MERCER INTERNATIONAL INC.
Form 10-Q
November 08, 2006

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

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

For the quarterly period ended September 30, 2006

OR

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

For the transition period from __________ to __________

Commission File No.: 000-51826
MERCER INTERNATIONAL INC.
(Exact name of Registrant as specified in its charter)

Washington	**47-0956945**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*

Suite 2840, 650 West Georgia Street, Vancouver, British Columbia, Canada, V6B 4N8
(Address of office)
(604) 684-1099
(Registrant s telephone number, including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the *Securities Exchange Act of 1934* during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES þ NOo

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

Large Accelerated Filer o Accelerated Filer þ Non-Accelerated Filer o

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

The Registrant had 33,214,140 shares of common stock outstanding as at November 6, 2006.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

MERCER INTERNATIONAL INC.
CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2006
(Unaudited)

MERCER INTERNATIONAL INC.
CONSOLIDATED CONDENSED BALANCE SHEETS
As at September 30, 2006 and December 31, 2005
(Unaudited)
(Euros in thousands)

	September 30, 2006	**December 31, 2005**
ASSETS		
Current Assets		
Cash and cash equivalents	69,373	83,547
Cash restricted		7,039
Receivables	83,853	74,315
Note receivable, current portion	7,230	
Inventories	62,508	81,147
Prepaid expenses and other	5,626	5,474
Total current assets	228,590	251,522
Long-Term Assets		
Cash restricted	57,000	24,573
Property, plant and equipment	994,805	1,024,662
Investments	1,396	6,314
Deferred note issuance and other costs	7,329	8,364
Deferred income tax	43,189	78,381
Note receivable, less current portion	4,036	
	1,107,755	1,142,294
Total assets	1,336,345	1,393,816
LIABILITIES		
Current Liabilities		
Accounts payable and accrued expenses	103,321	112,726
Debt, current portion	40,903	27,601
Total current liabilities	144,224	140,327
Long-Term Liabilities		
Debt, less current portion	883,096	922,619
Unrealized foreign exchange rate derivative loss	16,506	61,979
Unrealized interest rate derivative losses	52,022	78,646
Pension and other post-retirement benefit obligations	16,631	17,113
Capital leases and other	8,893	9,945
Deferred income tax	19,130	14,444

	996,278	1,104,746
Total liabilities	1,140,502	1,245,073
Minority Interest		
SHAREHOLDERS EQUITY		
Common shares	181,731	181,586
Additional paid-in capital, stock options	123	14
Deficit	(6,233)	(47,970)
Accumulated other comprehensive income	20,222	15,113
Total shareholders equity	195,843	148,743
Total liabilities and shareholders equity	1,336,345	1,393,816

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

MERCER INTERNATIONAL INC.
CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS
For Nine Months Ended September 30, 2006 and 2005
(Unaudited)
(Euros in thousands, except for per share data)

	2006	**2005**
Revenues	500,954	376,430
Costs and expenses:		
Cost of sales	433,432	350,185
	67,522	26,245
General and administrative expenses	(24,344)	(22,399)
Sale of emission allowances	13,246	12,353
Gain on sale of assets	359	
Income from operations	56,783	16,199
Other income (expense)		
Interest expense	(68,129)	(63,320)
Investment income	4,096	1,594
Unrealized foreign exchange gain (loss) on debt	11,469	(1,591)
Realized loss on derivative instruments	(5,219)	(2,455)
Unrealized gain (loss) on derivative instruments	76,251	(67,804)
Impairment of investments		(1,699)
Total other income (expense)	18,468	(135,275)
Income (loss) before income taxes and minority interest	75,251	(119,076)
Income tax (provision) benefit	(40,388)	14,627
Income (loss) before minority interest	34,863	(104,449)
Minority interest	6,874	17,076
Net income (loss)	41,737	(87,373)
(Deficit) retained earnings, beginning of period	(47,970)	69,176
Deficit, end of period	(6,233)	(18,197)
Income (loss) per share		
Basic	1.26	(2.86)
Diluted	1.05	(2.86)

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

MERCER INTERNATIONAL INC.
CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS
For Three Months Ended September 30, 2006 and 2005
(Unaudited)
(Euros in thousands, except for per share data)

	2006	**2005**
Revenues	175,185	148,928
Costs and expenses:		
Cost of sales	135,387	140,018
	39,798	8,910
General and administrative expenses	(5,753)	(7,083)
Sale of emission allowances		6,065
Gain on sale of assets	359	
Income from operations	34,404	7,892
Other income (expense)		
Interest expense	(22,092)	(21,911)
Investment income	1,085	613
Unrealized foreign exchange gain (loss) on debt	(704)	5,918
Realized loss on derivative instruments		(284)
Unrealized gain (loss) on derivative instruments	(14,473)	3,335
Total other expense	(36,184)	(12,329)
Loss before income taxes and minority interest	(1,780)	(4,437)
Income tax (provision) benefit	2,532	(6,785)
Income (loss) before minority interest	752	(11,222)
Minority interest	5,976	5,667
Net income (loss)	6,728	(5,555)
Deficit, beginning of period	(12,961)	(12,642)
Deficit, end of period	(6,233)	(18,197)
Income (loss) per share		
Basic	0.20	(0.17)
Diluted	0.19	(0.17)

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

MERCER INTERNATIONAL INC.
CONSOLIDATED CONDENSED STATEMENTS OF
COMPREHENSIVE INCOME (LOSS)
For Nine Months Ended September 30, 2006 and 2005
(Unaudited)
(Euros in thousands)

	2006	**2005**
Net income (loss)	41,737	(87,373)
Other comprehensive income:		
Foreign currency translation adjustment	4,417	4,418
Pension plan additional minimum liability	(20)	412
Unrealized gains on securities		
Unrealized holding gains arising during the period	712	564
Other comprehensive income	5,109	5,394
Total comprehensive income (loss)	46,846	(81,979)

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

MERCER INTERNATIONAL INC.
CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
For Three Months Ended September 30, 2006 and 2005
(Unaudited)
(Euros in thousands)

	2006	**2005**
Net income (loss)	6,728	(5,555)
Other comprehensive (loss) income:		
Foreign currency translation adjustment	(943)	3,300
Pension plan additional minimum liability	(3)	412
Unrealized gains on securities		
Unrealized holding gains arising during the period	22	259
Other comprehensive (loss) income	(924)	3,971
Total comprehensive income (loss)	5,804	(1,584)

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

MERCER INTERNATIONAL INC.
CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
For Nine Months Ended September 30, 2006 and 2005
(Unaudited)
(Euros in thousands)

	2006	**2005**
Cash Flows from (used in) Operating Activities:		
Net income (loss)	41,737	(87,373)
Adjustments to reconcile net income (loss) to cash flows from operating activities		
Unrealized (gains) losses on derivatives	(71,032)	67,804
Depreciation and amortization	43,020	39,599
Unrealized foreign exchange (gain) loss on debt	(11,469)	1,591
Gain on sale of assets	(359)	
Impairment of investments and securities		1,699
Minority interest	(6,874)	(17,076)
Deferred income taxes	39,878	(14,642)
Stock compensation expense	293	330
Other	14	144
Changes in current assets and liabilities		
Receivables	(14,936)	(20,428)
Inventories	11,940	(9,581)
Accounts payable and accrued expenses	(136)	33,765
Other	(161)	(1,435)
Net cash from (used in) operating activities	31,915	(5,603)
Cash Flows used in Investing Activities:		
Cash restricted	(25,388)	60,650
Purchase of property, plant and equipment	(23,978)	(11,275)
Proceeds from sale of assets	5,000	
Acquisition of Celgar pulp mill		(146,608)
Net cash used in investing activities	(44,366)	(97,233)
Cash Flows from (used in) Financing Activities:		
Decrease in construction costs payable	(270)	(64,348)
Proceeds from borrowings of notes payable and debt	77,300	311,792
Proceeds from minority shareholders	5,463	5,463
Repayment of notes payable and debt	(80,906)	(261,691)
Proceeds from investment grants	383	78,595
Repayment of capital lease obligations	(3,263)	(2,930)
Issuance of shares of common stock	145	67,329
Net cash from (used in) financing activities	(1,148)	134,210

Effect of exchange rate changes on cash and cash equivalents	(575)	8,097
Net (decrease) increase in cash and cash equivalents	(14,174)	39,471
Cash and cash equivalents, beginning of period	83,547	49,568
Cash and cash equivalents, end of period	69,373	89,039
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	75,996	44,597
Income taxes	310	345
Supplemental schedule of non-cash investing and financing activities:		
Acquisition of production and other equipment under capital lease obligations	3,465	2,471

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

MERCER INTERNATIONAL INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
FOR NINE MONTHS ENDED SEPTEMBER 30, 2006
(Unaudited)
(Euros in thousands, except for shares and per share data)

Note 1. Significant Accounting Policies

Basis of Presentation

Effective March 1, 2006, the Company was converted from a business trust organized under the laws of the State of Washington to a corporation organized under the laws of the State of Washington. The conversion was effected through the merger of Mercer Inc. with and into an indirect wholly owned Delaware subsidiary company followed by a merger with a direct wholly owned Washington subsidiary company. The conversion effected a change in the Company s legal form, but did not result in any change in its business, management, fiscal year, accounting practices, assets or liabilities (except to the extent of legal and other costs of effecting the conversion and maintaining ongoing corporate status) or location of its principal executive offices and facilities. The Company continues to operate under the name Mercer International Inc. following consummation of the conversion and continues to be engaged in the same business that it was engaged in prior to the conversion and its shares of common stock are quoted and listed for trading on the NASDAQ National Market and the Toronto Stock Exchange, respectively.

The interim period consolidated financial statements contained herein include the accounts of Mercer International Inc. (Mercer Inc.) and its wholly-owned and majority-owned subsidiaries (collectively, the Company).

The interim period consolidated financial statements have been prepared by the Company pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (the SEC). Certain information and footnote disclosure normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to such SEC rules and regulations. The interim period consolidated financial statements should be read together with the audited consolidated financial statements and accompanying notes included in the Company s latest annual report on Form 10-K for the fiscal year ended December 31, 2005. In the opinion of the Company, the unaudited consolidated financial statements contained herein contain all adjustments necessary to present a fair statement of the results of the interim periods presented. The results for the periods presented herein may not be indicative of the results for the entire year.

MERCER INTERNATIONAL INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
FOR NINE MONTHS ENDED SEPTEMBER 30, 2006
(Unaudited)
(Euros in thousands, except for shares and per share data)

Note 1. Significant Accounting Policies (cont d)

New Accounting Standards

In February 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140 (SFAS 155). This Statement amends FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, and Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. This Statement resolves issues addressed in Statement 133 Implementation Issue No. D1, Application of Statement 133 to Beneficial Interests in Securitized Financial Assets . This Statement will be effective for financial instruments acquired or issued by the Company after the beginning of its 2007 fiscal year. The Company expects that the adoption of this Statement will not have a material effect on its financial condition or results of operations.

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). This interpretation clarifies the recognition threshold and measurement of a tax position taken on a tax return, and requires expanded disclosure with respect to the uncertainty in income taxes. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact that adoption of FIN 48 will have on its financial condition or results of operations.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS 157). This statement defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS 157 does not require any new fair value measurements but rather eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. The Company expects that adoption of SFAS 157 will not have a material effect on its financial condition or results of operations.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, Employer s Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statement No. 87, 88, 106 and 132R (SFAS 158). This Statement requires an employer to recognize in its statement of financial position an asset of a plan s over funded status or a liability for a plan s under funded status, measure a plan s assets and its obligations that determine its funded status as of the end of the employer s fiscal year (with limited exceptions), and recognize changes in the funded status of a defined benefit postretirement plan in the year in which the changes occur. SFAS 158 is effective for fiscal years ending after December 15, 2006. The Company is currently evaluating the impact that the adoption of SFAS 158 will have on its financial condition or results of operations.

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FOR NINE MONTHS ENDED SEPTEMBER 30, 2006
(Unaudited)
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Note 1. Significant Accounting Policies (cont d)

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 108 (SAB 108). SAB 108 provides guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. SAB 108 permits existing public companies to record the cumulative effect of initially applying this approach in the fiscal year ending after November 15, 2006 by recording necessary correcting adjustments to the carrying values of assets and liabilities as of the beginning of that year with the offsetting adjustment recorded to the opening balance of retained earnings. The Company expects that adoption of SAB 108 will not have a material impact on its financial condition and results of operations.

Note 2. Stock-Based Compensation

The Company adopted Statement of Financial Accounting Standards (SFAS) No. 123R, *Share-Based Payment*, on January 1, 2006. This statement requires the Company to recognize the cost of employee services received in exchange for the Company s equity instruments. Under SFAS No. 123R, the Company is required to record compensation expense over an award s vesting period based on the award s fair value at the date of grant. The Company has elected to adopt SFAS No. 123R on a modified prospective basis; accordingly, the financial statements for periods prior to January 1, 2006 will not include compensation cost calculated under the fair value method.

Prior to January 1, 2006, the Company applied Accounting Principles Board Opinion 25, *Accounting for Stock Issued to Employees*, and, therefore, recorded the intrinsic value of stock-based compensation as expense and applied the disclosure provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation prior to January 1, 2006.

	Nine Months Ended September 30, 2005
Net Loss	
As reported	(87,373)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of any related tax effects	(51)
Pro forma	(87,424)
Basic and Diluted Loss Per Share	
As reported	(2.86)
Pro forma	(2.86)

MERCER INTERNATIONAL INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
FOR NINE MONTHS ENDED SEPTEMBER 30, 2006
(Unaudited)
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Note 2. Stock-Based Compensation (cont d)

	Three Months Ended September 30, 2005
Net Loss	
As reported	(5,555)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of any related tax effects	(30)
Pro forma	(5,585)
Basic and Diluted Loss Per Share	
As reported	(0.17)
Pro forma	(0.17)

The fair value of each option granted is estimated on the grant date using the Black-Scholes model. During the nine month period ended September 30, 2006, no options were granted, exercised or cancelled, and during the nine months ended September 30, 2005, 130,000 options were granted to purchase common shares and no options were exercised or cancelled.

Summarized information about stock options outstanding and exercisable at September 30, 2006 is as follows:

	Outstanding Options			Exercisable Options	
Exercise Price Range (In U.S. Dollars)	Number	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise price (In U.S. Dollars)	Number	Weighted Average Exercise Price (In U.S. Dollars)
$5.65 6.375	920,000	3.75	$ 6.30	920,000	$ 6.30
8.50	135,000	0.75	8.50	135,000	8.50
7.30	30,000	8.75	7.30	20,000	7.30
7.92	100,000	9.00	7.92	66,666	7.92
	1,185,000		$ 6.71	1,141,666	$ 6.67

As at September 30, 2006, the total remaining unrecognized compensation cost related to non-vested stock options amounted to 181, which will be amortized over their remaining vesting period.

During the nine-month period ended September 30, 2006, the number of non-vested options decreased by 76,667.

MERCER INTERNATIONAL INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
FOR NINE MONTHS ENDED SEPTEMBER 30, 2006
(Unaudited)
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Note 2. Stock-Based Compensation (cont d)

Restricted Stock

The fair value of restricted stock is determined based upon the number of shares granted and the quoted price of the Company s stock on the date of grant. Restricted stock generally vests over two years. Expense is recognized on a straight-line basis over the vesting period. Expense recognized for the nine months ended September 30, 2006 and 2005 was 292 and 330, respectively.

As at September 30, 2006, the total remaining unrecognized compensation cost related to restricted stock amounted to 232, which will be amortized over their remaining vesting period.

During the nine month period ended September 30, 2006, there were restricted stock awards of an aggregate of 20,000 of our common shares to independent directors and an officer of the Company.

MERCER INTERNATIONAL INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
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(Unaudited)
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Note 3. Income (Loss) Per Share

Basic income (loss) per share is computed by dividing income (loss) available to common shareholders by the weighted average number of shares outstanding during a period. Diluted income (loss) per share takes into consideration shares outstanding (computed under basic earnings (loss) per share) and potentially dilutive shares. The following table sets out the computation of basic income (loss) per share for the nine and three months ended September 30, 2006 and 2005, respectively:

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2006	2005	2006	2005
Income (loss) from continuing operations basic	41,737	(87,373)	6,728	(5,555)
Interest on convertible notes, net of tax	4,576		1,810	
Income (loss) from continuing operations diluted	46,313	(87,373)	8,538	(5,555)
Weighted average number of common shares outstanding:				
Basic	33,173,279	30,557,409	33,173,279	33,092,853
Effect of dilutive shares:				
Stock options and awards	284,589		313,946	
Convertible notes	10,645,161		10,645,161	
Diluted	44,103,029	30,557,409	44,132,386	33,092,853
Income (loss) from continuing operations per share:				
Basic	1.26	(2.86)	0.20	(0.17)
Diluted	1.05	(2.86)	0.19	(0.17)

The calculation of diluted income (loss) per share for the comparative 2005 period does not assume the exercise of stock options and awards or the conversion of convertible notes that would have an anti-dilutive effect on earnings per share. Stock options and awards excluded from the calculation of diluted income (loss) per share because they are anti-dilutive represented 224,626 for the nine months ended September 30, 2005. Convertible notes excluded from the calculation of diluted income (loss) per share because they are anti-dilutive represented 10,645,161 for the nine months ended September 30, 2005.

MERCER INTERNATIONAL INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
FOR NINE MONTHS ENDED SEPTEMBER 30, 2006
(Unaudited)
(Euros in thousands, except for shares and per share data)

Note 4. Acquisition of the Celgar Mill and Related Financings

Acquisition

On February 14, 2005, the Company completed its acquisition of the Celgar NBSK pulp mill. The aggregate consideration for the acquisition was 177,422, which included 142,940 in cash, acquisition related expenditures of 3,668 and 30,814 was paid in common shares of the Company. The results of the Celgar mill are included in the consolidated statement of operations since the acquisition date.

The allocation of the purchase price is summarized below.

Purchase price:	
Cash (including defined working capital)	142,940
Equity common shares	30,814
Acquisition costs	3,668
	177,422
Net assets acquired:	
Receivables	32
Inventories	19,969
Prepaids and other assets	616
Property, plant and equipment	175,096
Accrued expenses and other liabilities	(4,103)
Pension plan and post-retirement benefits obligations	(14,188)
	177,422

In October 2005, the Company s wholly owned subsidiary, Zellstoff Celgar Limited, received a re-assessment for real property transfer tax payable in British Columbia, Canada, in the amount of approximately 3.5 million in connection with the transfer of the land where the Celgar mill is situated. The Company is contesting the assessment and the amount, if any, that may be payable in connection therewith is not yet determinable. Any additional amount paid in connection with the re-assessment will increase the cost basis of the assets acquired.

MERCER INTERNATIONAL INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
FOR NINE MONTHS ENDED SEPTEMBER 30, 2006
(Unaudited)
(Euros in thousands, except for shares and per share data)

Note 5. Business Segment Information

The Company operates in two reportable business segments: pulp and paper. The segments are managed separately because each business requires different production and marketing strategies. The results of the Celgar mill presented below are from the date of its acquisition on February 14, 2005.

Summarized financial information concerning the segments is shown in the following table:

	Rosenthal Pulp	Celgar Pulp	Stendal Pulp	Total Pulp	Paper	Corporate, Other and Eliminations	Consolidated Total
Nine Months Ended September 30, 2006							
Sales to external customers	109,225	157,431	190,514	457,170	43,784		500,954
Intersegment net sales	(1,022)	(103)	7,326	6,201	(139)	(6,062)	
	108,203	157,328	197,840	463,371	43,645	(6,062)	500,954
Operating costs	73,333	140,343	143,022	356,698	40,038	(5,645)	391,091
Operating depreciation and amortization	10,857	9,491	21,210	41,558	551	232	42,341
General and administrative	5,565	7,484	7,852	20,901	2,828	615	24,344
Gain on sale of assets					(359)		(359)
(Sale) purchase of emission allowances	(3,651)		(9,595)	(13,246)			(13,246)
	86,104	157,318	162,489	405,911	43,058	(4,798)	444,171
Income (loss) from operations	22,099	10	35,351	57,460	587	(1,264)	56,783
Interest expense							(68,129)
Investment income							4,096
Unrealized foreign exchange gain on debt							11,469
Derivative financial instruments, net							71,032
							75,251

Income before income taxes and minority interest							
Segment assets	324,824	239,258	729,148	1,293,230	5,564	37,551	1,336,345

	Rosenthal Pulp	**Celgar[(1)] Pulp**	**Stendal Pulp**	**Total Pulp**	**Paper**	**Corporate, Other and Eliminations**	**Consolidated Total**
Nine Months Ended September 30, 2005							
Sales to external customers	103,058	97,458	128,919	329,435	46,995		376,430
Intersegment net sales			4,679	4,679		(4,679)	
	103,058	97,458	133,598	334,114	46,995	(4,679)	376,430
Operating costs	73,146	86,438	112,739	272,323	44,879	(5,879)	311,323
Operating depreciation and amortization	10,173	7,083	20,179	37,435	592	835	38,862
General and administrative	5,441	5,285	3,120	13,846	3,720	4,833	22,399
(Sale) purchase of emission allowances	(4,402)		(7,951)	(12,353)			(12,353)
	84,358	98,806	128,087	311,251	49,191	(211)	360,231
Income (loss) from operations	18,700	(1,348)	5,511	22,863	(2,196)	(4,468)	16,199
Interest expense							(63,320)
Investment income							1,594
Unrealized foreign exchange loss on debt							(1,591)
Derivative financial instruments, net							(70,259)
Impairment of investments							(1,699)
Loss before income taxes and minority interest							(119,076)
Segment assets	341,732	251,918	787,388	1,381,038	22,783	5,416	1,409,237

(1) The results of the Celgar pulp mill are from the date of its acquisition on February 14, 2005.

MERCER INTERNATIONAL INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
FOR NINE MONTHS ENDED SEPTEMBER 30, 2006
(Unaudited)
(Euros in thousands, except for shares and per share data)

Note 5. Business Segment Information (cont d)

	Rosenthal Pulp	Celgar Pulp	Stendal Pulp	Total Pulp	Paper	Corporate, Other and Eliminations	Consolidated Total
Three Months Ended September 30, 2006							
Sales to external customers	40,284	56,620	68,004	164,908	10,277		175,185
Intersegment net sales	(870)	(126)	2,638	1,642	(247)	(1,395)	
	39,414	56,494	70,642	166,550	10,030	(1,395)	175,185
Operating costs	23,880	41,641	47,451	112,972	10,067	(1,211)	121,828
Operating depreciation and amortization	3,107	3,200	7,081	13,388	95	76	13,559
General and administrative	1,973	2,545	1,912	6,430	552	(1,229)	5,753
Gain on sale of assets					(359)		(359)
	28,960	47,386	56,444	132,790	10,355	(2,364)	140,781
Income (loss) from operations	10,454	9,108	14,198	33,760	(325)	969	34,404
Interest expense							(22,092)
Investment income							1,085
Unrealized foreign exchange gain on debt							(704)
Derivative financial instruments, net							(14,473)
Loss before income taxes and minority interest							(1,780)

	Rosenthal Pulp	Celgar Pulp	Stendal Pulp	Total Pulp	Paper	Corporate, Other and Eliminations	Consolidated Total
Three Months Ended							

September 30, 2005							
Sales to external customers	37,122	48,978	47,313	133,413	15,515		148,928
Intersegment net sales			1,339	1,339		(1,339)	
	37,122	48,978	48,652	134,752	15,515	(1,339)	148,928
Operating costs	25,741	45,884	41,193	112,818	15,278	(2,057)	126,039
Operating depreciation and amortization	3,543	2,986	6,725	13,254	213	512	13,979
General and administrative	1,631	2,448	1,443	5,522	1,158	403	7,083
(Sale) purchase of emission allowances	(2,267)		(3,798)	(6,065)			(6,065)
	28,648	51,318	45,563	125,529	16,649	(1,142)	141,036
Income (loss) from operations	8,474	(2,340)	3,089	9,223	(1,134)	(197)	7,892
Interest expense							(21,911)
Investment income							613
Derivative financial instruments, net							3,051
Unrealized foreign exchange loss on debt							5,918
Loss before income taxes and minority interest							(4,437)

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Note 6. Inventories

	September 30, 2006	December 31, 2005
Raw materials	40,713	42,649
Finished goods	21,795	38,498
	62,508	81,147

Note 7. Pension and Other Post-Retirement Benefit Obligations

Included in pension and other post-retirement benefit obligations are amounts related to the Company s Celgar and German pulp mills.

The Celgar mill maintains defined benefit pension and post-retirement benefit plans for certain employees. Pension benefits are based on employees earnings and years of service. The pension plans are funded by contributions from the Company based on management s best estimates. Pension contributions for the nine month period ended September 30, 2006 and the period from acquisition to September 30, 2005 totaled 1,056 and 994, respectively.

	Nine Months Ended September 30,			
	2006		2005	
	Pension Benefits	Post-Retirement Benefits	Pension Benefits	Post-Retirement Benefits
Service cost	667	339	420	183
Interest cost	1,051	568	826	402
Expected return on plan assets	(1,170)		(808)	
Recognized net loss		75		
Net periodic benefit cost	548	982	438	585

	Three Months Ended September 30,			
	2006		2005	
	Pension Benefits	Post-Retirement Benefits	Pension Benefits	Post-Retirement Benefits
Service cost	219	112	175	76
Interest cost	345	186	345	168
Expected return on plan assets	(384)		(337)	
Recognized net loss		25		
Net periodic benefit cost	180	323	183	244

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Note 8. Derivatives Transactions

	Nine Months Ended September 30,	
	2006	**2005**
Realized loss on derivative financial instruments	(5,219)	(2,455)
Unrealized net gain (loss) on interest rate derivatives	26,624	(15,165)
Unrealized net gain (loss) on foreign exchange derivatives	49,627	(52,639)
Unrealized gain (loss) on derivative financial instruments	76,251	(67,804)

	Three Months Ended September 30,	
	2006	**2005**
Realized loss on derivative financial instruments		(284)
Unrealized net gain (loss) on interest rate derivatives	(9,702)	5,310
Unrealized net loss on foreign exchange derivatives	(4,771)	(1,975)
Unrealized gain (loss) on derivative financial instruments	(14,473)	3,335

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Note 9. Restricted Group Supplemental Disclosure

The terms of the indenture governing our 9.25% senior unsecured notes requires that the Company provide the results of operations and financial condition of Mercer Inc. and our restricted subsidiaries under the indenture, collectively referred to as the Restricted Group . From February 14, 2005, the Restricted Group includes Mercer Inc., certain holding subsidiaries, Rosenthal and the Celgar mill. The Restricted Group excludes its paper operations and the Stendal mill.

Combined Condensed Balance Sheet

	September 30, 2006			
	Restricted Group	Unrestricted Subsidiaries	Eliminations	Consolidated Group
ASSETS				
Current assets				
Cash and cash equivalents	37,381	31,992		69,373
Cash restricted				
Receivables	45,683	38,170		83,853
Note receivable, current portion	1,963	5,267		7,230
Inventories	38,951	23,557		62,508
Prepaid expenses and other	3,271	2,355		5,626
Total current assets	127,249	101,341		228,590
Cash restricted		57,000		57,000
Property, plant and equipment	424,205	570,600		994,805
Other	3,118	5,607		8,725
Deferred income tax	17,093	26,096		43,189
Due from unrestricted group	48,352		(48,352)	
Note receivable, less current portion		4,036		4,036
Total assets	620,017	764,680	(48,352)	1,336,345
LIABILITIES				
Current liabilities				
Accounts payable and accrued expenses	41,532	61,789		103,321
Debt, current portion		40,903		40,903
Total current liabilities	41,532	102,692		144,224
Debt, less current portion	317,999	565,097		883,096
Due to restricted group		48,352	(48,352)	
Unrealized derivative loss		68,528		68,528
Other	21,213	4,311		25,524
Deferred income tax	2,604	16,526		19,130
Total liabilities	383,348	805,506	(48,352)	1,140,502

SHAREHOLDERS EQUITY				
Total shareholders equity (deficit)	236,669	(40,826)[1]		195,843
Total liabilities and shareholders equity	620,017	764,680	(48,352)	1,336,345

(1) Shareholders equity does not include government grants received or receivable related to the Stendal mill. Shareholders equity is impacted by the unrealized non-cash marked to market valuation losses on derivative financial instruments.

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Note 9. Restricted Group Supplemental Disclosure (cont d)

Combined Condensed Balance Sheet

	December 31, 2005			
	Restricted Group	Unrestricted Subsidiaries	Eliminations	Consolidated Group
ASSETS				
Current				
Cash and cash equivalents	48,790	34,757		83,547
Cash restricted		7,039		7,039
Receivables	41,349	32,966		74,315
Inventories	47,100	34,047		81,147
Prepaid expenses and other	2,940	2,534		5,474
Total current assets	140,179	111,343		251,522
Cash restricted		24,573		24,573
Property, plant and equipment	404,151	620,511		1,024,662
Other	10,533	4,145		14,678
Deferred income tax	24,303	54,078		78,381
Due from unrestricted group	46,412		(46,412)	
Total assets	625,578	814,650	(46,412)	1,393,816
LIABILITIES				
Current				
Accounts payable and accrued expenses	46,867	65,859		112,726
Debt, current portion		27,601		27,601
Total current liabilities	46,867	93,460		140,327
Debt, less current portion	342,023	580,596		922,619
Due to restricted group		46,412	(46,412)	
Unrealized derivative loss		140,625		140,625
Other	20,722	6,336		27,058
Deferred income tax	1,851	12,593		14,444
Total liabilities	411,463	880,022	(46,412)	1,245,073
SHAREHOLDERS EQUITY				
Total shareholders equity (deficit)	214,115	(65,372)[1]		148,743
Total liabilities and shareholders equity	625,578	814,650	(46,412)	1,393,816

(1) Shareholders equity does not include government grants received or receivable related to the Stendal mill. Shareholders equity is impacted by the unrealized non-cash marked to market valuation losses on derivative financial instruments.

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Note 9. Restricted Group Supplemental Disclosure (cont d)

Combined Condensed Statement of Operations

	Nine Months Ended September 30, 2006			
	Restricted Group	Unrestricted Subsidiaries	Eliminations	Consolidated Group
Revenues	265,531	241,485	(6,062)	500,954
Operating costs	214,093	176,998		391,091
Operating depreciation and amortization	20,580	21,761		42,341
General and administrative expenses	13,664	10,680		24,344
(Sale) purchase of emission allowances	(3,651)	(9,595)		(13,246)
Gain on sale of assets		(359)		(359)
	244,686	199,485		444,171
Income from operations	20,845	42,000	(6,062)	56,783
Other income (expense)				
Interest expense	(24,602)	(46,182)	2,655	(68,129)
Investment income	3,262	2,283	(1,449)	4,096
Unrealized foreign exchange gain on debt	11,469			11,469
Derivative financial instruments, net		71,032		71,032
Total other (expense) income	(9,871)	27,133	1,206	18,468
Income (loss) before income taxes and minority interest	10,974	69,133	(4,856)	75,251
Income tax provision	(8,094)	(32,102)	(192)	(40,388)
Income (loss) before minority interest	2,880	37,031	(5,048)	34,863
Minority interest		6,874		6,874
Net income (loss)	2,880	43,905	(5,048)	41,737

	Nine Months Ended September 30, 2005			
	Restricted Group	Unrestricted Subsidiaries	Eliminations	Consolidated Group
Revenues	200,516	175,914		376,430
Operating costs	158,384	152,939		311,323
Operating depreciation and amortization	17,431	20,771	660	38,862

General and administrative	15,559	6,840		22,399
(Sale) purchase of emission allowances	(4,402)	(7,951)		(12,353)
	186,972	172,599	660	360,231
Income (loss) from operations	13,544	3,315	(660)	16,199
Other income (expense) Interest expense	(23,918)	(41,351)	1,949	(63,320)
Investment income	2,313	1,230	(1,949)	1,594
Unrealized foreign exchange loss on debt	(1,591)			(1,591)
Derivative financial instruments, net	(494)	(69,765)		(70,259)
Impairment of investments	(1,699)			(1,699)
Total other expense	(25,389)	(109,886)		(135,275)
Loss before income taxes and minority interest	(11,845)	(106,571)	(660)	(119,076)
Income tax (provision) benefit	(7,867)	22,494		14,627
Loss before minority interest	(19,712)	(84,077)	(660)	(104,449)
Minority interest		17,076		17,076
Net loss	(19,712)	(67,001)	(660)	(87,373)

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Note 9. Restricted Group Supplemental Disclosure (cont d)

Combined Condensed Statement of Operations

	Three Months Ended September 30, 2006			
	Restricted Group	Unrestricted Subsidiaries	Eliminations	Consolidated Group
Revenues	95,908	80,672	(1,395)	175,185
Operating costs	65,705	51,689	4,434	121,828
Operating depreciation and amortization	6,383	7,176		13,559
General and administrative expenses	3,289	2,464		5,753
Gain on sale of assets		(359)		(359)
	75,377	60,970	4,434	140,781
Income (loss) from operations	20,531	19,702	(5,829)	34,404
Other income (expense)				
Interest expense	(8,160)	(14,827)	895	(22,092)
Investment income	1,143	(369)	311	1,085
Foreign exchange loss on debt	(704)			(704)
Derivative financial instruments, net		(14,473)		(14,473)
Total other (expense) income	(7,721)	(29,669)	1,206	(36,184)
Income (loss) before income taxes and minority interest	12,810	(9,967)	(4,623)	(1,780)
Income tax provision	(1,189)	3,913	(192)	2,532
Income (loss) before minority interest	11,621	(6,054)	(4,815)	752
Minority interest		5,976		5,976
Net income (loss)	11,621	(78)	(4,815)	6,728

	Three Months Ended September 30, 2005			
	Restricted Group	Unrestricted Subsidiaries	Eliminations	Consolidated Group
Revenues	86,100	62,828		148,928
Operating costs	71,124	54,915		126,039
Operating depreciation and amortization	6,602	7,155	222	13,979
General and administrative	4,482	2,601		7,083

(Sale) purchase of emission allowances	(2,267)	(3,798)		(6,065)
	79,941	60,873	222	141,036
Income from operations	6,159	1,955	(222)	7,892
Other income (expense)				
Interest expense	(7,987)	(14,780)	856	(21,911)
Investment income	1,016	453	(856)	613
Unrealized foreign exchange gain on debt	5,918			5,918
Derivative financial instruments, net	(31)	3,082		3,051
Total other income (expense)	(1,084)	(11,245)		(12,329)
Income (loss) before income taxes and minority interest	5,075	(9,290)	(222)	(4,437)
Income tax (provision) benefit	(3,091)	(3,694)		(6,785)
Income (loss) before minority interest	1,984	(12,984)	(222)	(11,222)
Minority interest		5,667		5,667
Net income (loss)	1,984	(7,317)	(222)	(5,555)

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Note 10. Reorganization and Divestment of Interests in Paper Assets

In August 2006, the Company reorganized and divested its equity interests in certain paper production assets for aggregate consideration of approximately 5.0 million of indebtedness, in the form of a secured note, and 5.0 million in cash. Only the cash portion of the consideration appears on the consolidated condensed statements of cash flows.

Note 11. Subsequent Event

Subsequent to September 30, 2006, the Company increased its interest in the Stendal mill to 70.6% by acquiring a 7% minority interest therein for 8.1 million, of which 6.7 million was paid by a note that, at its election, the Company can satisfy in shares of its common stock.

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

In this document: (i) unless the context otherwise requires, references to we , our , us , the Company or Mercer me Mercer International Inc. and its subsidiaries; (ii) references to Mercer Inc. mean the Company excluding its subsidiaries; (iii) information is provided as of September 30, 2006, unless otherwise stated; (iv) all references to monetary amounts are to Euros , unless otherwise stated; (v) refers to Euros and C$ refers to Canadian dollars; and (vi) ADMTs refers to air-dried metric tonnes.

The following discussion and analysis of our results of operations and financial condition for the nine months ended September 30, 2006 should be read in conjunction with our consolidated financial statements and related notes included in this quarterly report, as well as our most recent annual report on Form 10-K for the fiscal year ended December 31, 2005 filed with the Securities and Exchange Commission (the SEC). Certain reclassifications have been made to the prior period financial statements to conform with the current period presentation.

Results of Operations

Nine Months Ended September 30, 2006 Compared to Nine Months Ended September 30, 2005

Selected sales data for the nine months ended September 30, 2006 and 2005 is as follows:

	Nine Months Ended September 30,	
	2006	**2005**
	(ADMTs)	
Sales Volume by Product Class		
Pulp sales volume by mill:		
Rosenthal	229,891	241,572
Stendal	422,272	243,267
Celgar(1)	342,404	325,419
Total pulp sales volume(2)	994,567	810,258
Paper sales volume	42,655(3)	51,406
Total sales volume(2)	1,037,222	861,664

	(in thousands)	
Revenues by Product Class		
Pulp revenues by mill:		
Rosenthal	105,812	100,967
Stendal	188,546	127,637
Celgar(1)	157,328	97,458
Total pulp revenues(2)	451,686	326,062
Paper revenues	43,465(3)	46,995
Total pulp and paper sales revenues(2)	495,151	373,057
Third party transportation revenues	5,802	3,373
Total sales revenues	500,953	376,430

(1)

The results of the Celgar pulp mill are included from the date of its acquisition on February 14, 2005.

(2) Excluding intercompany sales volumes of 12,631 and 10,651 ADMTs of pulp and intercompany net sales revenues of approximately 5.8 million and 4.8 million in the nine months ended September 30, 2006 and 2005, respectively.

(3) In August 2006, we sold our Heidenau paper mill.

Selected production data for the nine months ended September 30, 2006 and 2005 is as follows:

	Nine Months Ended September 30,	
	2006	**2005**
Production by Product Class	**(ADMTs)**	
Pulp production by mill:		
Rosenthal	227,645	240,665
Stendal	414,787	357,814
Celgar(1)	330,978	289,868
Total pulp production	973,410	888,347
Paper production	44,313(2)	50,001
Total production	1,017,723	938,348

(1) The results of the Celgar pulp mill are included from the date of its acquisition on February 14, 2005.

(2) In August 2006, we sold our Heidenau paper mill.

Revenues for the nine months ended September 30, 2006 increased to 501.0 million from 376.4 million in the comparative period of 2005, primarily due to higher pulp prices and sales from our Celgar and Stendal pulp mills. Pulp sales by volume increased to 994,567 ADMTs in the first nine months of 2006 from 810,258 ADMTs in the comparative period of 2005.

Cost of sales and general, administrative and other expenses in the first nine months of 2006 increased to 444.2 million from 360.2 million in the comparative period of 2005, primarily as a result of higher sales from our Celgar and Stendal mills.

For the first nine months of 2006, revenues from our pulp operations increased to 457.2 million from 329.4 million in the same period a year ago. List prices for NBSK pulp in Europe were approximately 533 ($663) per ADMT in the first nine months of 2006, approximately 484 ($611) per ADMT in the first nine months of 2005 and approximately 556 ($708) per ADMT in the third quarter of 2006.

Mill net pulp sales realizations increased to 454 per ADMT on average in the first nine months of 2006 from 402 per ADMT in the first nine months of 2005, primarily as a result of higher pulp prices.

During the current period, we took an aggregate of 50 days scheduled maintenance and strategic capital expenditure downtime at our pulp mills, including 21 days at our Rosenthal mill, 16 days at our Stendal mill and 13 days at our Celgar mill. During the downtime at our Rosenthal mill, we completed the installation of a new brownstock washer at a cost of approximately 9.7 million, which is expected to further improve pulp quality and lower chemical costs and effluents. During the comparative period of 2005, our pulp mills took approximately 44 days maintenance and strategic capital expenditure downtime.

Cost of sales and general, administrative and other expenses for the pulp operations increased to 405.9 million in the first nine months of 2006 from 311.3 million in the comparative period of 2005 primarily as a result of higher sales from our Celgar and Stendal mills.

Fiber costs at our German pulp mills increased by approximately 7% in the first nine months of 2006 versus the same period of 2005. This resulted from lower availability because of severe winter conditions in Germany and central Europe, which caused sawmillers and log harvesters to curtail operations in the first part of the year and increased competition for fiber primarily from renewable energy operations. The increase in worldwide energy prices has made projects generating energy from renewable sources such as wood residuals more viable in Europe. As a result, there has been increased fiber demand and competition in our fiber base. In the first nine months of 2006, average fiber costs at our Celgar mill decreased by approximately 10% versus the same period of 2005, primarily because of fluctuations in regional wood chip availability. We expect that reduced fiber availability during the winter harvesting season will result in upward pressure on fiber prices into the last part of 2006 and into the first part of 2007.

In the first nine months of 2006, we recorded a contribution to income from operations of 13.2 million resulting from the sale of emission allowances compared to 12.4 million in the comparative period of 2005.

Depreciation for the pulp operations increased to 41.6 million in the first nine months of 2006, from 37.4 million in the first nine months of 2005, primarily as a result of the inclusion of depreciation for the Celgar mill for the full period.

For the first nine months of 2006, our pulp operations generated operating income of 57.5 million, versus operating income of 22.9 million in the same period of 2005, primarily due to improving pulp markets and the higher operating income at our Celgar pulp mill, partially offset by maintenance and strategic capital expenditure downtime at our pulp mills. The overall strength of the Canadian dollar versus the U.S. dollar negatively impacted our Celgar mill s results.

In August 2006, we disposed of our equity interest in the Heidenau paper mill and in a Swiss specialty paper mill for cash proceeds of 5.0 million and a secured note of 5.0 million. We recorded a gain of 0.4 million on the transaction. We currently operate one paper mill at Fährbrücke, that we do not consider part of our core operations. We are continuing to explore and consider strategic options for such mill, including a sale, closure or divestiture thereof.

Revenues from our paper operations in the first nine months of 2006 decreased to 43.8 million from 47.0 million in the same period of last year, primarily as a result of the sale of our Heidenau paper mill in August 2006.

Cost of sales and general, administrative and other expenses for the paper operations in the first nine months of 2006 decreased to 43.1 million from 49.2 million in the comparative period of 2005.

In the first nine months of 2006, our paper operations generated operating income of 0.6 million, compared to an operating loss of 2.2 million in the first nine months of 2005.

In the first nine months of 2006, income from operations increased to 56.8 million from 16.2 million in the same period last year, primarily as a result of higher pulp prices and improved results from our Celgar pulp mill.

Interest expense in the first nine months of 2006 increased to 68.1 million from 63.3 million in the year ago period, primarily due to higher borrowing costs relating to the Stendal mill.

Stendal entered into certain foreign currency derivatives to swap all of its long-term bank indebtedness from Euros to U.S. dollars in 2005 and certain currency forwards. In addition, Stendal previously entered into interest rate swaps to fix the interest rate on its outstanding bank indebtedness. Due to the weakening of the U.S. dollar versus the Euro and an increase in long-term interest rates, we recorded a net unrealized non-cash holding gain of 76.3 million before minority interests upon the marked to market valuation of such derivatives that were outstanding at the end of the current period, compared to a net non-cash holding loss of 67.8 million before minority interests upon the marked to market valuation of our outstanding derivatives in the comparative period of 2005. In the first nine months of 2006, we recorded a realized loss of 5.2 million compared to a realized loss of 2.5 million in the comparative period of 2005 primarily from the sale of currency forwards.

In the first nine months of 2006, minority interest, representing the two minority shareholders proportionate interest in the Stendal mill s losses for the period, was 6.9 million, compared to 17.1 million in the first nine months of 2005. Subsequent to September 30, 2006, we increased our ownership in Stendal to 70.6% by acquiring a 7% minority interest therein for 8.1 million, of which 6.7 million was paid by a note that, at our election, we can satisfy in shares of our common stock.

We reported net income for the first nine months of 2006 of 41.7 million, or 1.26 per basic and 1.05 per diluted share, which reflected a net realized and unrealized gain of 71.0 million on our interest rate and currency derivatives, an unrealized non-cash foreign exchange gain on our long-term debt of 11.5 million and improved pulp markets. In the first nine months of 2005, we reported a net loss of 87.4 million, or 2.86 per basic and diluted share, which reflected interest expense related to our Stendal mill of 41.0 million, the realized and unrealized net losses on our currency and interest rate derivatives of 70.1 million, the unrealized non-cash foreign exchange loss on our long-term debt of 1.6 million, and the non-cash impairment charge of 1.7 million relating to investments, partially offset by a non-cash benefit for income taxes of 14.6 million.

We generated Operating EBITDA of 99.1 million and 55.1 million in the nine months ended September 30, 2006 and 2005, respectively. Operating EBITDA is defined as income (loss) from operations plus depreciation and amortization and non-recurring capital asset impairment charges.

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

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

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

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

	Nine Months Ended September 30,	
	2006	**2005[(1)]**
	(in thousands)	
Net income (loss)	41,737	(87,373)
Minority interest	(6,874)	(17,076)
Income taxes (benefit)	40,388	(14,627)
Interest expense	68,129	63,320
Investment income	(4,096)	(1,594)
Foreign exchange (gain) loss on debt	(11,469)	1,591
Derivative financial instruments, net (gain) loss	(71,032)	70,259
Impairment of investments		1,699
Income from operations	56,783	16,199
Add: Depreciation and amortization	42,341	38,862
Operating EBITDA	99,124	55,061

(1) The results of the Celgar pulp mill are included from the date of its acquisition on February 14, 2005.

Three Months Ended September 30, 2006 Compared to Three Months Ended September 30, 2005

Selected sales data for the three months ended September 30, 2006 and 2005 is as follows:

	Three Months Ended September 30,	
	2006	**2005**
	(ADMTs)	
Sales Volume by Product Class		
Pulp sales volume by mill:		
Rosenthal	80,655	86,772

Stendal	144,864	120,431
Celgar	112,682	125,079
Total pulp sales volume[(1)]	338,201	332,282
Paper sales volume	10,571(2)	16,928
Total sales volume[(1)]	348,772	349,210

	Three Months Ended September 30,	
	2006	2005
	(in thousands)	
Revenues by Product Class		
Pulp revenues by mill:		
Rosenthal	38,419	36,463
Stendal	68,004	46,764
Celgar	56,494	48,978
Total pulp revenues[1]	162,917	132,205
Paper revenues	10,022[2]	15,532
Total pulp and paper sales revenues[1]	172,939	147,737
Third party transportation revenues	2,246	1,191
Total sales revenues	175,185	148,928

(1) Excluding intercompany sales volumes of 2,774 and 3,057 ADMTs of pulp and intercompany net sales revenues of approximately 1.3 million and 1.3 million in the three months ended September 30, 2006 and 2005, respectively.

(2) In August 2006, we sold our Heidenau paper mill.

Selected production data for the three months ended September 30, 2006 and 2005 is as follows:

	Three Months Ended September 30,	
	2006	2005
Production by Product Class	(ADMTs)	

Pulp production by mill:		
Rosenthal	84,115	83,350
Stendal	144,195	126,202
Celgar	118,890	118,035
Total pulp production	347,200	327,587
Paper production	10,711(1)	16,064
Total production	357,911	343,651

(1) In August 2006, we sold our Heidenau paper mill.

Revenues for the three months ended September 30, 2006 increased to 175.2 million from 148.9 million in the comparative period of 2005, primarily due to higher pulp prices and sales from our Stendal pulp mill. Pulp sales by volume increased to 338,201 ADMTs in the third quarter of 2006 from 332,282 ADMTs in the comparative period of 2005.

Cost of sales and general, administrative and other expenses in the third quarter of 2006 decreased to 140.8 million from 141.0 million in the comparative period of 2005.

For the third quarter of 2006, revenues from our pulp operations increased to 164.9 million from 133.4 million in the same period a year ago. List prices for NBSK pulp in Europe were approximately 556 ($708) in the third quarter of 2006, compared to approximately 476 ($580) per ADMT in the third quarter of 2005.

Mill net pulp sales realizations increased to 482 per ADMT on average in the third quarter of 2006 from 398 per ADMT in the third quarter of 2005, primarily as a result of higher pulp prices.

Cost of sales and general, administrative and other expenses for the pulp operations increased to 132.8 million in the third quarter of 2006 from 125.5 million in the comparative period of 2005, primarily as a result of the absence of the sale of emission allowances and higher sales from our Stendal mill.

Fiber costs at our German pulp mills increased by approximately 10% in the third quarter of 2006 versus the same period of 2005 primarily because of increased demand for wood residuals. In the third quarter of 2006, average fiber costs at our Celgar mill increased by approximately 6% versus the same quarter of 2005, primarily because of fluctuations in regional wood chip availability. We expect that reduced fiber availability during the winter harvesting season will result in continued upward pressure on fiber prices into the last part of 2006 and into the first part of 2007.

In the third quarter of 2006, we recorded a contribution to income from operations of nil resulting from the sale of emission allowances compared to 6.1 million in the comparative quarter of 2005.

Depreciation for the pulp operations increased to 13.4 million in the third quarter of 2006, from 13.3 million in the comparative quarter of 2005.

For the third quarter of 2006, our pulp operations generated operating income of 33.8 million, versus operating income of 9.2 million, primarily as a result of higher pulp prices and improved operating results at our Celgar pulp mill.

In August 2006, we disposed of our equity interest in the Heidenau paper mill and in a Swiss specialty paper mill for cash proceeds of 5.0 million and a secured note of 5.0 million. We recorded a gain of 0.4 million on the transaction. We currently operate one paper mill at Fährbrücke, that we do not consider part of our core operations. We are continuing to explore and consider strategic options for such mill, including a sale, closure or divestiture thereof.

Revenues from our paper operations were 10.3 million in the current quarter, compared to 15.5 million in same quarter of last year.

Cost of sales and general, administrative and other expenses for the paper operations in the third quarter of 2006 decreased to 10.4 million from 16.6 million in the comparative quarter of 2005.

For the third quarter of 2006, our paper operations generated an operating loss of 0.3 million, compared to an operating loss of 1.1 million in the third quarter of 2005.

In the third quarter of 2006, we had income from operations of 34.4 million, compared to 7.9 million in the same quarter last year. Interest expense in the third quarter of 2006 increased to 22.1 million from 21.9 million in the year ago period.

Stendal entered into certain foreign currency derivatives to swap all of its long-term bank indebtedness from Euros to U.S. dollars in 2005 and certain currency forwards. In addition, Stendal previously entered into interest rate swaps to fix the interest rate on its outstanding bank indebtedness. The weakening of the U.S. dollar versus the Euro was more than offset by a recent reduction in long-term interest rates, leading to a net unrealized non-cash holding loss of 14.5 million before minority interests upon the marked to market valuation of such derivatives that were outstanding at the end of the current quarter, compared to a net realized and unrealized non-cash holding gain of 3.1 million before minority interests upon the marked to market valuation of our outstanding derivatives in the comparative quarter of 2005.

In the third quarter of 2006, minority interest, representing the two minority shareholders proportionate interest in the Stendal mill, was 6.0 million, compared to 5.7 million in the third quarter of 2005.

We reported net income for the three months ended September 30, 2006 of 6.7 million, or 0.20 per basic and 0.19 per diluted share, which included an aggregate of 15.2 million unrealized losses on our outstanding derivatives and a foreign exchange loss on our long-term debt. In the third quarter of 2005, we reported a net loss of 5.6 million, or 0.17 per basic and diluted share, which reflected the inclusion of interest expense related to our Stendal mill of 14.7 million and the net realized and unrealized gain of 3.1 million on our interest rate and currency derivatives and the unrealized non-cash foreign exchange gain on our long-term debt of 5.9 million.

We generated Operating EBITDA of 48.0 million and 21.9 million in the three months ended September 30, 2006 and 2005, respectively. Operating EBITDA has significant limitations as an analytical tool, and should not be considered in isolation, or as a substitute for analysis of our results as reported under GAAP. See the discussion of our results for the first nine months of 2006 for additional information relating to Operating EBITDA.

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

	Three Months Ended September 30,	
	2006	**2005**
	(in thousands)	
Net income (loss)	6,728	(5,555)
Minority interest	(5,976)	(5,667)
Income taxes (benefit)	(2,532)	6,785
Interest expense	22,092	21,911
Investment income	(1,085)	(613)
Foreign exchange (gain) loss on debt	704	(5,918)
Derivative financial instruments, net (gain) loss	14,473	(3,051)
Income from operations	34,404	7,892
Add: Depreciation and amortization	13,559	13,979
Operating EBITDA	47,963	21,871

Liquidity and Capital Resources

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

	As at September 30, 2006	**As at December 31, 2005**
	(in thousands)	
Financial Position		
Cash and cash equivalents	69,373	83,547
Working capital[(1)]	84,366	111,195
Property, plant and equipment	994,805	1,024,662
Total assets	1,336,345	1,393,816
Long-term liabilities	996,278[(2)]	1,104,746
Shareholders equity	195,843	148,743

(1) Does not include approximately 8.7 million of

government grants in 2006, which we expect to receive in 2006, and approximately 65.9 million of government grants in 2005, all of which has been received, related to the Stendal mill from German federal and state governments.

(2) Includes 8.6 million outstanding under the revolving credit facility for the Celgar mill.

At September 30, 2006, our cash and cash equivalents were 69.4 million, compared to 83.5 million at December 31, 2005.

During the third quarter of 2006, restricted cash at Stendal decreased by 9.5 million to 57.0 million due to the final drawdown on the shareholder standby loan. The restricted cash at September 30, 2006 is a debt service security or reserve equal to approximately one year s worth of Stendal s scheduled principal and interest payments under the Stendal Loan facility. As this debt service account secures Stendal s obligations under the Stendal Loan Facility, it is recorded as a long-term asset.

Our reduction in working capital at September 30, 2006 compared to December 31, 2005 of approximately 26.8 million resulted principally from a build-up of 32.4 million in the restricted cash in the Stendal debt service account, which is classified as a long-term asset, and the reclassification as current liabilities of certain principal payments on the Stendal Loan Facility that mature within one year.

At September 30, 2006, we qualified for investment grants related to the Stendal mill totaling approximately 8.7 million from the federal and state governments of Germany, which we expect to receive in the fourth quarter of 2006. These grants, when received, will be applied to repay the amounts drawn under the current portion of a dedicated tranche of the Stendal Loan Facility. Under our accounting policies, we do not record these grants until they are received. The grants are not reported in our income and reduce the cost basis of the assets purchased when they are received.

As at September 30, 2006, we had not drawn any amount under the 40.0 million Rosenthal revolving term credit facility and had drawn down approximately 8.6 million of the C$40 million Celgar revolving credit facility.

We expect to meet our interest and debt service expenses and the working and maintenance capital requirements for our operations (other than at Stendal) from cash flow from operations, cash on hand and the two revolving working capital facilities for the Rosenthal and Celgar mills.

We expect to meet the capital requirements for the Stendal mill, including potential losses during ramp up, interest and principal service expenses through cash on hand, cash flow from operations, shareholder advances already made to Stendal, the Stendal Loan Facility (which includes a revolving working capital tranche and a debt service reserve account) and the receipt of government grants.

Operating Activities

Operating activities in the first nine months of 2006 provided cash of 31.9 million, compared to using cash of 5.6 million in the comparative period of 2005. An increase in receivables due primarily to higher sales used cash of 14.9 million in the first nine months of 2006, compared to an increase in receivables using cash of 20.4 million in the comparative period of 2005. A decrease in inventories due primarily to a reduction in raw materials and finished goods at the Stendal mill provided cash of 11.9 million in the first nine months of 2006, compared to using cash of 9.6 million in the comparative period of 2005. A decrease in accounts payable and accrued expenses used cash of 0.1 million in the first nine months of 2006, compared to an increase that provided cash of 33.8 million in the comparative period of 2005.

Working capital is subject to cyclical operating needs, the timing of collections, receivables and government grants and the payment of payables and expenses.

Investing Activities

Investing activities in the nine months ended September 30, 2006 used cash of 44.4 million, compared to the nine months ended September 30, 2005 when investing activities used cash of 97.2 million. In the nine months ended September 30, 2006, a drawdown under a tranche of the Stendal project financing facility to increase our restricted cash in the Stendal debt service reserve account used cash of 25.4 million versus a decrease in restricted cash providing cash of 60.7 million in the comparative period of 2005.

Financing Activities

Financing activities used cash of 1.1 million in the nine months ended September 30, 2006, compared to the first nine months of 2005 when, in connection with the acquisition of the Celgar pulp mill, financing activities, including the issuance of common stock and senior notes, provided cash of 134.2 million.

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

Contractual Obligations and Commitments

There were no material changes outside the ordinary course to any of our contractual obligations during the first nine months of 2006.

Capital Resources

In addition to our revolving credit facilities for the Rosenthal and Celgar mills and the revolving working capital tranche of the Stendal Loan Facility, respectively, we may seek to raise future funding in the debt markets if our indenture relating to our 9.25% senior notes permits, subject to compliance with the indenture. The indenture governing the senior notes provides that, in order for Mercer Inc. and its restricted subsidiaries (as defined in the indenture and which excludes the Stendal mill and our paper operations) to enter into certain types of transactions, including the incurrence of additional indebtedness, the making of restricted payments and the completion of mergers and consolidations (other than, in each case, those specifically permitted by our senior note indenture), we must meet a minimum ratio of Indenture EBITDA to Fixed Charges as defined in the senior note indenture of 2.0 to 1.0 on a pro forma basis for the most recently ended four full fiscal quarters.

Stendal Pulp Mill EPC Contract

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

Pursuant to the EPC contract, each department of the mill is tested on a stand-alone basis for compliance with its design specifications. Under the EPC contract, RWE warrants conformity to specifications, compliance with permits and laws, suitability for intended use, compliance with performance requirements and against defects in construction for a stipulated period, subject to extension in certain circumstances. The testing and warranty are highly technical and include detailed design and performance specifications. Some of the prescribed testing was unsatisfactory to Stendal. As is common in large greenfield projects like the Stendal mill, Stendal made a significant number of claims, including rights to penalties and/or liquidated damages against the contractor under the EPC contract prior to the expiry of the applicable warranty claim period in September 2006. Many claims are highly technical and relate to, among other things, design and performance specifications and reliability, as well as penalties in regards to delays. Stendal and the contractor have agreed to try to work to resolve such outstanding claims by late December 2006 without either party seeking recourse to arbitration or other similar legal remedies under the EPC contract.
Currently, we cannot predict with any certainty which claims of Stendal the contractor may accept, the amount, if any, of any recoveries associated therewith or the final determination of such claims whether through further work and retesting by the contractor, legal proceedings, negotiation or other settlement.

Foreign Currency

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

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

In the nine months ended September 30, 2006, we reported a net 4.4 million foreign exchange translation gain and, as a result, the cumulative foreign exchange translation gain increased to 20.0 million at September 30, 2006 from 15.6 million at December 31, 2005.

Based upon the exchange rate at September 30, 2006, the U.S. dollar decreased by approximately 5% in value against the Euro since September 30, 2005. See Quantitative and Qualitative Disclosures about Market Risk .

Results of Operations of the Restricted Group Under Our Senior Note Indenture

The indenture governing our 9.25% senior notes requires that we also provide a discussion in annual and quarterly reports we file with the SEC under Management s Discussion and Analysis of Financial Condition and Results of Operations of the results of operations and financial condition of Mercer Inc. and our restricted subsidiaries under the indenture, referred to as the Restricted Group . As at and during the nine months ended September 30, 2006, the Restricted Group was comprised of Mercer Inc., certain holding subsidiaries, Rosenthal and Celgar. During the nine months ended September 30, 2005 and as at December 31, 2005, the Restricted Group was comprised of Mercer Inc., certain holding subsidiaries, Rosenthal and the Celgar mill from February 14, 2005, the date of the acquisition of the mill. The Restricted Group excludes our paper operations and our Stendal mill.

The following is a discussion of the results of operations and financial condition of the Restricted Group. For further information regarding the operating results of the Rosenthal and Celgar mills, see Note 5 of our quarterly financial statements included herein. For further information regarding the Restricted Group including, without limitation, a reconciliation to our consolidated results of operations, see Note 9 of our quarterly financial statements included herein.

Restricted Group Results Nine Months Ended September 30, 2006 Compared to Nine Months Ended September 30, 2005

Total revenues for the Restricted Group for the nine months ended September 30, 2006 increased to 265.5 million from 200.5 million in the comparative period of 2005, primarily because of higher pulp sales from the Celgar mill and higher prices. Pulp sales realizations for the Restricted Group were 460 per ADMT on average in the nine months ended September 30, 2006 and 409 per ADMT in the comparative period of 2005. The increase in NBSK pulp prices was partially offset by the strength of the Canadian dollar versus the U.S. dollar during the current period.

Costs of sales and general, administrative and other expenses for the Restricted Group in the nine months ended September 30, 2006 increased to 244.7 million from 187.0 million in the comparative period of 2005 primarily as a result of higher sales.

During the current period, we took an aggregate of 34 days scheduled maintenance and strategic capital expenditure downtime at the Rosenthal and Celgar mills, including 21 days at our Rosenthal mill and 13 days at our Celgar mill. During the downtime at our Rosenthal mill, we completed the installation of a new brownstock washer at a cost of approximately 9.7 million, which is expected to further improve pulp quality and lower chemical costs and effluents. During the comparative period of 2005, our Rosenthal and Celgar mills took approximately 13 days of maintenance and strategic capital expenditure downtime.

In the first nine months of 2006, we recorded income from operations of 3.7 million through the sale of emission allowances by our Rosenthal pulp mill, compared to 4.4 million in the same period of 2005. The market for emission allowances is relatively new and volatile. Based upon our activities to date, we currently estimate the Restricted Group s overall volume of emission allowance sales in the current year will be at or near the total volume sold by it for the full year in 2005.

On average, fiber costs at our Rosenthal pulp mill increased by approximately 11% in the first nine months of 2006 versus the same period of 2005. This resulted from lower availability because of severe winter conditions in Germany and central Europe, which caused sawmillers and log harvesters to curtail operations in the first part of the year and increased competition for fiber primarily from renewable energy operations. In the first nine months of 2006, average fiber costs at our Celgar mill decreased by approximately 10% versus the same period of 2005, primarily because of increased regional wood chip availability. We expect that reduced fiber availability during the winter harvesting season will result in upward pressure on fiber prices into the last part of 2006 and into the first part of 2007.

Depreciation and amortization for the Restricted Group increased to 20.6 million in the current period from 17.4 million in the comparative period of 2005, primarily as a result of the inclusion of depreciation of the Celgar mill for the full period.

In the first nine months of 2006, the Restricted Group reported income from operations of 20.8 million, compared to 13.5 million in the first nine months of 2005, primarily as a result of a higher operating income at our Celgar mill.

Interest expense for the Restricted Group in the nine months ended September 30, 2006 increased to 24.6 million from 23.9 million in the first nine months of 2005.

In the first nine months of 2006, the Restricted Group recorded a foreign exchange gain on debt of 11.5 million, compared to a loss of 1.6 million in the comparative period of 2005. In the first nine months of 2005, the Restricted Group reported a non-cash impairment charge of 1.6 million related to an investment in a venture company.

For the nine months ended September 30, 2006, the Restricted Group reported net income of 2.9 million, compared to a loss of 19.7 million in the first nine months of 2005, primarily as a result of higher pulp prices and improved results at our Celgar mill.

The Restricted Group generated Operating EBITDA of 41.4 million and 31.0 million in the nine months ended September 30, 2006 and 2005, respectively. Operating EBITDA is defined as income (loss) from operations plus depreciation and amortization and non-recurring capital asset impairment charges. Operating EBITDA for the Restricted Group is calculated by adding depreciation and amortization and non-recurring capital asset impairment charges of 20.6 and 17.4 million to the income from operations of 20.8 million and 13.5 million for the nine months ended September 30, 2006 and 2005, respectively.

Operating EBITDA has significant limitations as an analytical tool, and should not be considered in isolation, or as a substitute for analysis of our results as reported under GAAP. See the discussion of Mercer s results for the nine months ended September 30, 2006 for additional information relating to such limitations and Operating EBITDA.

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

	Nine Months Ended September 30,	
	2006	2005(1)
	(in thousands)	
Restricted Group(2)		
Net income (loss)	2,880	(19,712)
Income taxes	8,094	7,867
Interest expense	24,602	23,918
Investment and other income	(3,262)	(2,313)
Derivative financial instruments, net		494
Unrealized foreign exchange (gain) loss on debt	(11,469)	1,591
Impairment of investments		1,699
Income from operations	20,845	13,544
Add: Depreciation and amortization	20,580	17,431
Operating EBITDA	41,425	30,975

(1) The results of the Celgar pulp mill are from the date of its acquisition on

February 14, 2005.

(2) See Note 9 of the financial statements included elsewhere herein for a reconciliation to our consolidated results.

Restricted Group Results Three Months Ended September 30, 2006 Compared to Three Months Ended September 30, 2005

Total revenues for the Restricted Group for the three months ended September 30, 2006 increased to 95.9 million from 86.1 million in the comparative period of 2005, primarily due to higher pulp prices and higher sales from our Celgar pulp mill. Pulp sales realizations for the Restricted Group were 491 per ADMT on average in the three months ended September 30, 2006 and 403 per ADMT in the comparative period of 2005.

Costs of sales and general, administrative and other expenses for the Restricted Group in the three months ended September 30, 2006 decreased to 75.4 million from 79.9 million in the comparative period of 2005, primarily as a result of lower operating costs at our Rosenthal mill.

During the current quarter we only took an aggregate of one day scheduled maintenance and strategic capital expenditure downtime at the Rosenthal and Celgar mills. During the same period of 2005, we had approximately two days of maintenance and strategic capital expenditure downtime at our Rosenthal and Celgar mills.

In the third quarter of 2006, we recorded a gain of nil million through the sale of emission allowances by our Rosenthal pulp mill, compared to 2.3 million in the same period of 2005.

On average, fiber costs at our Rosenthal pulp mill increased by approximately 13% in the third quarter of 2006 versus the same period of 2005. In the third quarter of 2006, average fiber costs at our Celgar mill increased by approximately 6% versus the same period of 2005 because of fluctuations in regional wood chip availability. We expect that reduced fiber availability during the winter harvesting season will result in continued upward pressure on fiber prices into the last part of 2006 and into the first part of 2007.

Depreciation and amortization for the Restricted Group decreased marginally to 6.4 million in the current quarter from 6.6 million in the comparative period of 2005.

In the third quarter of 2006, the Restricted Group reported income from operations of 20.5 million, compared to reported income from operations of 6.2 million in the third quarter of 2005, primarily as a result of higher prices and operating income at our Celgar mill.

Interest expense for the Restricted Group in the three months ended September 30, 2006 increased to 8.2 million from 8.0 million in the third quarter of 2005.

In the third quarter of 2006, the Restricted Group recorded a foreign exchange loss on debt of 0.7 million, compared to a gain of 5.9 million in the comparative period of 2005.

For the three months ended September 30, 2006, the net income reported by the Restricted Group was 11.6 million, compared to net income of 2.0 million in the third quarter of 2005, primarily as a result of improved operating income of our Celgar mill.

The Restricted Group generated Operating EBITDA of 26.9 million and 12.8 million in the three months ended September 30, 2006 and 2005, respectively. Operating EBITDA for the Restricted Group is calculated by adding depreciation and amortization and non-recurring capital asset impairment charges of 6.4 million and 6.6 million to the income from operations of

20.5 million and 6.2 million for the three months ended September 30, 2006 and 2005, respectively.
Operating EBITDA has significant limitations as an analytical tool, and should not be considered in isolation, or as a substitute for analysis of our results as reported under GAAP. See the discussion of Mercer s results for the nine months ended September 30, 2006 for additional information relating to such limitations and Operating EBITDA.
The following table provides a reconciliation of net loss to income from operations and Operating EBITDA for the Restricted Group for the periods indicated:

	Three Months Ended September 30,	
	2006	2005
	(in thousands)	
Restricted Group[(1)]		
Net income	11,621	1,984
Income taxes	1,189	3,091
Interest expense	8,160	7,987
Investment and other expense (income)	(1,143)	(1,016)
Derivative financial instruments, net		31
Unrealized foreign exchange (gain) loss on debt	704	(5,918)
Income from operations	20,531	6,159
Add: Depreciation and amortization	6,383	6,602
Operating EBITDA	26,914	12,761

(1) See Note 9 of the financial statements included elsewhere herein for a reconciliation to our consolidated results.

Liquidity and Capital Resources of the Restricted Group

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

	As at September 30, 2006	As at December 31, 2005
	(in thousands)	
Restricted Group Financial Position[(1)]		
Cash and cash equivalents	37,381	48,790
Working capital	85,717	93,312
Property, plant and equipment	424,205	404,151
Total assets	620,017	625,578
Long-term liabilities	341,816	364,596
Shareholders equity	236,669	214,115

(1) See Note 9 of the financial statements included elsewhere herein for a reconciliation to our consolidated results.

At September 30, 2006, the Restricted Group had cash and cash equivalents of 37.4 million, compared to 48.8 million at December 31, 2005. At September 30, 2006, the Restricted Group had working capital of 85.7 million.

We expect the Restricted Group to meet its interest and debt service expenses and meet the working and maintenance capital requirements for its current operations from cash flow from operations, cash on hand and the revolving working capital loan facilities for the Rosenthal and Celgar mills. As at September 30, 2006, we had not drawn any amount under the Rosenthal revolving term credit facility and had drawn down approximately 8.6 million under the C$40 million Celgar revolving credit facility.

Critical Accounting Policies

The preparation of financial statements and related disclosures in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Estimates are used for, but not limited to, the accounting for doubtful accounts, depreciation and amortization, asset impairments, derivative financial instruments, environmental conservation, asset retirement obligations, pensions and post-retirement benefit obligations, income taxes, and contingencies. Actual results could differ from these estimates. Our management routinely makes judgments and estimates about the effects of matters that are inherently uncertain. As the number of variables and assumptions affecting the probable future resolution of the uncertainties increase, these judgments become even more subjective and complex. We have identified certain accounting policies that are the most important to the portrayal of our current financial condition and results of operations.

For information about our significant accounting policies, see our annual report on Form 10-K for the year ended December 31, 2005.

Cautionary Statement Regarding Forward-Looking Information

The statements in this report that are not reported financial results or other historical information are forward-looking statements within the meaning of the *Private Securities Litigation Reform Act of 1995*, as amended. These statements appear in a number of different places in this report and can be identified by words such as estimates , projects , expects , intends , believes , plans , or their negatives or other comparable words. Also look for discussions of strateg that involve risks and uncertainties. Forward-looking statements include statements regarding the outlook for our future operations, forecasts of future costs and expenditures, the evaluation of market conditions, the outcome of legal proceedings, the adequacy of reserves, or other business plans. You are cautioned that any such forward-looking statements are not guarantees and may involve risks and uncertainties. Our actual results may differ materially from those in the forward-looking statements due to risks facing us or due to actual facts differing from the assumptions underlying our estimates. Some of these risks and assumptions include those set forth in reports and other documents we have filed with or furnished to the SEC, including in our annual report on Form 10-K for the year ended December 31, 2005. We advise you that these cautionary remarks expressly qualify in their entirety all forward-looking statements attributable to us or persons acting on our behalf. Unless required by law, we do not assume any obligation to update forward-looking statements based on unanticipated events or changed expectations. However, you should carefully review the reports and other documents we file from time to time with the SEC.

Cyclical Nature of Business

Revenues

The pulp and paper business is cyclical in nature and markets for our principal products are characterized by periods of supply and demand imbalance, which in turn affects product prices. The markets for pulp and paper are highly competitive and are sensitive to cyclical changes in industry capacity and in the global economy, all of which can have a significant influence on selling prices and our earnings. Demand for pulp and paper products has historically been determined by the level of economic growth and has been closely tied to overall business activity. Although pulp prices have improved recently, we cannot predict the level of economic activity or growth in certain world markets or the impact of war, terrorist activity or other events on our markets and prices for our products.

Commencing in 2005, our German operations became subject to the European Union Emissions Trading Scheme pursuant to which our German mills were granted emission allowances. Emission allowances are granted based upon production volumes and the types of fuels consumed by the manufacturing facilities in Germany. Since then, we have benefited from the sale of emission allowances. However, the market for such sales is relatively new and volatile and we cannot predict the level of any sales thereafter.

Costs

Our production costs are influenced by the availability and cost of raw materials, energy and labor, and our plant efficiencies and productivity. Our main raw material is fiber in the form of wood chips and pulp logs for pulp production, and waste paper and pulp for paper production. Fiber costs are primarily affected by the supply of, and demand for, lumber and pulp, which are both highly cyclical in nature and can vary significantly by location. Recently, fiber demand in Europe has also increased because of demand from renewable energy projects and this has put upward pressure on prices for wood residuals such as wood chips. Production costs also depend on the total volume of production. Lower operating rates and production efficiencies during periods of cyclically low demand result in higher average production costs and lower margins.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to market risks from changes in interest rates and foreign currency exchange rates, particularly the exchange rate between the U.S. dollar and the Euro and to a lesser extent the Canadian dollar, which may affect our results of operations and financial condition and, consequently, our fair value. We manage these risks through internal risk management policies and, with respect to risks related to changes in exchange rates between the U.S. dollar and the Euro, with the use of derivatives. We use derivatives to reduce or limit our exposure to interest rate and U.S. dollar/Euro currency risks. We may in the future use derivatives to reduce or limit our exposure to fluctuations in pulp prices. We also use derivatives to reduce our potential losses or to augment our potential gains, depending on our management s perception of future economic events and developments. These types of derivatives are generally highly speculative in nature. They are also very volatile as they are highly leveraged given that margin requirements are relatively low in proportion to notional amounts.

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

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

In the first quarter of 2005, Stendal entered into currency swaps to convert a portion of its indebtedness under the Stendal Loan Facility from Euros into U.S. dollars and certain currency forwards. In April 2005, Stendal entered into a currency swap to convert the balance of its long-term indebtedness under the Stendal Loan Facility from Euros into U.S. dollars. During the first nine months of 2006, we recorded a net unrealized non-cash holding gain of 76.3 million before minority interests upon the marked to market valuation of such derivatives compared to a net non-cash holding loss of 67.8 million before minority interests upon the marked to market valuation of our outstanding derivatives in the comparative quarter of 2005. In the first nine months of 2006, we recorded a realized loss of 5.2 million compared to a realized loss of 2.5 million in the comparative period of 2005 primarily from the sale of currency forwards.

ITEM 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures. Our management, with the participation of our Principal Executive Officer and Principal Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)), as of the end of the period covered by this report. Based on such evaluation, our Principal Executive Officer and Principal Financial Officer have concluded that, as of the end of such period, our disclosure controls and procedures are effective to ensure that information required to be disclosed in the reports that are filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Commission s rules and forms and to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Exchange Act is accumulated and communicated to management, including its Principal Executive Officer and Principal Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

It should be noted that any system of controls is based in part upon certain assumptions designed to obtain reasonable (and not absolute) assurance as to its effectiveness, and there can be no assurance that any design will succeed in achieving its stated goals.

Changes in Internal Controls. There have been no significant changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In October 2005, our wholly owned subsidiary, Zellstoff Celgar Limited, received a re-assessment for real property transfer tax payable in British Columbia, Canada, in the amount of approximately 3.5 million in connection with the transfer of the land where the Celgar mill is situated. The Company is contesting the assessment and the amount, if any, that may be payable in connection therewith is not yet determinable. Any additional amount paid in connection with the re-assessment will increase the cost basis of the assets acquired.

We are subject to routine litigation incidental to our business. We do not believe that the outcome of such litigation will have a material adverse effect on our business or financial condition.

ITEM 1A. RISK FACTORS

There have been no material changes to the factors disclosed in Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2005.

ITEM 6. EXHIBITS

Exhibit No.	Description
10.1	Share purchase agreement between MFC Industrial Holdings AG and Stendal Pulp Holding GmbH dated for reference the 18th day of October 2006
31.1	Section 302 Certification of Chief Executive Officer
31.2	Section 302 Certification of Chief Financial Officer
32.1*	Section 906 Certification of Chief Executive Officer
32.2*	Section 906 Certification of Chief Financial Officer

* In accordance with Release 33-8212 of the Commission, these Certifications: (i) are furnished to the Commission and are not filed for the purposes of liability under the Securities Exchange Act of 1934, as amended; and (ii) are not to be subject to automatic incorporation by reference into any of the

Company s registration statements filed under the Securities Act of 1933, as amended for the purposes of liability thereunder or any offering memorandum, unless the Company specifically incorporates them by reference therein.

SIGNATURES

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

MERCER INTERNATIONAL INC.

By: /s/ David M. Gandossi

David M. Gandossi
Secretary and Chief Financial Officer

Date: November 6, 2006