

FraserPapers

ANNUAL REPORT 2006

Corporate Profile

Fraser Papers is an integrated specialty paper company which produces a broad range of specialty packaging and printing papers. The company has operations in New Brunswick, Maine, New Hampshire and Quebec.

Fraser Papers is listed on the Toronto Stock Exchange under the symbol: FPS. For more information, visit the Fraser Papers web site at www.fraserpapers.com

Financial Highlights

<i>(US\$ millions, except per share data)</i>	2006	2005	2004 ⁽³⁾
Net sales ⁽¹⁾	\$ 796	\$ 918	\$ 996
EBITDA	(7)	4	20
Loss	(114)	(29)	(43)
Total assets	556	788	770
Net debt	55	76	41
Number of common shares outstanding ⁽²⁾	29.5	29.5	30.1
Loss per share, basic and diluted	\$ (3.86)	\$ (0.98)	\$ (1.43)
Total paper produced (000 tons)	661	723	840

(1) Net sales are gross sales, net of freight costs, commissions, and discounts and rebates to customers.

(2) Millions of shares.

(3) See note 1 of Notes to the Consolidated Financial Statements, "Basis of Presentation" for 2004 figures.

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Letter to Shareholders

OVERVIEW

The past year represented the end of a 2½ year period of repositioning where we surfaced value from non-core assets, closed uncompetitive businesses, refinanced the company and focused our efforts to improve our underlying paper operations. During 2006, the initiatives completed resulted in significant one-time accounting charges that are now behind us. We are now entering a period where continued improvement in our core business will lead to further opportunities for profitable growth.

While we have much left to accomplish, we did achieve a number of key objectives during the past year. In January, we sponsored the launch of the Acadian Timber Income Fund, which gave us the opportunity to monetize our New Brunswick timberlands at an attractive valuation while retaining a 20 year wood supply for our sawmills. In April, we took the difficult decision to permanently close our hardwood kraft mill in Berlin, New Hampshire. This enabled us to consolidate sales of market pulp and eliminate both operating losses at Berlin and low margin export sales at our remaining pulp mill in Thurso, Quebec. During the year we improved our balance sheet by reducing long term debt by \$82 million and we funded \$40 million into our employee benefit plans.

Markets improved during 2006 for pulp and paper. Importantly, we increased shipments of our highest margin products in specialty packaging and printing papers from 332,000 to 362,000 tons – a 9% improvement. This improvement in product mix, when combined with a 6% improvement in average realized paper prices in 2006, added \$31 million to our operating margins. Unfortunately, this was more than offset by \$41 million of additional non-controllable costs relating to higher oil and fibre prices along with a higher Canadian dollar exchange rate.

GOALS AND STRATEGY

While it appears ambitious today, our goal is to provide long term shareholders with a return of 12% on their investment. Clearly we are not there today, but we are confident that a high performing specialty paper business can and should generate that kind of return. We believe that we can improve our operating margins and achieve

this objective over the longer term by pursuing the following strategies:

- Focusing on **value-added products**, with an emphasis toward specialty printing and packaging applications;
- Providing **superior customer service** and technical support while delivering high quality specialty papers;
- Continuing **innovation** and development of new products to support ongoing growth of our business;
- Achieving **operating excellence** that surpasses industry benchmarks for efficiency, energy consumption and fibre costs at all our facilities; and
- Maintaining a culture focused on **execution and performance**.

OPERATING PLATFORM

The strength of the operating platform lies in the integrated nature of our assets, our capability to develop, manufacture and take to market a broad spectrum of specialty papers from three different sources of internal pulp fibre combined with the ability to optimize the process on a day-to-day basis.

Our paper business is led by a team of 25 sales and marketing professionals who are responsible for our commercial relationships and identifying new business opportunities. We also have product development specialists at each operation with a track record of success in bringing new paper grades to commercialization. In fact, over 90% of our current grade mix at East Papers is comprised of products developed by this team. In Montreal, we operate a Technology Centre with a fully-equipped paper chemistry laboratory that focuses on product quality, process improvement and optimization.

We have three pulp mills that are integrated into our paper business, providing high quality fibre produced to our specifications at a lower cost than purchased fibre. The ability to produce hardwood kraft, softwood sulphite and groundwood pulp within our own system provides the flexibility to develop and manufacture a wide variety of groundwood, freesheet and hybrid papers in response to market opportunities. For example, we have been able to benefit from the expanding market for high-brightness groundwood paper that is replacing traditional freesheet in specialty print applications.

We operate 13 paper machines at two locations, ranging in size from 30,000 to 120,000 tons per year, with a combined annual capacity of 675,000 tons of paper. Many of our machines have the capability of producing similar grades of paper, giving us the opportunity to optimize our allocation of individual customer orders across the machines.

We believe that our smaller paper machines can remain competitive so long as we can grow with our customers in niche markets. To some, this is counter-intuitive to the trend toward modern, highly efficient machines with capacities as large as 400,000 tons per year. In our case, we align market size and product specifications with our machine size and capability, such that we can be successful in our target market segments.

Our lumber mills in New Brunswick and Maine represent another piece of our integrated business model as they provide by-product chips that feed the sulphite mill. During the past ten year period, between 1997 and 2006, the lumber mills generated an average EBITDA of over \$10 million annually. This contributed to a lower net cost of fibre for our Edmundston pulp mill and therefore improved our paper manufacturing costs. With lumber markets depressed, our net chip costs have risen, but we believe that the markets for lumber in the U.S. will improve over 2007, providing the opportunity for us to once again benefit from this low cost source of fibre.

INDUSTRY DYNAMICS

For a number of years now, the North American paper industry has suffered from excess production capacity, primarily in the commodity segments. More recently, the industry has been undergoing a necessary period of rationalization and consolidation with a significant amount of capacity being closed and mergers between some of the larger players. We believe this trend should improve our future prospects. We expect the fewer but larger players who remain will narrow their focus to the largest market segments in order to achieve cost synergies and economies of scale. This should leave significant opportunities for our company in the smaller specialty segments where we can focus on delivering customized product offerings with a high level of service. In 2007, we are determined to grow in these kinds of segments at rates in excess of the broader commodity markets for uncoated freesheet and groundwood papers and as we grow, we will eliminate lower margin commodity papers from our business.

SUMMARY AND OUTLOOK


We are determined to reengineer our business to a point where shareholders can receive an acceptable and sustainable return on their capital invested with us. This kind of transformation is not completed overnight, but shareholders can expect to see meaningful change over the balance of 2007.

Our sales and marketing team has identified a number of specific opportunities that will improve and strengthen our product lines. We are particularly enthusiastic about the potential to grow in our core printing and packaging segments where we have not only retained existing customers but are also winning new business based on our competitive advantage.

At our operations, we have identified opportunities for improved performance. Paper mills generally have a high fixed cost structure and as such, there is significant earnings and cash flow leverage to increased throughput. Obviously it's not throughput at any cost, but rather increased throughput at lower costs as we have opportunities to improve operating efficiencies, energy consumption and lower fibre costs.


We recently announced an agreement to acquire the groundwood pulp and paper operations of Katahdin Paper Company from Brookfield. We know the assets well, having managed them since 2003, and believe this business is a good fit with our strategy of growing our company in segments like directory and super-calendered papers. We look forward to reviewing this opportunity with our shareholders. As the paper industry continues to rationalize around us, we anticipate additional opportunities to grow the business.

On behalf of all employees at Fraser, we thank you for your continued patience and support as we transform Fraser Papers into a successful and profitable company.



J. Peter Gordon
President

March 13, 2007



Dominic Gammiero
Chief Executive Officer

March 13, 2007

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

This Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") presents the factors that had a material effect on our results of operations during the years ended December 31, 2006 and 2005. Also discussed is our financial position as of the end of those periods. This discussion should be read in conjunction with our historical consolidated financial statements as at December 31, 2006 and 2005 and for the years then ended, and the notes thereto. Our consolidated financial statements have been prepared in accordance with Canadian Generally Accepted Accounting Principles ("GAAP"). This MD&A contains forward-looking statements. See "Forward-Looking Information".

The United States dollar is our reporting currency and the functional currency of all of our operations. All figures herein are in United States dollars unless otherwise noted.

EBITDA, net debt, net debt to net debt plus equity, and cash costs are non-GAAP measures described in the Definitions section at the end of this MD&A. Non-GAAP measures do not have any standardized meaning prescribed by GAAP and therefore are unlikely to be comparable to similar measures presented by other companies. These measures are presented because we believe they are useful measures of our liquidity, our operating performance, our financial position or our financial leverage. However, they should not be considered as alternatives to net cash provided by operating activities as a measure of our liquidity or as alternatives to net income as an indicator of our operating performance or any other measure of performance in accordance with Canadian GAAP. There are no directly comparable GAAP measures to any of these measures. However, a quantitative reconciliation of each non-GAAP measure to the nearest comparable GAAP measure is provided in the Definitions section.

In this MD&A, "Fraser Papers", "we", "us" and "our" means Fraser Papers Inc. and all of its subsidiaries while "Company" means Fraser Papers Inc. as a separate corporation. "Brookfield" means Brookfield Asset Management Inc. (a related party by way of a significant shareholding in the Company) and all of its subsidiaries. "Norbord" means Norbord Inc. (the former parent company of Fraser Papers and a related party by virtue of a common significant shareholder) or any of its consolidated subsidiaries. "Acadian" or the "Fund" means Acadian Timber Income Fund (a related party by way of the Company's equity interest in the Fund). The date of this MD&A is February 12, 2007.

INTRODUCTION

This MD&A is intended to provide investors with an understanding of the historical performance of our business, its financial condition and its prospects.

Our 2006 fourth quarter MD&A dated February 6, 2007 and relating to our unaudited interim consolidated financial results and notes thereto for the three month period ended December 31, 2006 is specifically incorporated by reference herein.

OVERVIEW OF BUSINESS

Fraser Papers is an integrated specialty paper company which produces a broad range of specialty packaging and printing papers. We also produce northern bleached hardwood kraft pulp and dimension lumber. The Company has operations in Maine, New Hampshire, New Brunswick and Quebec.

Strategy

Our objective is to achieve a 12% return on equity for long-term shareholders from the sale of our paper products. Fraser Papers currently operates in one business segment (the Paper segment) which involves the manufacture of paper, pulp and lumber. Prior to January 31, 2006, Fraser Papers operated a Timber segment which included freehold timber operations as well as the management of Crown licenses in New Brunswick. The Maine timberlands operations were sold in May, 2005 and the freehold timberlands in New Brunswick were sold in January, 2006. Commencing in 2006, the Company includes the management of its Crown licenses in the Paper segment.

Key aspects of our long-term business strategy include:

- focusing on specialty paper and higher value-added products for printing and packaging applications where we have a sustainable competitive advantage;
- continued innovation and development of new products offered;
- exceeding benchmark industry performance at each of our operations;
- building the business selectively and opportunistically, based on value; and
- maintaining a management culture focussed on execution and performance.

We believe that a focus on specialty papers provides the best opportunity to establish sustainable operating margins and create shareholder value. With the broader paper industry consolidating and rationalizing capacity, we anticipate that the largest players will narrow their focus on broader commodity markets, leaving attractive niche segments in lightweight papers available for smaller producers like Fraser Papers.

We track improvements in product and customer mix, volumes and cost reductions and report to shareholders under our margin improvement program. During 2006, we generated margin improvements of \$31 million relative to 2005. During 2005, we generated margin improvements of \$15 million relative to 2004. Our efforts to improve margins in 2006 were challenged by significant cost increases of \$41 million in our major manufacturing inputs, namely, chemical and energy costs and the effect of a stronger Canadian dollar. We have further opportunities to improve our operating performance which we will implement in 2007.

Fraser Papers will continue to focus our product development efforts on higher value products. Our goal is to replace the least profitable 10% of our products each year with higher value products. In 2006, we developed 38 new paper products and over 10% of our shipments were products developed over the last two years.

During 2005 and 2006, we executed our strategy of surfacing value from our timberlands by monetizing the New Brunswick timberlands in January, 2006 and our Maine timberlands in 2005. We generated net proceeds of approximately \$203 million from these two transactions and maintained fibre security through 20 year fibre supply agreements. These agreements give the Company the right to purchase, at market prices, the same volumes of fibre that it historically received from these lands. We also retained a partial interest in our New Brunswick timberlands through our 22% fully-diluted interest in Acadian. Cash proceeds of \$172 million were used to reduce long-term debt by \$82 million, fund defined benefit pension plans by \$63 million and invest \$27 million in capital, over the past two years.

We will pursue growth opportunities if they are consistent with our strategy. Acquisitions will be done selectively and on a value basis. In January 2007, Fraser Papers announced that it had signed an agreement to purchase Katahdin Holdings Company LLC, the owner of Katahdin Paper Company LLC ("Katahdin") subject to approval by a special committee of the Board and by the shareholders of the Company who are unrelated to Brookfield. The acquisition of Katahdin is consistent with the Company's focus on specialty products where it can develop sustainable advantage.

At December 31, 2006, Fraser Papers continues to have one of the strongest balance sheets among its public competitors with a ratio of net debt to net debt plus equity of 14%. During 2006, the Company increased its borrowing capacity under its existing credit lines and at year end had \$50 million of availability under its revolving working capital facility. Fraser Papers' conservative capital structure and the increased liquidity from the credit lines provide adequate financial flexibility to the Company for execution of its strategy.

RECENT DEVELOPMENTS

Proposed Acquisition of Katahdin

On January 30, 2007, Fraser Papers announced an agreement to acquire Katahdin from Brookfield for approximately \$80 million subject to an adjustment for closing working capital. In addition, Fraser Papers will grant Brookfield a royalty which will provide a percentage of the free cash flows from Katahdin's super-calendered business, initially set at 80% and declining over time as certain targets are met. This acquisition of Katahdin represents an opportunity for Fraser Papers to substantially grow our specialty papers business into two complementary groundwood segments, namely, directory and super-calendered papers. We know these assets well, having managed them on behalf of Brookfield since 2003. We believe the addition of scale, quality and technology that Katahdin's three paper machines bring to our existing asset base will improve the competitiveness of the Company.

The transaction is consistent with our strategy to focus on niche segments in the broader paper markets where we can establish sustainable competitive advantage. With its location in central Maine, Katahdin benefits from access to a healthy fibre basket, skilled labour, infrastructure, and proximity to our customers' press rooms in the Northeast and Midwest.

This acquisition qualifies as a related-party transaction under applicable Canadian securities regulations. The board of directors of the Company has established a special committee of the Board, comprised entirely of directors independent of Brookfield, to evaluate the potential acquisition of Katahdin. The acquisition will have to be approved by the special committee and by shareholders who are unrelated to Brookfield. Subject to receiving these approvals, the transaction is expected to close in April, 2007.

Sale of New Brunswick Timberlands

The Company sold its timberlands in New Brunswick to Acadian in a transaction that closed on January 31, 2006. Acadian was a newly formed income fund which financed the acquisition through an initial public offering of equity securities and bank debt.

The Company received net proceeds of \$125 million including cash of \$94 million and securities with a value of \$31 million. The securities are exchangeable for 3.6 million units of the Fund, representing a 22% interest in the Fund, on a fully-diluted basis. These securities have a book value of nil as at December 31, 2006, but based on quoted market prices at December 31, 2006, the Company estimates the fair market value to be \$29 million.

The Company realized a pre-tax gain of \$71 million on the sale of the timberlands. The gain on the sale was the result of the net cash proceeds of \$94 million adjusted for the proportionate share of the net liabilities of the Fund and the net assets contributed to the Fund. The Company accounts for its interest in the Fund on an equity basis. The Company's investment in the Fund entitles it to regular cash distributions from the Fund. During the year, the Company recognized \$2 million of equity earnings in the Fund based on its pro-rata share of the earnings of Acadian. The Company received \$2 million in distributions from the Fund during 2006.

In conjunction with the sale of assets to the Fund, we entered into a 20 year fibre supply agreement with Acadian which will provide us with substantially the same volumes of fibre that we had historically received from our freehold timberlands at prevailing market prices.

Sale of the Maine Timberlands

During 2005, Fraser Papers sold 240,000 acres of timberlands in Maine for net proceeds of \$78 million and a pre-tax gain of \$46 million. At the time of the sale, Fraser Papers also entered into a 20 year fibre supply agreement which provides us with the right to purchase fibre at prevailing market prices at volumes that approximate its historical usage from the sold lands.

Closure of Berlin pulp mill

During 2006, Fraser Papers announced the permanent closure of its pulp mill in Berlin, New Hampshire. We have recorded a charge of \$50 million of which \$45 million is related to an impairment in property, plant and equipment and other assets and the balance was for various costs related to closure. The mill, which had an annual capacity of 227,000 tonnes of NBHK pulp, was shut down in the second quarter and affected approximately 250 employees.

The decision to shut down the pulp mill enabled a consolidation of Fraser Papers' market pulp sales position at its remaining hardwood pulp mill in Thurso, Quebec and eliminated lower margin export sales, providing for an overall improvement in the average realization on sales. In 2005, over 55%, or 130,000 tonnes, of the total pulp produced at the Berlin pulp mill was surplus to the requirements of the adjacent Gorham paper mill and was sold to other paper mills, including Fraser Papers' mill located in Madawaska, Maine.

Smart Papers Restructuring

During the first quarter of 2005, Fraser Papers sold a production facility in Park Falls, Wisconsin, a leased distribution facility in West Chicago, Illinois and related net assets (collectively, the "Midwest Operations"). As consideration, Fraser Papers received a 40% common equity interest in an entity which owned Smart Papers LLC and the Midwest Operations.

Smart Papers LLC and its affiliates ("Smart Papers"), a previous equity investment of the Company, filed for creditor protection under Chapter 11 of the U.S. Bankruptcy Code, in the first quarter of 2006. As a result, Fraser Papers recorded a charge of \$111 million, consisting of an impairment charge against its investment in Smart Papers of \$74 million, a provision of \$15 million against a receivable from Smart Papers related to the lease of a boiler at one of its locations and estimated accruals of \$22 million related to the financial guarantees.

During 2006, Fraser Papers completed the sale of equipment previously leased to Smart Papers. The total proceeds of \$4 million, including contingent consideration of \$1 million, are receivable in instalments over seven years. Fraser Papers will recognize the benefit of these proceeds when the receipt is reasonably assured. During the year, Fraser Papers received less than \$1 million of proceeds from the sale.

The Company continues its efforts to preserve its interests in the bankruptcy proceedings and mitigate any remaining exposures to the extent possible.

Senior Unsecured Notes

During 2005, the Company issued \$150 million of senior unsecured notes ("Notes"). During 2006, the Company purchased \$30 million in principal amount of the Notes in the market. The Notes were purchased for \$26 million, resulting in a gain of \$3 million, net of a write-down in debt issuance costs of \$1 million. The net gain is reflected in the Consolidated Statement of Operations.

Also during 2006, the Company closed a tender offer to repay up to \$66 million in principal amount of the Notes. The Company repaid \$52 million of Notes to the public and cancelled \$14 million of Notes held by Fraser Papers. A write-down of deferred financing costs of \$1 million, related to the repayments under the tender offer, has been reflected in the Consolidated Statements of Operations and Statements of Cash Flows.

As a result of the market repurchases and the tender offer, the Company holds \$16 million of Notes. These Notes have not been cancelled but have been netted against long-term debt on the Consolidated Balance Sheet.

Sale of Paperboard Assets

During 2005, Fraser Papers sold its paperboard assets (the "Paperboard Operations") for proceeds of \$5 million. Our small paperboard market share, high cost structure and consolidation in the industry were impacting Fraser Papers' ability to generate sustainable profits. The sale of the Paperboard Operations was consistent with our strategy to focus on products for which we can develop a sustainable competitive advantage.

Impairment Charges

During 2005, Fraser Papers recorded a \$40 million pre-tax non-cash impairment charge against its pulp mill in Thurso, Quebec. Worldwide pulp capacity additions, the continued strength of the Canadian dollar and rising input costs negatively affected the long-term profitability of this operation. The fair value was determined based on a discounted cash flow analysis of the long-term projected operating results of the mill.

During 2005, prior to the sale of the Paperboard Operations, the Company recorded an impairment charge of \$1 million based on a firm offer to purchase.

BUSINESS PROFILE

Headquartered in Toronto, Canada, we employed approximately 2,600 people at December 31, 2006 at manufacturing facilities in the United States and Canada. The geographical breakdown of property, plant and equipment at the end of 2006 was 53% U.S. and 47% Canada.

Principal manufacturing facilities included:

- 13 paper machines at two paper mills in Madawaska, ME and Gorham, NH;
- one market pulp mill, producing northern hardwood kraft pulp in Thurso, QC;
- one integrated pulp operation in Edmundston, NB, producing softwood sulphite pulp and groundwood pulp; and
- four sawmills in New Brunswick and Maine.

The annual production capacity of these facilities at December 31, 2006 was:

- 680,000 tons of paper, including towel;
- 460 million board feet of lumber;
- 250,000 tonnes of market pulp;
- 260,000 tonnes of internally used sulphite pulp; and
- 120,000 tonnes of internally used groundwood pulp.

In conjunction with the sale of the timberlands in 2005 and 2006, Fraser Papers has entered into agreements whereby it will have the right to purchase fibre for a period of up to 20 years at prevailing market prices. The amount of fibre available to Fraser Papers under the agreements will approximate its historical consumption from the timberlands. Fraser Papers also purchases timber, chips and other wood residues on the open market.

In addition, we manage Katahdin, an affiliate of Brookfield, for a management fee.

KEY FACTORS AFFECTING OUR BUSINESS

Fraser Papers' operations and financial results are influenced by a number of factors, some of which we can control and some of which are outside of our control. A full discussion of the risks of the business is provided in the Company's Annual Information Form which is available at www.sedar.com.

Cyclical Business: In general, the Forest Products industry is highly cyclical characterized by periods of rising demand, supply shortages and rapidly rising market prices, leading to increased production and increased capital investment until new capacity and supply exceed demand. Those periods are then typically followed by periods of reduced market prices and excess capacity until the cycle is repeated.

Fraser Papers' strategy is to concentrate on products for which we can establish sustainable competitive advantage. We believe we lessen the threat of substitution and benefit from certain barriers to market entry that are related to quality and extensive product qualification requirements. By focusing our mix on value-added products with narrow technical specifications we also believe that we mitigate some of the cyclical risks. We accentuate our strengths by having small, flexible paper machines, by being a leader in developing high quality specialty packaging and paper grades and by providing superior customer and technical service. Our focus is to increase our market share in the specialty packaging and printing businesses such as those used in food packaging, thermal applications and financial printing.

Competitive Environment: The Forest Products industry is highly competitive. Our paper, pulp and lumber businesses compete directly with some of the leading manufacturers in the world. In order to differentiate Fraser Papers from our competition, we strive to provide excellent customer and technical service; focus on products which add value for our customer; and make products where we can leverage our unique manufacturing capabilities. Our sales force and technical service departments work very closely with our customers to ensure that Fraser Papers' products meet the customer's highly technical and operational needs and bring value to their process.

Cost Control: Fraser Papers' cost structure is highly dependant upon securing competitive pricing and ensuring efficient usage of raw material and energy inputs. Changes in these cost inputs can have a material effect on our results. To help mitigate some of the cost pressures, we have long-term fibre supply contracts for wood, we have balanced our market pulp requirements with internal production capacity, we focus on reducing input consumption rates, and from time to time we have hedged commodity prices.

Fraser Papers' margin improvement plan concentrates on the usage of raw materials and discretionary spending. In 2006, we created \$10 million of margin improvements compared to 2005 costs by focussing on fibre substitution and energy optimization.

Foreign Currency Risk: With 47% of Fraser Papers' plant, property and equipment located in Canada and 100% of our sales denominated in U.S. dollars, we are exposed to fluctuations in foreign exchange rates. Changes in these exchange rates could have a material effect on our results of operations. To mitigate these effects, we hedge both cash flow and balance sheet exposure when appropriate.

Margin Improvement

Fraser Papers' margin improvement program measures year-over-year improvements in EBITDA resulting from higher sales volumes, improved product mix and cost reduction assuming constant exchange rates and commodity prices. We are committed to the ongoing program which is the cornerstone of our cost reduction efforts. Targets for the program are set annually and actual results are measured against these targets on a monthly basis. The Company's annual incentive programs are tied to the targets of the margin improvement program.

For the year ended December 31, 2006, Fraser Papers generated \$31 million of margin improvements, exceeding the 2006 goal of \$29 million. The majority of the improvement resulted from improved sales mix, energy usage and fibre utilization. In 2005, Fraser Papers generated margin improvements of \$15 million compared to 2004.

The benefits achieved under our margin improvement program and improved product prices for paper and pulp were more than offset by the negative impact of lower lumber prices and higher fibre and energy costs and the effect of the stronger Canadian dollar. Energy and chemical prices and the impact of foreign exchange negatively impacted our EBITDA in 2006 by \$41 million relative to 2005. In 2005, these costs negatively impacted us by \$34 million relative to 2004.

Softwood Lumber Duties

Since 2002, the Company has paid antidumping duties ("ADD") on lumber it exports to the U.S. representing substantially all of our lumber sold from our Canadian sawmills. Since the inception of the duties, the Company paid \$16 million on these exports.

During 2006, the Company received refunds of \$14 million (including interest of \$2 million) related to ADD paid in previous years as a result of an administrative review in the normal course and the establishment of a new lumber agreement between Canada and the U.S. These refunds were recognized as income. The Company does not expect any further refunds.

RESULTS OF OPERATIONS AND RELATED INFORMATION

Selected Annual Information

(\$millions, except per share amounts)	For Year Ended December 31	
	2006	2005
Net sales ⁽¹⁾	\$ 796	\$ 918
EBITDA	(7)	4
Loss	(114)	(29)
Total assets	556	788
Net debt	55	76
Loss per share, basic	\$ (3.86)	\$ (0.98)

(1) Net sales are gross sales, less freight costs, commissions, and discounts and rebates to customers.

Overview

We experienced lower EBITDA in 2006 in a challenging operating environment, underscored by significant cost pressures. We achieved a number of objectives to reposition assets and optimize our financial position:

- Monetization of our timberlands in New Brunswick, generating net cash proceeds of \$94 million and a 22% interest in Acadian.
- Secured 20 year fibre supply, substantially equal to the fibre we previously received from the lands we sold in New Brunswick.
- Increased shipments of specialty packaging and printing papers by 9% from 332,000 tons in 2005 to 362,000 tons in 2006.

- Achieved \$31 million in margin improvements from sales mix optimizations and fibre, chemical and energy usage improvements.
- Repurchase and repayment of \$82 million of long-term debt and increased borrowing capacity under our operating line of credit.
- Funded \$40 million in pension and post-retirement obligations and increased the funded status of our defined benefit obligations to 81%, from 70% in 2005.
- Achieved environmental compliance of close to 100%.
- Consolidated our market pulp sales position and eliminated lower margin export sales with the permanent shutdown of the Berlin hardwood kraft pulp mill.

Summary of Quarterly Results

<i>(\$millions, except per share amounts)</i>	Net Sales	Earnings (loss)	Earnings (loss) per share <i>(basic and diluted)</i>
2006			
4th Quarter	\$ 187	\$ (12)	\$ (0.40)
3rd Quarter	185	(6)	(0.21)
2nd Quarter	208	(18)	(0.61)
1st Quarter	216	(78)	(2.64)
2005			
4th Quarter	\$ 219	\$ (22)	\$ (0.75)
3rd Quarter	226	(5)	(0.16)
2nd Quarter	217	(5)	(0.17)
1st Quarter	256	3	0.10

Net Sales

Net sales decreased by \$122 million in 2006 to \$796 million from \$918 million in 2005. The decrease was the result of the sale of the New Brunswick timberlands and the closure of the Berlin pulp mill in 2006 as well as the sale of the Midwest Operations, the Paperboard Operations and the Maine timberlands in 2005. After adjusting for the divestitures, sales were down \$15 million or 2% from 2005. Lumber sales in 2006 declined from the prior year by \$21 million due to lower selling prices and market-related downtime. External market pulp sales from the Thurso pulp mill were also reduced by \$27 million due to increased internal pulp shipments to the paper mill in Gorham, New Hampshire with the closure of the Berlin, New Hampshire market pulp mill. These revenue reductions were offset partially by higher realized revenues of \$45 million in the pulp and paper businesses. These increased revenues were a result of \$21 million in price increases and \$24 million in product mix improvements.

Paper segment sales accounted for 99% of net sales in 2006 and 95% in 2005 whereas Timber segment sales accounted for 1% in 2006 and 5% in 2005. See discussion in "Segment Results".

<i>(\$millions)</i>	For Year Ended December 31	
	2006	2005
Paper	\$ 792	\$ 874
Timber	6	74
Inter-segment	(2)	(30)
Total	\$ 796	\$ 918

EBITDA

EBITDA decreased by \$11 million in fiscal 2006 to a \$7 million loss from an EBITDA of \$4 million in fiscal 2005.

<i>(\$millions)</i>	For Year Ended December 31	
	2006	2005
Paper	\$ (9)	\$ (8)
Timber	2	12
Total	\$ (7)	\$ 4

In 2006, the Paper segment reported an EBITDA loss of \$9 million, up marginally from an EBITDA loss of \$8 million in 2005. Within the Paper segment, the results of lumber operations were lower while the results of our paper and pulp operations improved. The EBITDA from our lumber operations was lower by \$4 million, even after the recognition of \$14 million in ADD refunds, due to lower prices and the impact of market-related downtime as a result of weak markets relative to 2005. Our paper mills generated EBITDA of \$2 million in 2006 compared to \$1 million in 2005 with selling price and mix improvements. The results of our pulp operations improved by \$2 million due to stronger pricing and the closure of the

Berlin pulp mill during the year. Unfortunately, much of the benefit of these improvements was offset by the negative impact of significant cost increases in chemicals, energy and the strengthening Canadian dollar. The Timber segment contributed \$2 million of EBITDA in 2006, compared to \$12 million in 2005. See discussion in "Segment Results".

Depreciation

Depreciation expense for 2006 was \$32 million, down from the \$39 million recorded in 2005. The decrease in depreciation is due primarily to the sale of our New Brunswick and Maine timberlands, the closure of the Berlin pulp mill and the impact of the impairment charge recorded against the assets of the Thurso pulp mill in 2005.

Segment Results

At the start of 2006 and in 2005, Fraser Papers operated in two segments: Paper and Timber. With the sale of its remaining assets in the Timber segment in January, 2006, the Company currently operates in one segment.

Paper Segment

The Paper segment includes our paper, pulp and lumber operations at December 31, 2006. The Paper segment is composed of 13 paper machines at two locations, one market pulp mill, one integrated pulp mill and four sawmills. The Berlin market pulp mill was closed in 2006 and the Paperboard Operations and Midwest Operations were sold in 2005.

(\$millions)	For Year Ended December 31	
	2006	2005
Net sales	\$ 792	\$ 874
EBITDA	(9)	(8)
Depreciation	32	38
Capital investments	12	49

The EBITDA for each of these operations is as follows:

(\$millions)	For Year Ended December 31	
	2006	2005
Paper	\$ 2	\$ 1
Pulp	(13)	(15)
Lumber	2	6
Total	\$ (9)	\$ (8)

The Paper segment includes the production of uncoated freesheet and groundwood papers, towel, hardwood pulp and softwood lumber. The Company closed its Berlin market pulp mill in 2006 and sold its Midwest Operations and Paperboard Operations in 2005 which resulted in improved EBITDA despite the reduction in sales. EBITDA for the Paper segment was lower by \$1 million as improvements in paper and pulp operations were partially offset by weaker results from the lumber operations.

Markets

Uncoated Freesheet Paper

Fraser Papers focuses on market specialty segments for specialty packaging and paper applications where we have established competitive advantage due to our technical competency and superior customer service. We have approximately 82% of our freesheet paper sales that fit this description, and the strategy is to transition the balance into new or existing market segments.

Fraser Papers' total uncoated freesheet net realized pricing increased by 7% over 2005 levels. Our other freesheet papers pricing increased by 17%, a comparable improvement to the benchmark commodity pricing trend. Our specialty packaging and printing papers pricing improved by 3% reflecting its more stable pricing.

Fraser Papers' shipments of uncoated freesheet increased by 1% over 2005; however, we concentrated on our strategy of growing specialty packaging and papers grades. Specialty packaging and papers shipments grew by 9% compared to 2005 while our other freesheet papers declined by 25%.

Specialty packaging papers are used for food packaging which contain both stain resistant and non-stain resistant papers. Fraser Papers has the ability to meet tight technical standards for applications such as pet food bags and dry mix consumer pouches and bags. Fraser Papers' packaging papers have grown 8% for the year 2006 compared to 2005.

Specialty printing papers include grades that are characterized by narrow technical specifications and niche applications including labelling and thermal point-of-sale receipts as well as lightweight opaque grades for financial print applications. Our growth in this product line was 9% for the year 2006 compared to 2005.

Other freesheet papers include a number of commodity uncoated freesheet grades. The 2006 volume of other freesheet grades declined by 25% over 2005 levels as Fraser Papers narrows its focus on packaging and specialty paper products in strategic markets. These products are a key focus of efforts to replace our most unprofitable grades and customers over time.

Uncoated freesheet paper products include copier papers, tablet papers, book papers and printing papers. Market conditions continue to be healthy for uncoated freesheet paper products. The supply for uncoated freesheet grades has decreased over the last few years due to mill conversions and closures with more capacity constraints expected in 2007. Aggregate demand for uncoated freesheet declined by 1% over 2005 due to electronic substitution and the migration towards high brightness uncoated groundwood grades. As a result of the supply constriction and the slight demand decrease, average benchmark pricing increased by 15% or \$106 per ton over 2005 to a level of \$815 per ton.

Uncoated Groundwood Paper

Uncoated groundwood paper products include paper for catalogues, magazines, directories and inserts. Fraser Papers' groundwood strategy is to focus on targeted market segments that match our technical competencies for lightweight, high brightness groundwood grades.

Market conditions continue to be healthy for uncoated groundwood paper products, as Fraser Papers' net realized pricing increased by 10% over 2005 levels. This was an improvement over the benchmark commodity pricing which increased by 7%, or \$47 per ton during the same period. Fraser Papers' shipments of uncoated groundwood increased by 2% over 2005 levels.

Coated Groundwood Paper

With respect to the coated groundwood market, Fraser Papers' strategy is to focus on ultra-lightweight coated groundwood grades, a higher value added grade line with better pricing. Fraser Papers' coated groundwood net realized pricing decreased by 10% over 2005 levels reflecting the impact of a product mix with heavier weight coated groundwood grades. Fraser Papers' shipments of coated groundwood decreased by 11% over 2005 levels.

Market conditions have been weak for coated groundwood paper products. Supply of coated groundwood grades has increased over the last few years due to imports; however, demand for coated groundwood increased by only 1% over 2005. As a result, benchmark pricing decreased by 1% or \$11 per ton over 2005 to a level of \$975 per ton.

Towel

Fraser Papers' towel business is very small compared to the overall North American market. Our focus is on the away-from-home industrial towel markets. Fraser Papers' towel net realized pricing increased by 6% over 2005 levels while shipments increased by 3% over 2005.

Market Pulp

The predominant products of market pulp are northern bleached softwood kraft ("NBSK") and northern bleached hardwood kraft ("NBHK"). Market conditions for both qualities were very strong during 2006. The markets for these grades of pulp are influenced by global supply and demand with the largest variations in price often attributed to the purchasing patterns of large net pulp importing nations in Western Europe, in addition to recent activity from emerging markets such as China. Supply of NBSK remained flat compared to 2005, while the supply of NBHK increased by 5% in 2006 due to capacity increases in South America with more additions scheduled in 2007. Demand for NBSK increased by 1% over 2005 and NBHK increased by 7%. As a result of demand increases, benchmark pricing for NBSK has increased by 11% or \$76 per tonne over 2005 to an average in 2006 of \$722 per tonne. Benchmark pricing for NBHK has also increased by 9% or \$55 per tonne over 2005 to an average in 2006 of \$654 per tonne.

Fraser Papers manufactures NBHK, most of which is sold internally to Fraser Papers' paper mills. With the closure of the Berlin pulp mill in 2006, Fraser Papers is relatively balanced between its total market pulp purchases and its total market pulp sales, with purchases, including NBSK, of 226,000 tonnes and sales of 245,000 tonnes.

Fraser Papers' pulp marketing strategy is to focus on specialty pulp products due to our fibre resources and technical competencies. Fraser Papers' NBHK net realized pricing increased by 11% over 2005 levels and shipments decreased by 29% over 2005 levels due to the permanent closure of the Berlin pulp mill.

Lumber

Fraser Papers produces softwood lumber into markets predominately in the U.S. northeast. A significant downturn in the U.S. housing market led to a deterioration in the market conditions for lumber during 2006. Demand for lumber weakened by 36% over 2005, which was only partially offset by reductions in supply of 7%. As a result of the weakened demand, benchmark pricing for lumber decreased by 12% or \$48 per Mmfbm over 2005 to an average in 2006 of \$363 per Mmfbm.

Fraser Papers' lumber net realized pricing decreased by 9% over 2005 levels and shipments decreased by 8% over 2005 levels due to the market downtime taken at three of our four sawmills.

Operations

Paper Operations

	For Year Ended December 31	
	2006	2005
Net sales (US\$ millions)	596	563
EBITDA (US\$ millions)	2	1
EBITDA (\$ per ton)	3	2
EBITDA margin ⁽²⁾	0%	0%
Shipments (000 tons) ⁽¹⁾		
Specialty packaging	55	51
Specialty printing	307	281
Other freesheet papers	81	108
Specialty groundwood	117	115
Lightweight coated groundwood	59	66
Towel	39	38
	658	659
Average Revenue Realized (\$ per ton) ⁽¹⁾		
Specialty packaging	1,172	1,136
Specialty printing	948	918
Other freesheet papers	821	700
Specialty groundwood	766	696
Lightweight coated groundwood	782	872
Towel	774	728
Weighted Average (\$ per ton)	893	845
Average Cash Operating Cost (\$ per ton)	881	819
Reference Prices (\$ per ton) ⁽³⁾		
50# offset rolls	815	709
34# no. 5 rolls	975	986
22.1# white directory	722	675

(1) 2005 volumes exclude divested Midwest Operations and Paperboard Operations.

(2) EBITDA Margin is EBITDA as a percentage of Net sales.

(3) Reference prices are from Resource Information Systems, Inc. ("RISI").

Fraser Papers is focussed on improving the operating performance at its paper operations. This includes increasing production of internal fibre from its sulphite and groundwood pulp mill at East Papers which will reduce the cost of fibre to the paper machines. At Gorham, we have plans to optimize our use of alternative fibres and fillers.

Fraser Papers' average revenue realized for all paper grades improved by 6% compared to 2005 and our margin improvement initiatives improved our total cost of paper production by \$6 million. However, chemical and energy costs and the impact of the stronger Canadian dollar increased costs by \$24 million offsetting most of the price increases and the achieved margin improvements. As a result, EBITDA of the paper operations increased from \$1 million in 2005 to \$2 million in 2006.

Performance at the East Papers operations was comparable to 2005, with average throughput of 1,310 tons per day of paper, only slightly lower despite productivity issues at the sulphite mill in the second quarter. The annual maintenance shutdown at East Papers identified additional repairs that were required to the recovery boiler and led to an unscheduled maintenance period of eight days at the pulp mill in the second quarter and downtime on two paper machines. East Papers' margin improvement program more than offset the cost of the unscheduled outages primarily due to improved sales mix and improved energy usage. However, continued pressures from high fibre and energy costs and the strength of the Canadian dollar resulted in increased costs of \$22 million. Pricing for all freesheet papers, which represent a majority of the volume, improved by 4% over 2005. Uncoated groundwood prices improved by 10% over 2005 whereas coated groundwood declined by 10%.

The paper mill at Gorham increased total production of freesheet paper and towel by approximately 1%, running all five paper machines at the facility at an average of 508 tons per day of paper, for the full year 2006. Gorham's margin improvement program improved sales mix and fibre usage optimization. The increases in fibre and energy costs partially offset the higher volumes and cost reductions achieved in 2006. Average prices for uncoated freesheet paper, which represents the majority of the production, increased 14% over 2005 due to mix improvements and average towel prices increased approximately 6%.

Pulp Operations

	For Year Ended December 31	
	2006	2005
Net Sales (US\$ millions)	80	132
EBITDA (Thurso) (US\$ millions)	(4)	(2)
EBITDA (Berlin) (US\$ millions)	(5)	(8)
Loss on Pulp Hedge (US\$ millions)	(4)	(5)
	(13)	(15)
Pulp EBITDA (\$ per tonne)	(49)	(40)
EBITDA Margin ⁽¹⁾	(16)%	(11)%
Shipments (000 tonne) ⁽²⁾	263	371
Average Revenue Realized (\$ per tonne) ⁽²⁾	505	455
Average Cash Operating Costs (\$ per tonne)	528	475
Reference Price (\$ per tonne) ⁽³⁾		
NBHK market pulp	654	599

(1) EBITDA Margin is EBITDA as a percentage of net sales.

(2) Pulp volumes and revenues realized include internal sales but exclude pulp hedges.

(3) Reference prices are from RISI's Pulp and Paper Weekly.

Following the closure of the Berlin pulp mill, Fraser Papers has redirected a portion of its market pulp to internal use thereby eliminating export sales and decreasing the exposure to market pulp prices. Additionally, the closure of the Berlin pulp mill has placed Fraser Papers essentially in a balanced position for total market pulp volume which includes NBHK, NBSK and Southern Bleached Softwood Kraft.

EBITDA for the pulp operations was negative at \$13 million, compared to negative EBITDA of \$15 million in 2005. Thurso's results declined by \$2 million due to a scheduled annual maintenance shut in the fourth quarter which resulted in additional costs as more repairs were completed than originally planned and the mill ran into operational issues during the start-up. Thurso had pricing and mix improvements of \$14 million which were partially offset by higher energy costs and the impact of the stronger Canadian dollar relative to 2005.

The results of pulp operations include losses on pulp hedges of \$4 million for the current year and \$5 million for last year. The hedges expired at the end of 2006.

Lumber Operations

	For Year Ended December 31	
	2006	2005
Net sales (US\$ millions)	116	137
Anti-dumping duties refund (US\$millions)	14	–
EBITDA (US\$millions)	2	6
EBITDA (\$ per Mmfbm)	5	15
EBITDA Margin ⁽²⁾	2%	4%
Shipments (Mmfbm)	377	412
Average Revenue Realized (\$ per Mmfbm)	304	333
Average Cash Operating Cost (\$ per Mmfbm) ⁽³⁾	336	318
Reference Price (\$ per Mmfbm) ⁽¹⁾		
Boston SPF 2X4 #2&Btr	363	411

(1) Reference prices are from Random Lengths Publication.

(2) EBITDA Margin is EBITDA as a percentage of net sales.

(3) Cash operating costs exclude refunds of Anti-Dumping Duties.

The sawmills in Maine and New Brunswick produce lumber and supply approximately 55% of the chips required annually by the sulphite pulp mill in Edmundston. Year-over-year, the decline in average lumber prices was approximately 9%. The

lower lumber prices resulted in an \$11 million decrease in sales as compared to 2005. The declining prices, higher wood costs and the stronger Canadian dollar led us to take market-related downtime of 14 weeks at one of our Canadian sawmills, 11 weeks at the other Canadian sawmill and four weeks at one of our sawmills in Maine in 2006. The downtime affected our lumber shipments in 2006, which were down 7% compared to 2005. At the same time, rising wood costs at the sawmills resulted in increased costs compared to 2005. These negative trends were partially offset by our margin improvement initiatives and the positive impact of the \$14 million of lumber anti-dumping duty refunds. EBITDA from our lumber operations fell from \$6 million in 2005 to \$2 million in 2006.

In 2006, Fraser Papers targeted strategic capital spending at its Juniper, New Brunswick sawmill to improve its efficiency and throughput. These improvements should be fully realized in 2007.

Timber Segment

(\$millions)	For Year Ended December 31	
	2006	2005
Net sales	\$ 4	\$ 74
EBITDA	2	12
Depreciation	—	1
Capital investments	—	—

Fraser Papers sold its freehold New Brunswick timberlands on January 31, 2006 and its Maine timberlands in the second quarter of 2005. Concurrent with the sale of those assets, Fraser Papers secured its long-term fibre requirements through 20 year fibre supply agreements to purchase, at market prices, substantially the same volumes of wood as its historical usage from those timberlands.

SIGNIFICANT ACCOUNTING POLICIES AND ESTIMATES

The preparation of financial statements in conformity with GAAP requires management to make estimates that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities, and the reported revenues and expenses during the period. Significant estimates include the determination of the carrying value and useful lives of property, plant and equipment, provisions for employee future benefits and future income tax assets and liabilities. Actual results could differ from those estimates.

The impairment charge booked against the assets of the Thurso pulp mill in 2005 was based on significant estimates due to the inherent uncertainty in predicting long-term cash flows, exchange rates and commodity prices. Also, the provision for liabilities associated with the Smart Papers restructuring and the Berlin pulp mill closure were based on estimates of recoverability of certain claims and future cash flows. These estimates may be materially different from actual future cash flows due to a variety of factors including fluctuations in commodity prices, recoverability and exchange rates.

Revenue recognition

Net sales are net of freight costs, commissions, discounts and rebates and are recognized when the title and risks of ownership pass to the purchaser. This generally occurs when goods are shipped. Sales are governed by contract or by standard industry terms. Revenue is not recognized prior to the completion of those terms. The majority of product is shipped via third party transport on an FOB shipping basis. In all cases, product is subject to quality testing to ensure it meets applicable standards prior to shipment.

Property, plant and equipment

Property, plant and equipment are recorded at cost and are depreciated on a straight-line basis. The rates of depreciation are intended to fully depreciate manufacturing and non-manufacturing assets over the following periods which approximate their useful lives:

Buildings	20 to 40 years
Sawmills and lumber production equipment	10 to 15 years
Paper and pulp mill machinery and production equipment	20 years
Logging machinery and equipment	4 to 10 years

These periods are periodically assessed to ensure that they continue to approximate the useful lives of the related assets.

Financial Instruments

We use derivative financial instruments solely for the purpose of managing our foreign exchange and commodity price exposures. These activities are governed by the Board of Directors' approved financial policies that cover risk identification,

measurement and reporting. Derivative transactions are executed only with approved counterparties under master netting agreements. Derivative contracts, which are deemed to be highly effective in offsetting changes in the fair value or cash flows of hedged items, are designated as hedges of specific exposures and accordingly, all gains and losses on these instruments are recognized in the same manner as the item being hedged.

LIQUIDITY AND CAPITAL RESOURCES

Cash flow from operations before net change in non-cash working capital balances in 2006 amounted to a use of cash of \$45 million. In addition to reducing the unfunded balance of our defined benefit pension plans, operating losses and restructuring costs related to Smart Papers and the closure of the Berlin pulp mill were the primary causes for the negative cash flow. The Smart Papers payments related to certain financial guarantees for obligations of the Midwest Operations when those operations were sold to Smart Papers. Negative cash flow from operations before net change in non-cash working capital balances in 2005 of \$25 million was primarily the result of employment benefit plan funding.

Net change in non-cash working capital balances amounted to a use of cash of \$21 million in 2006 due primarily to payments of 2005 restructuring reserves of \$6 million, increases in paper inventory of \$5 million to better service customers and higher levels of log inventory of \$3 million. This compares to a use of cash of \$20 million in 2005.

Capital investments in 2006 amounted to \$12 million. The Company installed a high grader / edger optimizer at its sawmill in Juniper, New Brunswick for \$3 million. The remaining \$9 million was directed toward capital investments necessary to maintain our operations. In 2005, capital investments included \$34 million related to the acquisition of a boiler at the Berlin pulp mill and \$4 million to overhaul our cogeneration plant in Edmundston, New Brunswick. The remaining \$11 million of capital expenditures was from the acquisition of equipment previously under lease and other sustaining capital investments.

In 2005, Fraser Papers purchased two boilers: one in Park Falls, Wisconsin and one in Berlin, New Hampshire. These purchases, totaling \$49 million were made, in part, to remove Norbord from certain guarantees it had provided on behalf of Fraser Papers. In addition, a large portion of the payments relating to Smart Papers were for guarantees provided by Norbord. As of December 31, 2006, the maximum amount payable under the remaining guarantees is \$7 million.

In 2005 and 2006, Fraser Papers sold its timberlands operations in Maine and New Brunswick. Net cash proceeds on these dispositions amounted to \$172 million. The proceeds were used primarily to fund pension plans, repay debt and invest in capital.

At December 31, 2006 Fraser Papers' cash and cash equivalents amounted to \$13 million, resulting in net debt of \$55 million, representing 14% of net debt plus equity as compared to 15% at the end of 2005.

On March 15, 2005, the Company issued \$150 million of Notes which bear interest at 8.75% and are due in 2015. Proceeds from the issuance of these Notes were used, in part, to repay \$75 million of debt owing to Brookfield. The indenture agreement governing the Notes contains certain covenants, the more significant of which include restrictions on the incurrence of additional indebtedness, sales of assets and reinvestment of proceeds, mergers, creation of liens, payment of dividends and repurchase of the Company's shares.

In 2006, the Company purchased \$30 million of the Notes, repaid \$52 million of the Notes and cancelled \$14 million held by Fraser Papers, leaving \$68 million outstanding. At December 31, 2006, the Company holds \$16 million of these Notes.

During 2006, the Company increased its committed revolving credit facility to \$90 million. The facility matures in November 2008 and bears interest at market rates. Borrowings under the facility are secured by a first charge against accounts receivable and inventory. At December 31, 2006, \$40 million of this facility was utilized, all of which was in the form of letters of credit to certain creditors.

At December 31, 2006, Fraser Papers had loss carry-forwards for income taxes of \$194 million of net losses in the United States and \$5 million in Canada. The tax benefit of losses in the U.S. have not been reflected in the financial statements as it is not more likely than not that these losses will be utilized. Loss carry-forwards will be available to reduce income taxes otherwise payable in future years.

Fraser Papers currently has significant cash balances and available liquidity under credit lines to support growth, weather any downturns and pursue its business plan. In addition, Fraser Papers has significant working capital which could be utilized to support additional borrowings.

Contractual Obligations

The following table presents the total contractual obligations for which cash flows are fixed or determinable as of December 31, 2006:

<i>(\$millions)</i>	Total	Less than one year	One to three years	Four to five years	After five years
Long-term debt	\$ 68	\$ —	\$ —	\$ —	\$ 68
Operating leases	1	1	—	—	—
Purchase obligations	49	37	12	—	—
Total contractual obligations	\$ 118	\$ 38	\$ 12	\$ —	\$ 68

Obligations under operating leases include future payments for warehouse and other office facilities, and equipment leases. The purchase obligations are commitments for the purchase of raw materials, primarily softwood kraft pulp, and energy.

Norbord provides guarantees for certain obligations of Fraser Papers under a financial commitments agreement. At December 31, 2006, the maximum potential amount of the obligations guaranteed was estimated to be \$7 million. These guarantees have not been included in the table above.

Asset Retirement Obligations

Asset retirement obligations relate primarily to closure costs and post-closure maintenance costs for landfills in the Paper segment. The liability is reflected in Other Liabilities on our Consolidated Balance Sheet at the discounted value of expected future cash flows. The liability associated with these obligations is reduced as these obligations are paid and the asset associated with these obligations is depreciated over the estimated useful life of the related facility. The obligations represent estimated future payments of \$19 million which have been discounted at an average rate of 8.75%. Total expense for the year related to asset retirement obligations was less than \$1 million, unchanged from 2005. In addition to the asset retirement obligations recorded, we may have other obligations in the event of a permanent plant shutdown. However, our plant assets have indeterminate lives and, therefore, the associated asset retirement obligations are not reasonably estimable and liabilities cannot be established.

Employee Benefit Plans

Our obligations under our defined benefit pension plans are determined periodically through actuarial valuations, which are the basis for calculating pension expense and determining pension funding. At December 31, 2006, defined benefit pension plan assets were \$475 million, up from \$415 million in 2005, while the benefit obligations of \$588 million were slightly lower than the \$590 million of obligations in 2005. At December 31, 2006, the unfunded pension liability was \$113 million, a marked improvement compared to the \$175 million of unfunded liability at December 31, 2005. The decrease of \$62 million was primarily the result of improved returns on plan assets of 16.1%, compared to 7.8% in 2005 and defined benefit pension funding of \$33 million. The funded status of our defined benefit pension plans is 81% at the end of 2006 compared to 70% in 2005.

Defined benefit pension expense of \$19 million was an increase from the \$14 million recorded in 2005 primarily due to lower discount rates and updated mortality tables. Funding for the year was \$33 million, up from the \$30 million funded in 2005. Our defined benefit pension plans are funded in accordance with all applicable regulatory requirements. Employer contributions are expected to decrease in 2007 due to improved plan returns in 2006.

For 2007, we anticipate lower pension funding as a result of a better pension funded position. The Company is currently in discussions with regulatory agencies regarding funding requirements of certain of its pension plans. If regulatory approval is obtained, the Company expects funding requirements will be further reduced in 2007.

The assumed return on assets is 8% and is based on management's best estimate of the long-term expected rate of return on plan assets, including consideration of asset mix, equity risk premium and active investment management premium. The weighted-average discount rate for the accrued benefit obligations is 5.20% as compared to 5.14% in 2005, and is based on the market yield of high quality corporate bonds of similar duration to the pension plan liabilities.

Sensitivity to a 1% decrease in these two key assumptions is estimated as follows:

	Impact Dec. 31, 2006 Unfunded Liability	Impact on 2006 Pension Expense
Return on assets	\$5 million increase	\$5 million increase
Discount rate	\$70 million increase	\$6 million increase

Our obligations under our post-retirement benefit plans are determined periodically through actuarial valuations, which are the basis for calculating post-retirement benefit expense. We fund these plans on a "pay-as-you-go" basis. At December 31, 2006, the accrued benefit obligations of these plans were \$62 million compared to \$64 million at the end of 2005.

In 2006, there was no financial impact to post-retirement benefit income from plan amendments and curtailment gains from divested operations, as compared to an expense of \$1 million in 2005. Payments under these plans were \$4 million in 2006 and \$4 million in 2005.

Significant changes in assumptions, driven by changes in financial markets, asset performance different from the assumed rate of return, significant new plan enhancements, acquisitions, divestitures, changes in the regulatory environment, and the measurement uncertainty incorporated into the actuarial valuation process could materially affect our future plan assets, accrued benefit obligations, and the expenses and contributions associated with our employee benefit plans.

OFF-BALANCE SHEET ARRANGEMENTS

We have no material off-balance sheet arrangements.

COMMON SHARES

The authorized capital stock of the Company consists of an unlimited number of Class A preferred shares, Class B preferred shares, non-voting participating shares and common shares.

The weighted average number of shares outstanding used for calculating loss per share was 29,509,876 for 2006 (2005 – 29,728,060).

During 2005, the Company repurchased a total of 602,100 shares, or approximately 2% of the outstanding shares, at a weighted-average price per share of CAD\$12.79 for a total consideration of \$6 million. The transaction resulted in a decrease in common stock of \$10 million. As the purchase price was below the stated value of the common shares, the transaction resulted in contributed surplus of \$4 million.

Common Share Information	December 31, 2006	December 31, 2005
Shares outstanding	29,509,876	29,509,876
Book value	\$11.25	\$15.11
Market price at year-end	CAD\$6.19	CAD\$10.01
Market price at February 12, 2007	CAD\$5.96	

There have been no changes in common shares outstanding up to the date of this MD&A.

DIVIDENDS

We paid no dividends in 2006. The Board of Directors reviews this policy at each of its regularly scheduled meetings.

STOCK-BASED COMPENSATION

We account for stock options using the fair value method. Under this method, compensation expense for options is measured at the grant date using an option pricing model and recognized on a straight-line basis over the vesting period. During 2005, the Board approved the issuance to certain executives of 30,000 options with a strike price of CAD\$14.59. During 2006, the Board approved the issuance to certain executives of 485,000 options with a strike price of CAD\$8.04. In 2005 and 2006, we recognized less than \$1 million in expense related to stock option expense.

The Company has two deferred share unit plans which provide certain directors and senior officers of the Company with an opportunity to invest a portion of their compensation in deferred stock units. Deferred stock units may be subject to vesting periods. Payments under the plans are made in cash only. The total number of deferred stock units outstanding at December 31, 2006 was 472,142. During the year, the Company recognized expense of less than \$1 million related to these plans.

TRANSACTIONS WITH RELATED PARTIES

Fraser Papers purchases certain of its electricity from Brookfield. In addition, prior to the establishment of Acadian, Fraser Papers purchased wood fibre from Brookfield. During 2006, Fraser Papers purchased \$10 million of these goods from Brookfield, compared to \$18 million in 2005.

Fraser Papers has invested in convertible, term, preferred units (the "Units") of Katahdin, an indirectly, wholly owned subsidiary of Brookfield. The Units earn a preferential cumulative distribution of 5% per annum. Cumulative distributions accrued on this investment amount to \$2 million.

During the year, Fraser Papers sold \$3 million of goods and services to Katahdin and earned a management fee of \$8 million. In 2005, Fraser Papers sold less than \$1 million of goods and services to Katahdin and earned a management fee of \$7 million.

The Company entered into a 20 year Fibre Supply Agreement with Acadian. Total purchases of fibre from the Fund since January 31, 2006 amounted to \$35 million. The Company paid \$1 million to Acadian as a fee for administering the Company's Crown Licenses. Fraser Papers provided certain administrative and support services to the Fund during the transitional period following the set-up of the Fund. As Fraser Papers was a sponsor of the Fund, no amounts were charged for these services. During the year, the Company recognized equity in earnings of the Fund of \$2 million and distributions received from the Fund were \$2 million.

During 2006, Fraser Papers sold less than \$1 million of pulp to Smart Papers, compared to \$4 million in 2005.

Brookfield has provided the Company with a facility with a notional amount of \$150 million to enter into forward foreign exchange contracts as part of the Company's hedging activities. At December 31, 2006, the Company has entered into forward foreign exchange contracts of CAD\$57 million as a hedge against certain Canadian dollar-denominated net monetary liabilities, compared to CAD\$70 million in 2005. In addition, Fraser Papers held \$21 million as a hedge against future Canadian dollar cash flows, under this facility. No Canadian dollar cash flow contracts were held in 2005.

MARKET RISKS AND UNCERTAINTIES

We are exposed to a number of risks in the normal course of our business that have the potential to affect our operating performance. Major risks are discussed below.

Commodity and Price Sensitivity

Our earnings are sensitive to changes in world economic conditions, primarily in North America. Paper, pulp and lumber markets are competitive in nature and prices for many products are sensitive to variations in supply and demand.

Based on the operating levels in 2006, the following table shows the approximate annualized impact on after tax earnings of changes in product prices.

	Sensitivity Factor	Impact on Earnings (\$millions)	Impact on EBITDA (\$millions)	Average Mill Nets Q4, 2006
Uncoated freesheet	\$25 per ton	\$ 7	\$ 11	\$ 976
Groundwood paper	\$25 per ton	\$ 3	\$ 4	\$ 774
Market pulp	\$25 per tonne	\$ —	\$ 1	\$ 530
Lumber	\$10 per Mfbm	\$ 3	\$ 4	\$ 261

Competition

The forest products industry is a highly competitive business environment in which companies compete, to a large degree, on the basis of price. Our principal market is in the U.S. where we compete with North American and, in some instances, foreign producers. Certain competitors may have lower cost facilities than us. Our ability to compete in these and other markets is dependent on a variety of factors such as manufacturing costs, continued free access to markets, customer service, product quality, and currency exchange rates.

Foreign Exchange

We compete within North American markets where product prices are significantly influenced by U.S. dollar exchange rates.

Our foreign exchange exposure arises from the following sources:

- Net Canadian dollar-denominated monetary assets and liabilities.
- Committed or anticipated foreign currency transactions, primarily Canadian dollar costs in our Canadian operations.

Our policy is to hedge all significant balance sheet foreign exchange exposures. We may hedge a portion of net Canadian dollar-denominated cash flows for periods up to three years in order to reduce the potential negative effect of a strengthening Canadian dollar versus the U.S. dollar.

In 2006, we were negatively impacted by the continued strengthening of the Canadian dollar, with an average exchange rate, relative to the U.S. dollar, of US\$0.88 compared to US\$0.83 in 2005 on our approximately CAD\$370 million net Canadian dollar cash flows. We estimate that each U.S. one cent change in the value of the Canadian dollar impacted annualized after tax earnings by approximately \$2 million in 2006. We estimate that the actual impact of the strengthening Canadian dollar amounted to a \$24 million decrease in EBITDA compared to 2005.

Environmental

Our operations are subject to a wide range of general and industry specific environmental laws and regulations relating to air emissions, wastewater discharges, solid and hazardous waste management, plant and wildlife protection, and site remediation.

Compliance with these laws and regulations is a significant factor in our business and we incur, and expect to continue to incur, significant capital and operating expenditures in order to maintain compliance with these laws and regulations. Future events such as changes in environmental laws and regulations, increasingly strict enforcement policies or the discovery of previously unknown contamination or other liabilities relating to our properties may give rise to additional costs that could require significantly increased capital expenditures which would reduce the funds otherwise available for operations, capital expenditures, future business opportunities or other purposes. For example, the ratification of the Kyoto Protocol by Canada may result in lower limits for the emission of carbon dioxide and other greenhouse gases, which would require us to regulate production or invest in the installation of additional pollution control equipment.

Furthermore, failure by us to comply with applicable environmental and safety laws and regulations, and the permit requirements related thereto, could result in civil or criminal fines or penalties or enforcement actions, including regulatory or judicial orders enjoining or curtailing operations or requiring corrective measures, installation of pollution control equipment or remedial actions, any of which could result in significant capital expenditures or reduced results of operations.

CONTROLS AND PROCEDURES

Management has designed internal controls over financial reporting, or caused them to be designed under the supervision of the President and the CEO, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of these financial statements in accordance with Canadian GAAP. They have considered the need to disclose in this MD&A any change in the Company's internal control over financial reporting that occurred during the Company's most recent interim period that has materially affected, or is reasonably likely to materially affect, the Company's internal control and have not identified any such changes.

Disclosure controls are procedures designed to ensure that information required to be disclosed in reports filed with securities regulatory authorities is recorded, processed, summarized and reported on a timely basis, and is accumulated and communicated to the Company's management, including the CEO, the President and the CAO, as appropriate, to allow timely decisions regarding required disclosure.

FORWARD-LOOKING INFORMATION

This report contains forward-looking information and statements relating, but not limited to, anticipated or prospective financial performance, results of operations, business prospects, the success of Company actions, expected pension funding, anticipated selling prices for products, maximum possible amounts under certain guarantees and Fraser Papers' strategies. Examples of such statements included in this document include, but are not limited to, the expected improvements in results following divestitures and other initiatives, expected changes in significant cash flows, note repurchases, potential recoveries associated with the Berlin pulp mill closure, adjustments in regards to Smart Papers losses, proposed acquisition of Katahdin, strategic and operational intentions and others.

Forward-looking information typically contains statements with words such as "consider", "anticipate", "believe", "expect", "plan", "intend", "likely", "will", "could", "seek", "estimate", "possible" "foresee" or similar words, or variations of those words suggesting future outcomes. In addition, forward-looking statements may reflect the outlook on future changes in volumes, prices, costs, estimated amounts and timing of cash flows, or other expectations or beliefs, objectives or assumptions about future events or performance. Readers should be aware that these statements are subject to known and unknown risks, uncertainties and other factors that could cause actual results to differ materially from those suggested by the forward-looking statements.

The significant risks that impact Fraser Papers' business and future performance are discussed in the Annual Information Form as well as Fraser Papers' Annual Report and other filings with Canadian securities regulatory authorities. The Company cautions that the list of risks and factors discussed in those documents may not be exhaustive. Readers should consider those risks, as well as other uncertainties and factors and potential events. Although Fraser Papers believes it has reasonable basis for making the forward-looking statements included in this report, readers are cautioned not to place undue reliance on such forward-looking information.

Fraser Papers undertakes no obligation, except as required by law, to update publicly or otherwise revise any forward-looking information, whether as a result of new information, future events or otherwise.

The "Outlook" sections that follow in this document are based on the Company's views and the actual outcome is uncertain.

OUTLOOK

Markets for the Company's specialty packaging and printing papers are expected to remain firm with volumes comparable with the fourth quarter and prices continuing to trend higher in certain segments. The first and second quarters of the calendar year are typically strong for lightweight financial and specialty packaging papers. During the fourth quarter, Fraser Papers announced price increases of \$20-60 per ton relating to approximately 250,000 tons of annual paper sales that became effective on or before January 1, 2007. Certain segments of the paper markets including lightweight coated groundwood and commodity freesheet began to soften during the fourth quarter of 2006 reflecting seasonal weakness in demand. The Company took seven days of downtime on one paper machine at its Gorham paper mill during January, 2007.

List prices for northern bleached hardwood pulp remain at attractive levels worldwide with strong demand from non-integrated paper mills. Higher market prices, the elimination of lower margin export sales and strong demand from domestic customers for high quality hardwood pulp produced at the Company's Thurso pulp mill led to an improvement in mill nets of \$82 per tonne in the fourth quarter over the same period one year ago. While additional global capacity, built to supply the Asian and European markets, is expected to come on stream during 2007, the Company expects that demand for Fraser Papers' hardwood pulp in domestic markets will remain firm in the short term.

While housing markets and lumber prices continue to be weak, the most recent press release from the U.S. Federal Reserve provided optimism for firmer economic growth and some tentative signs of stabilization in the U.S. housing market.

Management believes that the acquisition of Katahdin, expected to close at the end of April, is an attractive investment for the Company, providing the opportunity for substantial growth in the complementary directory and super-calendered paper segments, with products having strong brand recognition and providing a broader offering to Fraser Papers' publication customers. The closing of the transaction is subject to approvals by a special committee of the board of directors, the board of directors and shareholders other than Brookfield.

Fraser Papers is focused on improving results from its operations. Priority is being placed on lowering overall fibre costs and maximizing production from our paper machines. There are no scheduled maintenance outages during the first quarter of 2007. The sulphite pulp mill in Edmundston, New Brunswick will take an extended 21 day outage to perform major maintenance on its recovery boiler during the second quarter.

ADDITIONAL INFORMATION

Additional information relating to the Company, including information contained in our annual information form, can be obtained without charge on our web site at www.fraserpapers.com or on SEDAR at www.sedar.com.

DEFINITIONS

As there is no generally accepted method of calculating the measures outlined below, these measures as calculated by Fraser Papers may not be comparable to similar titled measures reported by other companies.

EBITDA is earnings from continuing operations before interest, taxes, depreciation and amortization, and restructuring charges. EBITDA is presented as a useful indicator of a company's ability to meet debt service and capital expenditure requirements. Fraser Papers interprets EBITDA trends as an indicator of relative operating performance.

Net debt is debt less cash and cash equivalents. Net debt is provided as a useful indicator of a company's financial leverage.

Net debt to net debt plus equity is net debt divided by the sum of net debt and shareholders' equity. Net debt to net debt plus equity is provided as a useful indicator of a company's financial leverage.

Cash costs include all cash costs of operations and exclude depreciation and amortization. Cash costs are presented to provide additional information about the cash generating capabilities of the Company's operations. This measure captures the key costs of operations and is a key performance measure that management uses to evaluate costs at the operations.

EBITDA (\$millions)	Year Ended December 31,	
	2006	2005
Loss	\$ (114)	\$ (29)
Add: Interest expense, net	6	9
Less: Income tax recovery	(16)	(26)
Less: Gain on sale of New Brunswick timberlands	(71)	—
Less: Gain on sale of Maine timberlands	—	(46)
Add: Losses from Smart Papers	111	—
Add: Closure of Berlin pulp mill	50	—
Add: Impairment Charges	—	41
Less/Add: Other	(5)	16
Add: Depreciation	32	39
EBITDA	\$ (7)	\$ 4

Net Debt (\$millions)	Year Ended December 31,	
	2006	2005
Long-term debt	\$ 68	\$ 150
Add: Current portion of long-term debt	—	1
Less: Cash and cash equivalents	(13)	(75)
Net debt	\$ 55	\$ 76

Cash Cost (\$millions)	Year Ended December 31,	
	2006	2005
Net sales	\$ 796	\$ 918
Add/Less: EBITDA	7	(4)
Add: Anti-dumping duties recovery	14	—
Cash cost	\$ 817	\$ 914

Management's Responsibility for the Financial Statements

The accompanying consolidated financial statements and other financial information have been prepared by the Company's management, which is responsible for their integrity and objectivity, in accordance with Canadian generally accepted accounting principles. Financial statements are not precise since they include certain amounts based upon estimates and judgements. When alternative methods exist, management has chosen those it deems to be the most appropriate in the circumstances.

Management is responsible for establishing and maintaining adequate internal controls. Fraser Papers maintains internal controls systems which are designed to permit the accurate and timely preparation of financial statements in accordance with Canadian generally accepted accounting principles.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and is ultimately responsible for reviewing and approving the financial statements. The Board carries out this responsibility principally through its Audit Committee.

The Audit Committee is appointed by the Board and reviews the consolidated financial statements and management's discussion and analysis; considers the report of the external auditors; assesses the adequacy of the internal controls of the Company; examines the fees and expenses for audit services; and recommends to the Board the independent auditors for appointment by the shareholders. The Committee reports its findings to the Board of Directors for consideration when approving the consolidated financial statements for issuance to the shareholders.



Dominic Gammiero
Chief Executive Officer

February 5, 2007



Peter Gordon
President

Auditors' Report

To the Shareholders of Fraser Papers Inc.

We have audited the consolidated balance sheets of Fraser Papers Inc. as at December 31, 2006 and 2005 and the consolidated statements of operations, deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of Fraser Papers Inc. as at December 31, 2006 and 2005 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Ernst & Young LLP

Chartered Accountants

Toronto, Canada
February 5, 2007

Consolidated Balance Sheets

As at December 31
(US\$ millions)

	2006	2005
Assets		
Current assets		
Cash and cash equivalents	\$ 13	\$ 75
Accounts receivable	106	109
Inventory (note 9)	118	113
Future income taxes (note 15)	1	10
	238	307
Property, plant and equipment (note 10)		
Paper	279	340
Timber (note 2)	—	19
Other assets (note 11)	39	122
	\$ 556	\$ 788
Liabilities and Shareholders' Equity		
Current liabilities		
Accounts payable and accrued liabilities	\$ 86	\$ 90
Current portion of long-term debt	—	1
	86	91
Long-term debt (note 12)	68	150
Other liabilities (note 13)	51	55
Future income taxes (note 15)	19	46
Shareholders' equity (note 16)	332	446
	\$ 556	\$ 788

(See accompanying notes)

On behalf of the Board,



Paul Gagné, CA
Audit Committee Chair



Dominic Gammiero
Chief Executive Officer

Consolidated Statements of Operations and Deficit

Years ended December 31

(US\$ millions, except per share amounts)

	2006	2005
Net sales	\$ 796	\$ 918
Earnings (loss) before the following		
Paper	(9)	(8)
Timber	2	12
	(7)	4
Gain on sale of New Brunswick timberlands (note 2)	71	—
Losses from Smart Papers (note 3)	(111)	—
Closure of pulp mill (note 4)	(50)	—
Gain on sale of Maine timberlands (note 7)	—	46
Impairment charges (note 8)	—	(41)
Restructuring charges (note 6)	—	(8)
Other (notes 2, 5, 6 and 12)	5	(8)
Interest income	4	3
Interest expense (note 12)	(10)	(12)
Loss before depreciation and income taxes	(98)	(16)
Depreciation	(32)	(39)
Income tax recovery (note 15)	16	26
Loss	\$ (114)	\$ (29)
Loss per share (basic and diluted)	\$ (3.86)	\$ (0.98)
Deficit		
Balance, beginning of year	\$ (48)	\$ (19)
Loss	(114)	(29)
Balance, end of year	\$ (162)	\$ (48)

(See accompanying notes)

Consolidated Statements of Cash Flows

Years ended December 31
(US\$ millions)

	2006	2005
Cash provided by (used for):		
Operating Activities		
Loss	\$ (114)	\$ (29)
Items not affecting cash:		
Depreciation	32	39
Future income taxes (note 15)	(17)	(27)
Losses from Smart Papers (note 3)	111	—
Gain on sale of New Brunswick timberlands (note 2)	(71)	—
Closure of pulp mill (note 4)	50	—
Gain on sale of Maine timberlands (note 7)	—	(46)
Impairment charges (note 8)	—	(41)
Employment benefit plan expense (note 14)	21	13
Other (notes 4, 6 and 12)	(4)	18
Employment benefit plan funding (note 14)	(37)	(34)
Payments related to Smart Papers (note 3)	(16)	—
	(45)	(25)
Net change in non-cash working capital balances (note 17)	(21)	(20)
	(66)	(45)
Investing Activities		
Capital investments	(12)	(49)
Proceeds on sale of New Brunswick timberlands (note 2)	94	—
Investment in lease (note 3)	—	(15)
Proceeds on sale of Maine timberlands (note 7)	—	78
Proceeds on sale of paperboard operations and other assets (note 5)	—	7
	82	21
Financing Activities		
Repayment of long-term debt (note 12)	(52)	(75)
Purchase of long-term debt (note 12)	(26)	—
Issuance of long-term debt (note 12)	—	185
Debenture issue costs (note 11)	—	(5)
Share repurchases (note 16)	—	(6)
	(78)	99
Increase (decrease) in cash and cash equivalents	\$ (62)	\$ 75

(See accompanying notes)

Notes to the Consolidated Financial Statements

(US\$ millions, unless otherwise noted)

In these notes "Fraser Papers" means Fraser Papers Inc. and all of its consolidated subsidiaries and affiliates and "Company" means Fraser Papers Inc. as a separate corporation. "Norbord" means Norbord Inc. (the former parent company of Fraser Papers and a related party by virtue of a common significant shareholder) or any of its consolidated subsidiaries. "Brookfield" means Brookfield Asset Management Inc, (a related party by virtue of a significant shareholding in the Company) or any of its consolidated subsidiaries.

NOTE 1. SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP") and include the significant accounting policies listed below.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities, and the reported revenues and expenses during the period. Significant estimates include the determination of the carrying value and useful lives of property, plant and equipment, provisions for employee future benefits and future income tax assets and liabilities. Actual results could differ from those estimates.

Cash and Cash Equivalents

Cash and cash equivalents consists of cash in the bank and short-term deposits with a term to maturity of less than ninety days at the date of purchase. Cash and cash equivalents are recorded at cost, which approximates their fair value.

Valuation of Inventories

Inventories of raw materials and operating supplies are valued at the lower of average cost and replacement cost or net realizable value. Inventories of manufactured products are valued at the lower of average cost, which includes all direct production costs and an allocation of overhead costs incurred at production facilities, and net realizable value.

Property, Plant and Equipment

Property, plant and equipment are recorded at cost and are depreciated on a straight-line basis. The rates of depreciation are intended to fully depreciate manufacturing and non-manufacturing assets over the following periods which approximate their useful lives:

Buildings	20 to 40 years
Sawmills and lumber production equipment	10 to 15 years
Paper and pulp mill machinery and production equipment	20 years
Logging machinery and equipment	4 to 10 years

Prior to the sale of Fraser Papers' timberlands, silviculture costs on owned timberlands were capitalized. Depletion of timber was recorded in a systematic manner based on the utilization of timber resources.

Interest costs on major capital projects are capitalized during construction. Costs, net of revenues, incurred during the start-up period of major capital projects are deferred as other assets and amortized over the first three years of the life of the project.

Employee Future Benefits

Fraser Papers sponsors various defined benefit and defined contribution pension plans, which cover substantially all employees and are funded in accordance with applicable plan and regulatory requirements. The benefits under Fraser Papers' defined benefit pension plans are generally based on an employee's length of service and the final five years' average salary. The plans do not provide for indexation of benefit payments. Hourly employees are generally members of negotiated plans. Fraser Papers also provides non-pension post-retirement benefits to certain eligible retirees, consisting of medical and dental benefits, which are funded on a "pay-as-you-go" basis.

The measurement date for all defined benefit plans is December 31. The obligations associated with Fraser Papers' defined benefit pension plans are actuarially valued using the projected unit credit method pro rated on pensionable services, management's best estimate assumptions for expected investment performance, salary escalation, health care cost trend rates, expected mortality rates and a current market discount rate. For the purpose of calculating the expected return on plan assets, those assets are measured at fair value. Prior service costs related to plan amendments and transitional assets are amortized on a straight-line basis over the estimated average remaining service lives ("EARSL") of the employee groups. The net actuarial gains or losses in excess of 10% of the greater of the accrued benefit obligation and the fair value of plan assets are amortized on a straight-line basis over EARSL.

Asset Retirement Obligations

Fraser Papers' asset retirement obligations relate primarily to closure costs for landfill sites at Fraser Papers' operating locations. The liability associated with these sites is reduced as these obligations are paid and the asset associated with these obligations is depreciated over the estimated useful life of the related facility. Revisions to the liability could occur due to changes in the estimated costs or timing of closures or possible new regulations affecting these closures.

Revenue Recognition

Net sales are net of freight costs, commissions, discounts and rebates to customers and are recognized when the title and risks of ownership pass to the purchaser. This generally occurs when goods are shipped. Sales are governed by standard industry terms and in some cases by contract. Revenue is not recognized prior to completion of all relevant terms.

Translation of Foreign Currencies

The United States dollar is the reporting currency of Fraser Papers and the functional currency of its operations.

Monetary assets and liabilities denominated in currencies other than the United States dollar are translated at the rate of exchange prevailing at year end. Gains or losses on translation of these items are included in the Consolidated Statements of Operations. Gains or losses on transactions that hedge these items are also included in the Consolidated Statements of Operations.

Gains or losses on derivative financial instruments that serve to hedge future Canadian dollar-denominated costs are recognized in the same period as gains and losses on the underlying exposure being hedged.

Stock-based Compensation

The Company has a stock-based compensation plan, which is described in Note 16. The Company accounts for stock options using the fair value method. Under this method, compensation expense for stock options is measured at fair value at the grant date using the Black-Scholes valuation model and is recognized over the vesting period of the options granted.

The Company has two deferred share unit plans which provide certain directors and senior officers of the Company with an opportunity to invest a portion of their compensation in deferred stock units. Deferred stock units can be subject to vesting periods at the discretion of the Board of Directors. Payments under the plans are made in cash only. The expense associated with these stock units is recognized over the vesting period. The liability associated with these plans is measured based on the fair value of the vested units which is based on the current market price of the shares of the Company.

Financial Instruments

The fair values of financial instruments approximate their carrying values, except where disclosed elsewhere in these notes. Fair values disclosed are determined using actual quoted market prices or, if not available, indicative prices based on similar publicly traded instruments.

Fraser Papers uses derivative financial instruments to manage its foreign currency and commodity price exposures. Fraser Papers does not use derivative financial instruments for speculative purposes. All hedging relationships, risk management objectives and hedging strategies are formally documented and periodically assessed as to whether changes in the value of derivatives are highly effective in offsetting changes in the fair values or cash flows of hedged items.

Realized and unrealized gains and losses on derivative financial instruments designated as hedges for accounting purposes are treated in the same manner as gains and losses on the underlying item being hedged.

Gains and losses on forward foreign exchange contracts that serve to hedge Canadian dollar-denominated net monetary liabilities are recognized in cost of sales, with the fair value of the forward foreign exchange contract accrued in other assets. These contracts are generally short-term in nature. As such, any forward premium or discount is recognized at maturity of the contract in cost of sales.

Gains or losses on futures or swap contracts that serve to hedge the future selling prices for certain of our products are recognized in net sales when the products being hedged are sold. The fair value of a hedging instrument that has been recognized in net sales and has not yet settled is accrued in accounts receivable or accounts payable and accrued liabilities.

NOTE 2. SALE OF NEW BRUNSWICK TIMBERLANDS

On January 31, 2006, the Company sold its timberland assets in New Brunswick (the "NB Timberlands") to Acadian Timber Income Fund ("Acadian" or the "Fund"). Acadian was a newly formed income fund which financed the acquisition through an initial public offering of equity securities and the issuance of bank debt. The Company was the promoter of the Fund.

Net proceeds were \$125, including \$94 in cash and \$31 of securities which are exchangeable for 3.6 million units of the Fund, representing a 30% interest in the equity of the Fund, or a 22% interest in the Fund on a fully diluted basis. These securities are entitled to the same rights as units of the Fund and are entitled to cash distributions from the Fund. Acadian is related to Fraser Papers by virtue of the Company's equity interest in the Fund.

The Company accounts for its investment using the equity method. At the time of the transaction, the net book value of this investment was nil while the fair value, based on quoted market prices, was estimated to be \$31. At December 31, 2006, the net book value of the investment is nil, as the Company has recognized its proportionate share of the earnings of Acadian for the period from February 1, 2006 to December 31, 2006, net of distributions. The investment is estimated to have a fair market value of \$29, based on quoted market prices at December 31, 2006. During the year, the Company recognized equity earnings from Acadian of \$2, which have been reported in the Consolidated Statements of Operations. During the year, the Company received distributions of \$2 from Acadian.

The sale of the NB Timberlands resulted in a gain of \$71. In accordance with GAAP, the gain on the sale was the result of the net cash proceeds of \$94 adjusted for the proportionate share of the net liabilities of the Fund (excluding those related to the NB Timberlands) and the net assets contributed to the Fund (net of Fraser Papers' retained interest).

In conjunction with the sale, Fraser Papers entered into agreements with Acadian whereby Fraser Papers will have the right to purchase fibre for a period of up to 20 years at prevailing market prices. The amount of fibre available to Fraser Papers under the agreement will approximate its historical consumption from the timberlands owned by Acadian.

Certain liabilities of the NB Timberlands were retained by Fraser Papers consisting primarily of employment, pension and post retirement obligations related to past service.

NOTE 3. SALE OF MIDWEST OPERATIONS AND LOSSES FROM SMART PAPERS

On February 18, 2005, Fraser Papers sold a production facility in Park Falls, Wisconsin, a leased distribution facility in West Chicago, Illinois and related net assets (collectively, the "Midwest Operations"). As consideration for these net assets, Fraser Papers received a 40% common equity interest in an entity which owned Smart Papers LLC and the Midwest Operations (the "Investment"). The transaction was accounted for at fair value with fair value based on the value of the Investment and there was no resulting gain or loss.

Certain liabilities of the Midwest Operations were retained by Fraser Papers and consist primarily of employment, pension and post retirement obligations related to past service. In addition, the Company has effectively provided financial guarantees for certain obligations of the Midwest Operations under operating leases, purchase contracts and landfill obligations.

Smart Papers LLC and its affiliates ("Smart Papers"), filed for creditor protection under Chapter 11 of the US Bankruptcy Code, in the first quarter of 2006. As a result, Fraser Papers recorded a charge of \$111, consisting of an impairment charge against its investment in Smart Papers of \$74, a provision of \$15 against a receivable from Smart Papers related to the lease of a boiler at one of its locations and estimated accruals of \$22 related to the financial guarantees. During 2006, Fraser Papers made \$16 of payments against these accruals.

In the third quarter, Fraser Papers completed the sale of equipment previously leased to Smart Papers. The total proceeds of \$4, including contingent consideration of \$1, are receivable in instalments over seven years. Fraser Papers will recognize the benefit of these proceeds when the receipt is reasonably assured. During the year, Fraser Papers received less than \$1 of proceeds from the sale.

During 2005, Fraser Papers accounted for its investment in Smart Papers using the equity method. When Smart Papers filed for protection under Chapter 11 of the Bankruptcy Code, Fraser Papers lost its significant influence over Smart Papers. As a consequence, the Company began accounting for its investment in Smart Papers on a cost basis effective the beginning of 2006.

During 2005, Fraser Papers recognized equity losses from Smart Papers and losses on the sale of its Park Falls operations to Smart Papers totalling \$8, which have been reflected in the Statements of Operations and Statements of Cash Flows.

NOTE 4. CLOSURE OF BERLIN PULP MILL

On May 7, 2006, Fraser Papers permanently shut down its pulp mill in Berlin, New Hampshire. As a result of the announcement, Fraser Papers recorded a charge of \$50 consisting of an impairment in property, plant and equipment and other assets of \$45 and various accruals related to severance and closure of \$5. During the year, the Company applied payments and charges of \$4 against the accruals.

During the fourth quarter of 2006, Fraser Papers sold substantially all remaining assets related to the Berlin pulp mill for net cash proceeds of \$3. No gain or loss was recorded on the sale.

NOTE 5. SALE OF PAPERBOARD AND OTHER ASSETS

During 2006, the Company sold non-core assets for net proceeds of \$1.

On October 4, 2005, Fraser Papers sold its paperboard assets for proceeds of \$5. In addition, the Company sold two other non-core assets for total proceeds of \$2. There were no gains or losses recorded on these sales.

NOTE 6. RESTRUCTURING CHARGES AND OTHER

As a result of the sale of its paperboard business in 2005, the Company reduced its workforce by 98 positions at its mill in Edmundston, New Brunswick. The elimination of these positions resulted in a restructuring charge of \$8 consisting of severance and early retirement costs of \$5 and a non-cash charge for pension and non-pension post retirement benefits of \$3.

During 2006, the Company made payments of \$2, net of government training grants of \$2, related to the paperboard restructuring accruals.

During 2006, the Company reversed \$2 of restructuring accruals as a result of renegotiation of severance arrangements relating to a 2004 provision and the completion of the paperboard restructuring. These amounts have been partially offset by additional restructuring charges with respect to the elimination of certain positions at its operations in 2006. A net amount of less than \$1, has been reflected in the Consolidated Statements of Operations.

NOTE 7. SALE OF MAINE TIMBERLANDS

On May 19, 2005 Fraser Papers completed the sale of approximately 240,000 acres of timberlands in Maine (the "Maine Timberlands") for net proceeds of \$78. The sale resulted in a pre-tax gain of \$46. Fraser Papers has entered into an agreement with the purchaser whereby Fraser Papers has the right to purchase fibre from the purchaser for 20 years at prevailing market prices. The amount of fibre available to Fraser Papers under the agreement will approximate its historical usage from the sold lands.

NOTE 8. IMPAIRMENT CHARGES

During 2005, the Company performed an impairment review and considered a number of factors which were determined to be indicators that the carrying amount of its pulp mill in Thurso, Quebec, may not be fully recoverable. Based on this review, the Company recorded a pre-tax, non-cash impairment charge of \$40 against the assets of this mill.

During 2005, the Company recognized an impairment charge of \$1 related to its paperboard operations in Edmundston, New Brunswick as the carrying value of the assets exceeded the expected proceeds from the sale of those assets, which closed in 2005.

NOTE 9. INVENTORY

	2006	2005
Raw materials	\$ 34	\$ 32
Finished goods	50	48
Operating and maintenance supplies	34	33
	\$ 118	\$ 113

NOTE 10. PROPERTY, PLANT AND EQUIPMENT

	Cost	Accumulated Depreciation	Net Book Value
2006			
Pulp and paper mills	\$ 906	\$ (656)	\$ 250
Sawmills	116	(87)	29
	\$ 1,022	\$ (743)	\$ 279
2005			
Pulp and paper mills	\$ 941	\$ (634)	\$ 307
Sawmills	113	(80)	33
Timber and timberlands	40	(21)	19
	\$ 1,094	\$ (735)	\$ 359

NOTE 11. OTHER ASSETS

	2006	2005
Pension plans (note 14)	\$ 25	\$ 11
Investment in Katahdin Paper Company LLC (note 19)	12	11
Debt issuance costs	2	4
Investment in Smart Papers (note 3)	—	74
Investment in lease (note 3)	—	14
Deferred start-up costs	—	8
	\$ 39	\$ 122

Debt issuance costs relate to the issuance of \$150 of 8.75% senior, unsecured notes (the "Notes") and fees and expenses related to a committed, revolving credit facility. During 2006, \$2 of debt issuance costs were written off as a result of the repurchase and repayment of Notes. The remaining balance is being amortized over the term of the Notes, or the facility as appropriate (Note 12).

NOTE 12. LONG-TERM DEBT

On March 15, 2005, the Company issued the Notes which bear interest at 8.75% and are due in 2015. The indenture agreement governing the Notes contains certain covenants, the more significant of which include restrictions on the incurrence of additional indebtedness, sale of assets and reinvestment of proceeds, mergers, creation of liens, payment of dividends and repurchase of the Company's shares.

During 2006, the Company purchased \$30 in principal amount of Notes in the market. The Notes were purchased for \$26, resulting in a gain of \$3, net of a write-down in debt issuance costs of \$1. The net gain is reflected in the Consolidated Statements of Operations.

During 2006, the Company closed a tender offer to repay up to \$66 in principal amount of the Notes. The Company repaid \$52 of Notes to the public and cancelled \$14 of Notes held by Fraser Papers. A write-down of deferred financing costs of \$1, related to the repayments under the tender offer has been reflected in the Consolidated Statements of Operations and Statements of Cash Flows.

As a result of the market repurchases and the tender offer, the Company holds \$16 of Notes. These Notes have not been cancelled but have been netted against long-term debt on the consolidated balance sheet.

During 2006, the Company increased its committed, revolving credit facility to \$90. The facility matures in November 2008 and bears interest at market rates. Borrowings under the facility are secured by a first charge against accounts receivable and inventory. At December 31, 2006, \$40 (2005 – \$35) of this facility was utilized, all of which was in the form of letters of credit to certain creditors.

During the year, the Company made interest payments of \$11 (2005 – \$7).

On March 16, 2005, the Company repaid \$75 owing to an affiliate of Brookfield under a revolving credit facility. The facility was then cancelled.

NOTE 13. OTHER LIABILITIES

	2006	2005
Post-retirement benefit plans (note 14)	\$ 41	\$ 43
Asset retirement obligations	8	9
Deferred revenue and other	2	3
	\$ 51	\$ 55

Asset retirement obligations relate primarily to closure costs and post-closure maintenance costs for landfills at Fraser Papers' operating locations. The obligations represent estimated future payments of \$19 (2005 – \$25) which have been discounted at 8.75%. Total accretion expense for the year related to asset retirement obligations was less than \$1 (2005 – \$1). In addition to the asset retirement obligations recorded, Fraser Papers may have other obligations in the event of a permanent shutdown of any of its operations. However, these plant assets have indeterminate lives and, therefore, the associated asset retirement obligations are not reasonably estimable and liabilities cannot be established.

NOTE 14. EMPLOYEE BENEFIT PLANS

Pension Plans

Fraser Papers has a number of pension plans, participation in which is available to substantially all employees. Three of Fraser Papers' defined benefit pension plans are closed to new employees hired after January 1, 2005. Fraser Papers' obligations under

its defined benefit pension plans are determined periodically through the preparation of actuarial valuations, which are required every one to three years, depending on where the plan is registered. Information about these plans is as follows:

	2006	2005
Change in Accrued Benefit Obligation During the Year:		
Accrued benefit obligation, beginning of year	\$ 590	\$ 498
Employee contributions	2	2
Current service cost	9	7
Interest on accrued benefit obligation	31	29
Benefits paid	(40)	(42)
Net actuarial (gain) loss	(5)	75
Restructuring (<i>note 6</i>)	1	(3)
Plan amendments	—	1
Foreign currency exchange rate impact	—	14
Accrued benefit obligation, end of year ⁽¹⁾	\$ 588	\$ 590
Change in Plan Assets During the Year:		
Plan assets, beginning of year	\$ 415	\$ 390
Actual return on plan assets	66	26
Employer contributions	33	30
Employee contributions	2	2
Benefits paid	(40)	(42)
Foreign currency exchange rate impact	(1)	9
Plan assets, end of year ⁽¹⁾	\$ 475	\$ 415
Reconciliation of Funded Status:		
Accrued benefit obligation	\$ 588	\$ 590
Plan assets	475	415
Accrued benefit obligation in excess of plan assets	(113)	(175)
Unamortized net actuarial loss	137	185
Unamortized prior service costs	8	9
Unamortized net transitional asset	(7)	(8)
Net accrued benefit asset	\$ 25	\$ 11

(1) All plans have accrued benefit obligations in excess of plan assets before unamortized amounts.

	2006	2005
Components of Net Pension Expense:		
Current service cost	\$ 9	\$ 7
Interest on accrued benefit obligation	31	29
Actual return on plan assets	(66)	(26)
Net actuarial (gain) loss	(5)	75
Plan amendments	—	10
Restructuring (<i>note 6</i>)	1	3
Difference between actual and expected return on plan assets	32	(6)
Difference between actual and recognized net actuarial loss	17	(69)
Difference between actual and recognized prior service costs	1	(8)
Amortization of net transitional asset	(1)	(1)
Net periodic pension expense	\$ 19	\$ 14

The net actuarial gain of \$5 is primarily the result of a change in the rate used to discount the accrued benefit obligations.

	2006	2005
Significant Weighted-Average Actuarial Assumptions:		
Used in calculation of net periodic pension expense for the year:		
Discount rate	5.14%	5.75%
Expected long-term rate of return on plan assets	8.00%	8.00%
Rate of compensation increase	3.75%	3.75%
Used in calculation of accrued benefit obligation, end of year:		
Discount rate	5.20%	5.14%
Rate of compensation increase	3.82%	3.75%

The weighted average asset allocation of Fraser Papers' defined benefit pension plan assets is as follows:

Asset category:		
Equity investments	73%	73%
Fixed income investments	27%	27%
Total assets	100%	100%

The Consolidated Statements of Operations include \$3 (2005 – \$3) related to contributions to Fraser Papers' defined contribution pension plans.

Post-retirement Benefit Plans

Fraser Papers funds health care benefits costs on a pay-as-you-go-basis. Fraser Papers' obligations under its post-retirement benefit plans are determined periodically through actuarial valuations, which are conducted no less frequently than every three years. Information about these plans is as follows:

	2006	2005
Change in Accrued Benefit Obligation During the Year:		
Accrued benefit obligation, beginning of year	\$ 64	\$ 66
Current service cost	1	1
Interest on accrued benefit obligation	3	3
Benefits paid	(4)	(4)
Net actuarial loss	—	10
Plan amendment	—	(13)
Divested operations (<i>note 2</i>)	(2)	—
Foreign currency exchange rate impact	—	1
Accrued benefit obligation, end of year	\$ 62	\$ 64
Reconciliation of Funded Status:		
Accrued benefit obligation	\$ 62	\$ 64
Plan assets	—	—
Accrued benefit obligation in excess of plan assets	(62)	(64)
Unamortized net actuarial loss	27	31
Unamortized prior service cost	(6)	(10)
Net accrued benefit liability	\$ (41)	\$ (43)

	2006	2005
Components of Net Post-retirement Benefit Expense:		
Current service cost	\$ 1	\$ 1
Interest on accrued benefit obligation	3	3
Plan amendment	—	(13)
Net actuarial loss	—	10
Difference between actual and recognized net actuarial loss	2	(9)
Difference between actual and recognized prior service losses	(4)	10
Divested operations (note 6)	—	(3)
Net periodic post-retirement benefit expense (income)	\$ 2	\$ (1)
Significant Weighted-Average Actuarial Assumptions:		
Used in calculation of net post-retirement benefit expense for the year:		
Discount rate	5.24%	5.75%
Used in calculation of accrued benefit obligation, end of year:		
Discount rate	5.37%	5.24%
Health care cost trend rate used in calculation of accrued benefit obligation, end of year:		
Initial rate	9.51%	10.00%
Ultimate rate	5.00%	5.00%
Year ultimate rate reached	2014	2014
Sensitivity to change in health care cost trend rate, for year ended December 31, 2006:		
	1% increase	1% increase
Impact on net periodic post-retirement benefit expense	1	1
Impact on accrued benefit obligation	7	8

NOTE 15. INCOME TAXES

Future income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities in the consolidated financial statements and the amounts used for income tax purposes.

Significant components of the provision for recovery of income taxes are as follows:

	2006	2005
Current tax expense	\$ (1)	\$ (1)
Future income tax recovery	17	27
Income tax recovery	\$ 16	\$ 26

The differences between income taxes computed using statutory tax rates and income tax as recorded are as follows:

	2006	2005
Loss before income taxes	\$ (130)	\$ (55)
Tax recovery at combined statutory rates	45	19
Effect of:		
Rate differences on foreign activities	18	1
Non-taxable portion of net capital gains	13	—
Foreign exchange and other	5	8
Change in valuation allowance	(65)	(2)
Income tax recovery	\$ 16	\$ 26

The income tax effects of temporary differences that give rise to future income taxes are as follows:

	2006	2005
Benefit of tax loss carryforwards	\$ 59	\$ 14
Capital losses	21	—
Post-employment benefits	6	12
Current future income tax assets	10	10
Other future net income tax assets (liabilities)	5	(8)
Property, plant and equipment	(47)	(57)
Future income taxes	\$ 54	\$ (29)
Less: Valuation allowance	(72)	(7)
Future income taxes, net	\$ (18)	\$ (36)
Represented by:		
Current future income tax asset	\$ 1	\$ 10
Long-term future income tax liability	(19)	(46)
	\$ (18)	\$ (36)

The benefit of tax loss carry-forwards includes the benefit of \$194 (2005 – \$17) of net losses in the United States which expire between 2012 and 2026. A valuation allowance of \$72 (2005 – \$7) has been provided against the benefit of income tax assets as it is not more likely than not that they will be realized. Included in the valuation allowance is \$79 of future income tax assets related to these losses, partly offset by \$7 of net future income tax liabilities. The Company has \$5 (2005 – \$21) of loss carry-forwards in Canada which begin to expire in 2012.

Income or income-related taxes of \$1 (2005 – \$7) were paid during the year. Income tax recoverable of \$2 (2005 – \$6) is included in accounts receivable, as at December 31, 2006.

NOTE 16. SHAREHOLDERS' EQUITY

	2006	2005
Common shares – 29,509,876 outstanding	\$ 490	\$ 490
Contributed surplus	4	4
Deficit	(162)	(48)
	\$ 332	\$ 446

The authorized capital stock of the Company consists of an unlimited number of Class A preferred shares, Class B preferred shares, non-voting participating shares and common shares.

The weighted average number of shares outstanding used for calculating loss per share was 29,509,876 for 2006 (2005 – 29,728,060).

During 2005, the Company repurchased a total of 602,100 shares at a weighted-average price of CAD\$12.79 per share for total consideration of \$6. As the purchase price was below the stated value of the common shares, the transactions resulted in a decrease of common stock of \$10 and contributed surplus of \$4.

Under Fraser Papers' Stock Option Plan, the Board of Directors may issue stock options to certain officers of the Company. These options have a ten year life and vest evenly over five years. Total compensation expense in each of 2005 and 2006 related to these options was less than \$1.

The following table summarizes options outstanding and the weighted average exercise price, as at December 31, 2006:

Year granted	Options outstanding			Options vested
	Number of Options	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price (CAD\$)	Number of Options
2004	215,000	7.7	\$ 16.45	86,000
2005	30,000	8.1	14.59	6,000
2006	485,000	9.2	8.04	—
	730,000	8.7	\$ 10.79	92,000

NOTE 17. CHANGE IN NON-CASH WORKING CAPITAL

The net change in non-cash working capital balances is comprised of the following:

	2006	2005
Cash provided by (used for):		
Accounts receivable	\$ (8)	\$ 7
Inventory	(5)	(15)
Accounts payable and accrued liabilities	(8)	(12)
	<u>\$ (21)</u>	<u>\$ (20)</u>

NOTE 18. COMMITMENTS AND CONTINGENCIES

Foreign Exchange Hedges

As at December 31, 2006, the Company has forward foreign exchange contracts outstanding of CAD\$57 (2005 – CAD\$70), which are designated as a hedge against certain Canadian dollar-denominated net monetary liabilities and \$21 (2005 – nil), which are designated as hedges against future Canadian dollar cash flows. The Consolidated Statements of Operations include a realized gain of \$2 (2005 – \$2) on matured forward foreign exchange contracts and an unrealized loss of less than \$1 (2005 – less than \$1) on outstanding contracts. These realized and unrealized gains or losses are offset by realized and unrealized gains or losses on the net monetary liabilities being hedged.

Commodity Hedges

During 2006, Fraser Papers was party to a pulp swap to deliver 24,000 tonnes of market pulp in 2006 at an average price of \$574 per tonne. This swap effectively fixed the selling price on a portion of Fraser Papers' production and was designated as a hedge of a portion of its pulp sales. During the year ended December 31, 2006, Fraser Papers realized losses on these contracts of \$4 (2005 – \$5). There were no outstanding swap agreements at December 31, 2006.

Fraser Papers entered into lumber futures contracts which effectively fixed the selling price for lumber delivered on the expiry date and were designated as a hedge of a portion of future lumber sales. During the year, Fraser Papers realized net gains of \$1 (2005 – nil) on lumber futures contracts. There were no outstanding contracts at December 31, 2006 (2005 – 13 million board feet).

Softwood Lumber Anti Dumping Duties

Since the inception of the anti dumping duties imposed by the United States Department of Commerce, the Company paid \$16 on the export of lumber to the U.S. During the year, the Company received refunds and interest of \$14 related to anti-dumping duties paid in previous years. These refunds were recognized as income. The Company does not expect any further refunds.

Guarantees

Norbord provided guarantees for certain obligations of Fraser Papers under a financial commitment agreement (the "FCA"). These guarantees were previously obligations of the paper division of Norbord. At December 31, 2006, the maximum potential amount of the obligations guaranteed was estimated to be \$7 (2005 – \$13).

Under the FCA, Fraser Papers agreed to provide letters of credit or other acceptable collateral to secure any guarantees outstanding on December 31, 2007. As security for these ongoing financial commitments to Fraser Papers, Norbord has the right, at any time, to require Fraser Papers to provide a fixed first charge security interest over Fraser Papers' manufacturing facilities.

Other

Fraser Papers has entered into various commitments for the future supply of operating services and materials. Commitments under operating leases and other obligations for which the cash flows are fixed or determinable at December 31, 2006, are:

2007	\$ 40
2008	13
2009	4
Subsequent	—
	<u>\$ 57</u>

NOTE 19. RELATED PARTY TRANSACTIONS

Fraser Papers purchases certain of its electricity from Brookfield. In addition, prior to the establishment of Acadian, Fraser Papers purchased wood fibre from Brookfield. During 2006, Fraser Papers purchased \$10 (2005 – \$18) of these goods from Brookfield. Included in accounts payable and accrued liabilities is \$1 (2005 – \$2) related to these purchases.

Fraser Papers has invested in convertible, term, preferred units (the “Units”) of Katahdin Paper Company LLC (“Katahdin”), an indirectly, wholly owned subsidiary of Brookfield. The Units earn a preferential cumulative distribution of 5% per annum. Cumulative distributions accrued on this investment amount to \$2. The investment is accounted for using the cost method and is included in other assets.

During the year, Fraser Papers earned a management fee of \$8 (2005 – \$7) from Katahdin. \$2 is included in accounts receivable at December 31, 2006 (2005 – \$2).

During 2006, Fraser Papers sold \$3 (2005 – less than \$1) of goods and services to Katahdin. \$2 is included in accounts receivable at December 31, 2006 (2005 – less than \$1).

As described in Note 2, the Company entered into 20 year Fibre Supply Agreements with Acadian. Total purchases of fibre from the Fund since January 31, 2006 amounted to \$35. The Company paid \$1 to Acadian as a fee for administering the Company’s Crown Licenses. Fraser Papers provided certain administrative and support services to the Fund during the transitional period following the set-up of the Fund. As Fraser Papers was a sponsor of the Fund, no amounts were charged for these services. During the year, the Company recognized equity in earnings of the Fund of \$2 and distributions received from the Fund were \$2.

Brookfield has provided the Company with a facility with a notional amount of \$150 to enter into forward foreign exchange contracts as part of the Company’s hedging activities. At December 31, 2006, the Company has entered into forward foreign exchange contracts of CAD\$57 (2005 – CAD\$70) as a hedge against certain Canadian dollar-denominated net monetary liabilities and \$21 (2005 – nil) as a hedge against future Canadian dollar cash flows, under this facility.

During 2006, Fraser Papers sold less than \$1 (2005 – \$4) of pulp to Smart Papers.

NOTE 20. SUBSEQUENT EVENT

On January 30, the Company announced that it had entered into an agreement to acquire Katahdin for \$80 million, subject to an adjustment for working capital, all payable in cash on closing. In addition, Fraser Papers will make contingent royalty payments based on the cash flow of the super-calendered business of Katahdin. The transaction is expected to close in the second quarter of 2007 and is subject to approval of a committee of directors who are independent of Brookfield, approval of the board of directors, approval of shareholders of Fraser Papers other than Brookfield and regulatory approval.

NOTE 21. SEGMENTED INFORMATION

Geographic Segments

Net sales by geographic segment are determined based on the country of shipment.

	Net Sales		Property, Plant and Equipment	
	2006	2005	2006	2005
United States	\$ 649	\$ 678	\$ 147	\$ 203
Canada ⁽¹⁾	147	240	132	156
Combined total	\$ 796	\$ 918	\$ 279	\$ 359
(1) Export Sales included in total	\$ 85	\$ 147		

Operating Segments

As a result of the sale of its NB timberlands, Fraser Papers has one reportable segment comprised of its integrated paper, pulp, and sawmill operations.

In determining its reportable segments, Fraser Papers considers that it is an integrated producer of paper and pulp as its principal business. Its sawmill operations are an integral part of its overall business as these facilities provide fibre for the internal production of pulp.

NOTE 22. COMPARATIVE FIGURES

Certain comparative figures have been reclassified from those previously presented to conform to the current year’s presentation.

Directors and Officers of Fraser Papers

DIRECTORS

Rorke B. Bryan, Ph.D. ⁽³⁾
Corporate Director

Jack L. Cockwell, CA ⁽⁴⁾
Group Chairman
Brookfield Asset Management Inc.

Paul E. Gagné, CA ^{(1) (4) (5)}
Corporate Director

Dominic Gammiero
Chief Executive Officer
Fraser Papers Inc.

J. Peter Gordon (*Director-elect*)
President
Fraser Papers Inc.

Robert J. Harding, FCA ^{(2) (5)}
Chairman
Brookfield Asset Management Inc.

Aldéa Landry, C.M., Q.C. ^{(1) (2) (3)}
President
Landal Inc.

Margot Northey, Ph.D. ^{(1) (3) (4)}
Corporate Director

Samuel J.B. Pollock, CA ^{(3) (5)}
Managing Partner, Private Equity
Brookfield Asset Management Inc.

OFFICERS

Dominic Gammiero
Chief Executive Officer

J. Peter Gordon
President

Glen McMillan
Senior Vice President and
Chief Administrative Officer

William Manzer
Senior Vice President,
Pulp and Paper Operations

Brian McAlary
Vice President, Sales

Marina Mueller
Assistant Corporate Secretary

Committees of the Board:

- (1) Audit*
- (2) Corporate Governance and Nominating*
- (3) Environment, Health and Safety*
- (4) Human Resources*
- (5) Pension*

For a full description of the Board committees, and corporate governance practices, please see Fraser Papers' Management Proxy Circular on our web site at www.fraserpapers.com

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Peter Gordon
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Senior Vice President, Pulp and Paper Operations
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Paper sales

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Pulp sales

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Note: This report contains forward-looking information that is based on certain assumptions and reflects the Company's current expectations. Forward-looking information typically contains statements with words such as "consider", "anticipate", "believe", "expect", "plan", "intend", "likely", "will", "could", "seek", "estimate", "possible", "foresee", "can", "should" or similar words, or variations of those words suggesting future outcomes. Readers should be aware that these statements are subject to known and unknown risks, uncertainties and other factors that could cause actual results to differ materially from those suggested by the forward-looking statements. Significant risks that impact Fraser Papers' business and future performance are discussed in the Annual Information Form and other documents filed with Canadian securities regulatory authorities. The Company cautions that the list of risks and other factors discussed in those documents may not be exhaustive and readers should consider those risks, as well as other uncertainties and factors and potential events. Although Fraser Papers believes it has reasonable basis for making the forward-looking statements included in this report, readers are cautioned not to place undue reliance on such forward-looking information. Fraser Papers undertakes no obligation, except as required by law, to update publicly or otherwise revise any forward-looking information, whether as a result of new information, future events or otherwise.

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