prior to completion of the response work. In this event, each company would be notified and be provided an opportunity to contribute additional funds to the escrow account. Should the OU1 Consent Decree be terminated due to insufficient funds, each company would lose the protections contained in the Consent Decree, and the governments may order one or both parties to complete the required remedial activities for OU-1. The governments may issue a similar order to a third party or perform the work itself and seek response costs from any or all PRPs for the site, including Glatfelter. If the Consent Decree is terminated due to the insufficiency of the escrow funds, Glatfelter and WTM I each remain potentially responsible for the costs necessary to complete the remedial action.

In late 2006, Glatfelter and WTM I jointly submitted a proposed Final Plan for the completion of the remediation of OU1 (the FCP) to Wisconsin DNR and EPA. The FCP proposes the implementation of permitted alternative remedies that require acceptance by the agencies. Throughout 2007, Glatfelter and WTM I have been engaged in discussions with the government agencies concerning the FCP. In April 2007, we refined our cost estimates. As a result, we now believe the FCP ultimately will cost approximately \$80 million. We have considered the assets available to complete this remediation and, as a result, in the first quarter of 2007 increased our reserve by \$6.0 million. Since we have not come to final agreement with the agencies, it is possible that the costs to complete the remediation of OU1 could total \$95 million, which is in excess of the amount we have accrued and future charges may be necessary. Included in our closure plan is the capping of certain areas in the river. In the third quarter 2007, we plan to conduct a pilot program to validate certain aspects of the FCP, including evaluating capping contaminated areas as opposed to dredging. We expect to reach an agreement with the agencies for a final OU1 remedy in 2008.

The agencies have also expressed concerns that the cost of the ultimately accepted remediation plan may exceed the balance of the escrow fund. In order to provide the agencies financial assurances that, in the event the ultimate remediation plan should exceed financial resources currently allocated to the remedy, adequate funds would be readily available, we issued a \$6.0 million letter of credit from a financial institution in April 2007. The letter of credit would be funded in the event the balance of the escrow account becomes less than \$2.0 million. In addition, WTM I agreed to provide an additional \$6.0 million in cash to the escrow fund. In return, the agencies agreed to approve the basic approach proposed for the 2007 dredging season and to evaluate in good faith our proposed FCP. The agencies willingness to accept the FCP as submitted is uncertain and any changes required would likely necessitate an increase to our reserves. Any such changes would require additional cash to be contributed and such amounts could be material.

Based on information currently available to us, subject to i) government approval of the use of alternative remedies as proposed by us and WTM I; ii) the successful negotiation of acceptable and cost-effective contracts to complete the proposed remediation activities; and iii) effective implementation of the chosen technologies by the remediation contractor, and together with anticipated earnings on the funds currently on deposit in the escrow account and other assets available, we believe the required remedial actions can be completed for amounts reserved.

**OU3 5** On July 28, 2003, the EPA and the Wisconsin DNR issued a ROD (the Second ROD) for the cleanup of OU3 5. The Second ROD calls for the removal of 6.5 million cubic yards of sediment and certain monitoring at an estimated cost of \$324.4 million but could, according to the Second ROD, cost within a range from approximately \$227.0 million to \$486.6 million. The most significant component of the estimated costs is attributable to large-scale sediment removal by dredging.

In June 2007, the EPA and the Wisconsin DNR issued an amendment to the Second ROD (the Amended Second ROD) that primarily, among other matters, expanded the Remedial Design provided for under the original ROD to include the use of engineered caps as an alternative to dredging. The Amended Second ROD estimates the total

project costs to be approximately \$385 million. We are in the process of evaluating the impact, if any, the Amended Second ROD may have on our alternative remedies proposed for OU1 and the governments willingness to accept these proposed remedies. If we are required to apply the requirements of the Amended Second ROD as it applies to the use of

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capping, our estimated costs to complete OU1 could increase which would require additional charges to earnings.

During the first quarter of 2004, NCR Corp. and Georgia Pacific Corp. entered into an AOC with the United States EPA under which they agreed to perform the Remedial Design for OUs 3-5, thereby accomplishing a first step towards remediation.

In February 2007, we, along with the other PRPs involved in the OU2 and OU3-5 matters, received a General Notice Letter from the EPA requesting that each PRP advise the EPA of their willingness to discuss their liability for the costs to remediate OU3-5 and to provide a good faith offer to settle by April 1, 2007. Since the receipt of this letter, the relevant parties have been in discussions concerning potential avenues to reach an ultimate settlement of the asserted claims. In an attempt to resolve the differences concerning allocation of liability, the PRPs participated in non-binding mediation proceedings that officially concluded on July 31, 2007 but discussions between the parties and the mediator are expected to continue indefinitely. To date, the proceedings have not successfully resolved the allocation of remediation costs for OU 3-5. At this time we are not able to reasonably predict the outcome of such discussions. Therefore, the accompanying consolidated financial statements do not include any reserves for potential liabilities associated with OU2 or OU3-5.

We do not believe that we have more than a *de minimis* share of any equitable distribution of responsibility for OU3-5 after taking into account the location of our Neenah facility relative to the site and considering other work or funds committed or expended by us. However, uncertainty regarding responsibilities for the cleanup of these sites continues due to disagreement over a fair allocation or apportionment of responsibility among the PRPs. Although we believe we have meritorious positions to support our assessment of our fair share of any equitable allocation of responsibility, this matter could result in litigation. The accompanying consolidated financial statements do not include reserves for any future costs to defend ourselves, and should litigation be necessary, the costs to do so could be significant. If we are ordered to complete more than what we believe to be our fair share of any remediation efforts, the costs to do so could be significant.

**Natural Resource Damages** The ROD and Second ROD do not place any value on claims for NRDs associated with this matter. As noted above, NRD claims are distinct from costs related to the primary remediation of a Superfund site. Calculating the value of NRD claims is difficult, especially in the absence of a completed remedy for the underlying contamination. The State of Wisconsin, the United States Fish and Wildlife Service ( FWS ), the National Oceanic and Atmospheric Administration ( NOAA ), four Indian tribes and the Michigan Attorney General have asserted that they possess NRD claims related to the lower Fox River and the Bay of Green Bay.

In September 1994, FWS notified the then-identified PRPs that it considered them potentially responsible for NRDs. The federal, tribal and Michigan agencies claiming to be NRD trustees have proceeded with the preparation of an NRD assessment. While the final assessment has yet to be completed, the federal trustees released a plan on October 25, 2000 that values NRDs for injured natural resources that allegedly fall under their trusteeship at between \$176 million and \$333 million. We believe that the federal NRD assessment is technically and procedurally flawed. We also believe that the NRD claims alleged by the various alleged trustees are legally and factually without merit.

The OU1 Consent Decree required that Glatfelter and WTM I each pay the governments \$1.5 million for NRDs for the Fox River site, and \$150,000 for NRD assessment costs. Each of these payments was made in return for credit to be applied toward each settling company's potential liability for NRDs associated with the Fox River site.

**Other Information** The Wisconsin DNR and FWS have each published studies, the latter in draft form, estimating the amount of PCBs discharged by each identified PRP to the lower Fox River and the Bay of Green Bay. These reports estimate our Neenah facility's share of the volumetric discharge to be as high as 27%. We do not believe the volumetric estimates used in these studies are accurate because (a) the studies themselves disclose that they are not accurate and (b) the volumetric estimates contained in the studies are based on assumptions that are unsupported by existing evidence. We believe that our volumetric contribution is significantly lower than the estimates set forth in these studies. Further, we do not believe that a volumetric allocation would constitute an equitable distribution of the potential liability for the contamination. Other factors, such as the location of contamination, the location of discharge, and a party's role in causing discharge, must be considered in order for the allocation to be equitable.

We have entered into interim cost-sharing agreements with four of the other PRPs, pursuant to which such PRPs have agreed to share both defense costs and costs for scientific studies relating to PCBs discharged into the lower Fox River. These interim cost-sharing agreements have no bearing on the final allocation of costs related to this matter. Based upon our evaluation of the magnitude, nature and location of the various

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discharges of PCBs to the river and the relationship of those discharges to identified contamination, we believe our share of any liability among the identified PRPs is much less than our per capita share of the cost sharing agreement.

We also believe that there exist additional potentially responsible parties other than the identified PRPs. For instance, certain of the identified PRPs discharged their wastewater through public wastewater treatment facilities, which we believe makes the owners of such facilities potentially responsible in this matter. We also believe that entities providing PCB-containing wastepaper to each of the recycling mills are also potentially responsible in this matter.

While the OU1 Consent Decree provides a negotiated framework for resolving both ours and WTM I liability for the costs for completing the remediation of OU1, it does not completely resolve our potential liability related to the Fox River. We anticipate this matter may result in litigation but cannot predict the timing, nature, extent or magnitude of such litigation. We currently are unable to predict our ultimate cost related to this matter.

**Reserves for Fox River Environmental Liabilities**

We have reserves for existing environmental liabilities and for those environmental matters for which it is probable that a claim will be made and for which the amount of the obligation is reasonably estimable. The following table summarizes information with respect to such reserves.

| <i>In millions</i>          | <b>June<br/>30,<br/>2007</b> | December<br>31,<br>2006 |
|-----------------------------|------------------------------|-------------------------|
| <i>Recorded as:</i>         |                              |                         |
| Environmental liabilities   | \$ 5.7                       | \$ 5.5                  |
| Other long-term liabilities | 5.2                          | 2.2                     |
| Total                       | <b>\$ 10.9</b>               | <b>\$ 7.7</b>           |

The classification of our environmental liabilities is based on the development of the underlying Fox River OU1 remediation plan and execution of the related escrow agreement for the funding thereof. As discussed previously, we recorded additional charges of \$6.0 million associated with the Fox River matter in our results of operations during the first six months of 2007.

Other than with respect to the OU1 Consent Decree, the amount and timing of future expenditures for environmental compliance, cleanup, remediation and personal injury, NRDs and property damage liabilities cannot be ascertained with any certainty due to, among other things, the unknown extent and nature of any contamination, the extent and timing of any technological advances for pollution abatement, the response actions that may be required, the availability of qualified remediation contractors, equipment, and landfill space, and the number and financial resources of any other PRPs.

**Range of Reasonably Possible Outcomes** Based on currently available information, including actual remediation costs incurred to date, we believe that the remediation of OU1 can be satisfactorily completed for the amounts provided under the OU1 Consent Decree. Our assessment is dependent, in part, on government approval of the use of alternative remedies in OU1 as proposed by us and WTM I, on the successful negotiation of acceptable contracts to complete remediation activities, and an effective implementation of the chosen technologies by the remediation contractor. However, if we are unsuccessful in managing our costs to implement the ROD or if alternative remedies are not accepted by government authorities, additional charges may be necessary and such amounts could be material.

The OU1 Consent Decree does not address response costs necessary to remediate the remainder of the Fox River site and only addresses NRDs and claims for reimbursement of government expenses to a limited extent. Due to judicial interpretations that find CERCLA imposes joint and several liability, uncertainty persists regarding our exposure with respect to the remainder of the Fox River site.

Based on our analysis of currently available information and experience regarding the cleanup of hazardous substances, we believe that it is reasonably possible that our costs associated with the lower Fox River and the Bay of

Green Bay may exceed our original reserves by amounts that may prove to be insignificant or that could range, in the aggregate, up to approximately \$150 million, over a period that is undeterminable but that could range beyond 20 years. We believe that the likelihood of an outcome in the upper end of the monetary range is significantly less than other possible outcomes within the range and that the possibility of an outcome in excess of the upper end of the monetary range is remote.

In our estimate of the upper end of the range, we have considered: (i) the remedial actions agreed to in the OU1 Consent Decree and our belief that the required work can be accomplished with the funds to be escrowed under the OU1 Consent Decree; and (ii) no active remediation of OU2. We have also assumed dredging for the remainder of the Fox River site as set forth in the Second ROD, although at a significantly higher cost than estimated in the Second ROD. We have also assumed our share of the ultimate liability to be 18%, which is significantly higher than we believe is appropriate or than we will incur, and a level of NRD claims and claims for reimbursement of expenses from other parties that, although reasonably possible, is unlikely.

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In estimating both our current reserves for environmental remediation and other environmental liabilities and the possible range of additional costs, we have assumed that we will not bear the entire cost of remediation and damages to the exclusion of other known PRPs who may be jointly and severally liable. The ability of other PRPs to participate has been taken into account, generally based on their financial condition and probable contribution. Our evaluation of the other PRPs' financial condition included the review of publicly available financial information. Furthermore, we believe certain of these PRPs have corporate or contractual relationships with additional entities that may shift to those entities some or all of the monetary obligations arising from the Fox River site. The relative probable contribution is based upon our knowledge that at least two PRPs manufactured the paper, and arranged for the disposal of the wastepaper, that included the PCBs and consequently, in our opinion, bear a higher level of responsibility.

In addition, our assessment is based upon the magnitude, nature and location of the various discharges of PCBs to the river and the relationship of those discharges to identified contamination. We continue to evaluate our exposure and the level of our reserves, including, but not limited to, our potential share of the costs and NRDs, if any, associated with the Fox River site.

**Summary** Our current assessment is that we should be able to manage these environmental matters without a long-term, material adverse impact on the Company. These matters could, however, at any particular time or for any particular year or years, have a material adverse effect on our consolidated financial position, liquidity and/or results of operations or could result in a default under our loan covenants. Moreover, there can be no assurance that our reserves will be adequate to provide for future obligations related to these matters, that our share of costs and/or damages for these matters will not exceed our available resources, or that such obligations will not have a long-term, material adverse effect on our consolidated financial position, liquidity or results of operations. With regard to the Fox River site, if we are not successful in managing the implementation of the OU1 Consent Decree and/or if we are ordered to implement the remedy proposed in the Second ROD, such developments could have a material adverse effect on our consolidated financial position, liquidity and results of operations and may result in a default under our loan covenants.

In addition to the specific matters discussed above, we are subject to loss contingencies resulting from regulation by various federal, state, local and foreign governments with respect to the environmental impact of our mills. To comply with environmental laws and regulations, we have incurred substantial capital and operating expenditures in past years. We anticipate that environmental regulation of our operations will continue to become more burdensome and that capital and operating expenditures necessary to comply with environmental regulations will continue, and perhaps increase, in the future. In addition, we may incur obligations to remove or mitigate the adverse effects, if any, on the environment resulting from our operations, including the restoration of natural resources and liability for personal injury and for damages to property and natural resources.

We are also involved in other lawsuits that are ordinary and incidental to our business. The ultimate outcome of these lawsuits cannot be predicted with certainty; however, we do not expect that such lawsuits in the aggregate or individually will have a material adverse effect on our consolidated financial position, liquidity or results of operations.

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The following table sets forth financial and other information by business unit for the periods indicated:

| <b>Business Unit Performance</b>                          | For The Three Months Ended June 30, |            |                  |           |                       |             |            |             |
|---|-------------------------------------|------------|------------------|-----------|-----------------------|-------------|------------|-------------|
|   | Specialty Papers                    |            | Composite Fibers |           | Other and Unallocated |             | Total      |             |
|   | <i>In thousands</i>                 |            |                  |           |                       |             |            |             |
|   | 2007                                | 2006       | 2007             | 2006      | 2007                  | 2006        | 2007       | 2006        |
| Net sales   | \$ 202,606                          | \$ 203,461 | \$ 85,486        | \$ 76,263 | \$ (1)                | \$ (4)      | \$ 288,091 | \$ 279,720  |
| Energy sales, net   | 2,424                               | 2,847      |                  |           |                       |             | 2,424      | 2,847       |
| Total revenue   | 205,030                             | 206,308    | 85,486           | 76,263    | (1)                   | (4)         | 290,515    | 282,567     |
| Cost of products sold                                     | 192,817                             | 197,459    | 70,522           | 66,693    | (1,624)               | 12,682      | 261,715    | 276,834     |
| Gross profit (loss)                                       | 12,213                              | 8,849      | 14,964           | 9,570     | 1,623                 | (12,686)    | 28,800     | 5,733       |
| SG&A  | 14,521                              | 14,705     | 8,182            | 6,504     | 1,073                 | 3,831       | 23,776     | 25,040      |
| Shutdown and restructuring charges                        |                                     |            |                  |           | (63)                  | 6,657       | (63)       | 6,657       |
| Gains on dispositions of plant, equipment and timberlands |                                     |            |                  |           | (5,693)               | (1,095)     | (5,693)    | (1,095)     |
| Gain on insurance recoveries                              |                                     |            |                  |           |                       | (205)       |            | (205)       |
| Total operating income (loss)                             | (2,308)                             | (5,856)    | 6,782            | 3,066     | 6,306                 | (21,874)    | 10,780     | (24,664)    |
| Nonoperating income (expense)                             |                                     |            |                  |           | (6,940)               | (7,940)     | (6,940)    | (7,940)     |
| Income (loss) before income taxes                         | \$ (2,308)                          | \$ (5,856) | \$ 6,782         | \$ 3,066  | \$ (634)              | \$ (29,814) | \$ 3,840   | \$ (32,604) |
| <b>Supplementary Data</b>                                 |                                     |            |                  |           |                       |             |            |             |
| Net tons sold   | 183,344                             | 188,854    | 18,118           | 17,667    |                       | 10          | 201,462    | 206,531     |
| Depreciation expense                                      | \$ 8,881                            | \$ 7,679   | \$ 5,250         | \$ 4,493  |                       |             | \$ 14,131  | \$ 12,172   |

| <b>Business Unit Performance</b> | For The Six Months Ended June 30, |            |                  |            |                       |      |            |            |
|----------------------------------|-----------------------------------|------------|------------------|------------|-----------------------|------|------------|------------|
|                                  | Specialty Papers                  |            | Composite Fibers |            | Other and Unallocated |      | Total      |            |
|                                  | <i>In thousands</i>               |            |                  |            |                       |      |            |            |
|                                  | 2007                              | 2006       | 2007             | 2006       | 2007                  | 2006 | 2007       | 2006       |
| Net sales                        | \$ 399,510                        | \$ 305,810 | \$ 169,570       | \$ 134,516 | \$                    | \$   | \$ 569,080 | \$ 440,326 |
| Energy sales, net                | 4,638                             | 5,304      |                  |            |                       |      | 4,638      | 5,304      |