Financial Review

>

Basis of Presentation

On November 4, 1999, in connection with a corporate reorganization, Pactiv's former parent company, Tenneco, Inc. (Tenneco), and its subsidiaries completed various intercompany transfers and distributions to restructure and separate their then-existing businesses, assets, liabilities, and operations so that, among other things, the packaging businesses and certain corporate and administrative service operations of Tenneco would be owned by Pactiv. Tenneco subsequently distributed pro rata to holders of its common stock all of the outstanding common stock of Pactiv (the "spin-off"). Prior to the spin-off, Pactiv was named Tenneco Packaging, Inc. (TPI). As used herein, the terms "company" or "Pactiv" refer, for periods prior to the spin-off, to TPI and certain other packaging subsidiaries of Tenneco and, for periods after the spin-off, to Pactiv and its consolidated subsidiaries.

Prior to the spin-off, all of the outstanding common stock of the company was owned directly or indirectly by Tenneco. The financial statements in this report present the results of operations, financial position, and cash flows of the company as if it were a separate entity for all periods. Tenneco's historical basis in the assets and liabilities of the company has been carried over to Pactiv. All per-share information is presented on a diluted basis, unless otherwise noted.

The financial statements at December 31, 2000, and for the 12 months then ended are presented on a consolidated basis, while the financial statements at December 31, 1999, and 1998, and for the years then ended are presented on a combined basis, with the exception that the December 31, 1999, statement of financial position is presented on a consolidated basis. Certain amounts in prior years' financial statements have been reclassified to conform with the presentation used in 2000.

The company has 3 operating segments:

Consumer and Foodservice/Food Packaging, which relates to the manufacture and sale of disposable plastic, molded-fiber, pressed-paperboard, and aluminum packaging products for the consumer and foodservice/food packaging markets.

Protective and Flexible Packaging, which relates to the manufacture and sale of plastic, paperboard, and molded-fiber protective and flexible packaging products. Major markets served by protective packaging products include electronics, automotive, furniture, and e-commerce, while flexible packaging products are used mainly in food, medical, pharmaceutical, chemical, and hygienic applications.

Other, which primarily relates to corporate and administrative service operations and pension-plan income and expense.

Strategic Realignment

In January 1999, the company reached an agreement to contribute the containerboard assets of its paperboard packaging operation to a newly formed joint venture called Packaging Corporation of America (PCA). For the contribution, the company received approximately $2 billion, comprised of cash and assumed debt, and a 45% equity interest in PCA, which was subsequently reduced to 43% upon the issuance of equity to PCA's management. The equity interest was valued at approximately $200 million. In June 1999, the company sold its paperboard packaging operation's folding carton business to Caraustar Industries for $73 million. On November 4, 1999, Tenneco completed the spin-off by issuing a dividend of the common stock of Pactiv to Tenneco shareholders. The paperboard packaging segment is classified as a discontinued operation in the financial statements included in this report. See note 7 to the financial statements for further information.

Before the spin-off, Tenneco realigned substantially all of its existing debt through a combination of tender offers, exchange offers, and other refinancings. The realignment was financed through borrowings by Tenneco Automotive (formerly Tenneco, which changed its name to Tenneco Automotive, Inc., in connection with the spin-off) under a new credit facility, Tenneco Automotive's issuance of subordinated debt, Pactiv's issuance of public debt, and borrowings by Pactiv under new credit facilities.

At the spin-off date, Pactiv had total funded debt of $2.1 billion, which was comprised of new public-debt securities and credit-facility drawings. Pactiv's debt is rated as investment grade by both Standard & Poor's and Moody's. The debt is described in more detail in note 8 to the financial statements.

In connection with the spin-off, Pactiv entered into distribution, tax-sharing, human resource, insurance, and transition service agreements with Tenneco Automotive, which included contractual arrangements related to the provision of certain administrative services for specified periods of time.

Unusual Items

Restructuring and Other

In the fourth quarter of 1998, a restructuring plan was approved to reduce administrative and operating costs. As a result, Pactiv recorded a pre-tax charge against income from continuing operations of $32 million, $20 million after tax, or $0.12 per share. The restructuring plan involved the elimination of production lines and 104 positions at 2 plants; exiting 4 joint ventures; and the elimination of 184 administrative positions at business units and at corporate headquarters. Related actions generally have been completed and were executed in accordance with the company's initial plan. As a result of this restructuring, a total of 252 positions were eliminated as of December 31, 1999.

In the first quarter of 1999, a plan was adopted to realign company functions and to close Tenneco's headquarters facility in Greenwich, Connecticut. This plan, for which a $29 million restructuring charge, $17 million after tax, or $0.10 per share, was recorded, included the elimination of 40 positions. In the second quarter of 1999, $30 million was received in connection with the sale of the Greenwich facility. These restructuring actions were completed in 1999 and were executed in accordance with the company's initial plan.

In the fourth quarter of 1999, the company recorded a $154 million restructuring charge, $91 million after tax, or $0.54 per share, related to the decision to exit non-core businesses and to reduce overhead costs. The restructuring included (1) the sale of the company's forest products and aluminum foil container businesses in Europe ($68 million), for which cash proceeds of $20 million were received in the fourth quarter of 1999; (2) the sale of certain assets of the company's administrative service and corporate aircraft operations ($10 million); (3) impairment of long-lived assets of the company's packaging polyethylene business ($68 million); and (4) severance costs associated with the elimination of 161 positions, primarily in the company's international operations ($8 million). The impairment charge for the packaging polyethylene business' assets was deemed necessary following completion of an evaluation of strategic alternatives for the business, and represented the difference between the carrying value of the assets and the forecasted future cash flows of the business, computed on a discounted basis. These restructuring actions generally were completed in 2000; however, $1 million of the charge was reversed in the fourth quarter of 2000, as one planned product line consolidation was not undertaken and, as a result, 14 positions were not eliminated.

In the fourth quarter of 2000, the company recorded a restructuring charge of $71 million, $47 million after tax, or $0.29 per share. Of this amount, $45 million was for the impairment of assets held for sale, including those related to the packaging polyethylene business and the company's interest in Sentinel Polyolefins LLC, a protective packaging joint venture, for which cash proceeds of $72 million were received in January 2001. The remaining $26 million charge reflected the adoption of a restructuring plan to realign operations and exit low-margin businesses in the company's Protective and Flexible Packaging segment. Specifically, this charge was related to (1) plant closures in North America and Europe, including the elimination of 202 positions ($6 million); (2) other workforce reductions (187 positions), mainly in Europe ($6 million); (3) impairment of European long-lived assets held for sale ($10 million); and (4) asset write-offs related to the elimination of certain low-margin product lines ($4 million). The impairment charge for the European assets was recorded following completion of an evaluation of strategic alternatives for the related businesses and represented the difference between the carrying value of the assets and market estimates of fair value. The cash cost of executing the fourth-quarter 2000 restructuring plan will amount to approximately $15 million, which will be incurred in 2001, principally for severance and lease termination obligations.

An estimated $70 million of savings was realized in 1999 and 2000, and an additional $16 million is expected to be realized in 2001 ($10 million) and 2002 ($6 million), primarily reflecting lower cost of sales and selling, general, and administrative costs.

Spin-off Transaction Costs

In the fourth quarter of 1999, the company recorded transaction costs related to the spin-off that reduced income before interest expense, income taxes, and minority interest; net income; and earnings per share $136 million, $96 million, and $0.57, respectively. These costs related to special curtailment and termination benefits for former Tenneco employees ($72 million), professional services ($49 million), and separation from Tenneco operations ($15 million). In the fourth quarter of 2000, the company reversed $20 million, $12 million after tax, or $0.08 per share, of the previously recorded transaction costs to reflect lower-than-anticipated expenses.

Year 2000 compared with 1999

Results of Continuing Operations

Sales

(Dollars in millions)	2000	1999	Change
Consumer and Foodservice/ Food Packaging	**$ 2,283**	$ 2,217	3.0%
Protective and Flexible Packaging	**851**	896	(5.0)
Total	**$ 3,134**	$ 3,113	0.7%

Sales grew $21 million, or 0.7%, in 2000. Excluding the negative impact of foreign-currency exchange rates, divestitures, and discontinued product lines, sales increased 7.4% in 2000, driven primarily by higher selling prices and volume.

Sales for the Consumer and Foodservice/Food Packaging business advanced $66 million, or 3.0%, in 2000. Excluding the effects of divestitures and discontinued product lines, sales for this segment were 8.6% higher than 1999, primarily because of higher selling prices and volume gains. Sales of Protective and Flexible Packaging products declined $45 million, or 5.0%, from 1999. Excluding the negative impact of foreign-currency exchange rates and businesses divested in late 1999, sales for this segment were 4.6% higher than 1999, driven principally by selling price and volume increases.

Operating Income (Loss) - (Income (Loss) before Interest Expense, Income Taxes, and Minority Interest)

(Dollars in millions)	2000	1999	Change
Consumer and Foodservice/ Food Packaging	**$ 254**	$ 192	32.3%
Protective and Flexible Packaging	**5**	(2)	–
Other	**82**	(203)	–
Total	**$ 341**	$ (13)	–%

The $341 million operating income in 2000 included $70 million of restructuring and other charges, the effect of reversing $20 million of spin-off transaction costs recorded in 1999, and a $6 million gain on the sale of a business. The $13 million operating loss in 1999 included restructuring and other charges of $183 million and spin-off transaction expenses of $136 million. Excluding the effect of these unusual items, operating income (loss) by segment was as follows:

(Dollars in millions)	2000	1999	Change
Consumer and Foodservice/ Food Packaging	**$ 279**	$ 258	8.1%
Protective and Flexible Packaging	**44**	75	(41.3)
Other	**62**	(27)	–
Total	**$ 385**	$ 306	25.8%

Operating income before restructuring and other charges, spin-off transaction costs, and a gain on the sale of a business, was $385 million in 2000, an increase of $79 million, or 25.8%, from 1999. The increase was driven principally by higher volume and selling prices, significant reductions in overhead costs, and higher pension income; offset partially by higher resin costs.

Operating income for the Consumer and Foodservice/Food Packaging segment increased $21 million, or 8.1%, in 2000, driven principally by selling price increases and volume growth for core products; offset, in part, by higher raw material, freight, and warehousing costs.

Operating income for the Protective and Flexible Packaging segment declined $31 million, or 41.3%, from 1999. This decline was caused primarily by higher resin costs, inefficiencies associated with plant consolidations and start-ups, and the negative impact of foreign-currency exchange rates; offset partially by selling price increases and volume gains.

Operating income for the Other segment was $62 million in 2000, compared with a loss of $27 million in 1999. The $89 million improvement was driven principally by reductions in corporate overhead costs, higher pension income, and the impact of billing Tenneco Automotive for the full cost of administrative services provided to it by the company.

Interest Expense, Net of Interest Capitalized – Interest expense was $134 million in 2000, down $12 million, or 8.2%, from 1999, mainly because of lower borrowings. Prior to the spin-off, corporate debt of Tenneco and associated interest expense were allocated to the company, and related changes in allocated debt and after-tax interest costs were recorded as a component of the company's combined equity.

Income Taxes – Pactiv's effective tax rate for 2000 was 44.0%, compared with 29.6% (benefit) for 1999. Excluding the tax impact of the previously discussed restructuring and other charges and spin-off transaction expenses, the effective tax rate for 2000 and 1999 was 42.0% and 43.3%, respectively.

Income (Loss) from Continuing Operations – The company recorded net income from continuing operations of $113 million, or $0.70 per share, in 2000, compared with a net loss of $112 million, or $0.67 per share, in 1999. Excluding the impact of restructuring and other charges, spin-off transaction costs, and a gain on the sale of a business, net income from continuing operations was $143 million, or $0.89 per share, in 2000, compared with $93 million, or $0.55 per share, in 1999.

Discontinued Operations and Extraordinary Loss

The company recorded net income from discontinued operations of $134 million, or $0.83 per share, in 2000, which represented the gain on the February 2000 sale of the majority of the company's equity interest in PCA. The company recorded a net loss from discontinued operations of $193 million, or $1.15 per share, in 1999, which was comprised principally of an after-tax loss of $206 million on the sale of the paperboard packaging operation. In 1999, the company incurred an after-tax extraordinary loss of $7 million, or $0.04 per share, as a result of the early retirement of debt.

Liquidity and Capital Resources

Capitalization

December 31 (In millions)	**2000**	**1999**
Short-term debt, including current maturities of long-term debt	**$ 13**	$ 325
Long-term debt	**1,560**	1,741
Total debt	**1,573**	2,066
Minority interest	**22**	20
Shareholders' equity	**1,539**	1,350
Total capitalization	**$ 3,134**	$ 3,436

Pactiv's ratio of debt to total capitalization was 50.2% and 60.1% at December 31, 2000, and December 31, 1999, respectively. Total borrowings declined $493 million, or 23.9%, in 2000, as proceeds from the sale of PCA stock and free cash flow were used to repay debt.

Shareholders' equity increased $189 million in 2000, reflecting the recording of income from continuing and discontinued operations of $113 million and $134 million, respectively, and an unrealized gain of $42 million on the remaining 6.2 million shares of PCA stock held by the company, offset partially by the impact of repurchasing $100 million of the company's common stock.

Cash Flows

(In millions)	**2000**	**1999**
Cash provided (used) by:		
Operating activities	**$ 290**	$ (31)
Investing activities	**302**	(994)
Financing activities	**(578)**	1,030

The $321 million increase in cash provided by operating activities in 2000 was driven principally by higher net income from continuing operations, improvement in working capital management, and a decrease in the amount of cash used by discontinued operations.

Investing activities generated $302 million in 2000, principally because proceeds from the sale of PCA stock ($394 million) and other product lines ($50 million) more than offset expenditures for property, plant, and equipment ($135 million). Cash flow from investing activities in 1999 was impacted significantly by transactions related to the discontinued paperboard packaging operation.

Cash used by financing activities was $578 million in 2000, driven primarily by the retirement of debt and the repurchase of company stock. Financing activities provided $1,030 million in cash in 1999. During the second quarter of 1999, the company borrowed $1.8 billion in connection with the formation of the PCA joint venture and used $1.2 billion of the proceeds to purchase assets used by the discontinued containerboard business under operating leases and timber cutting rights and to acquire previously sold accounts receivable of this business. The remaining amounts from these borrowings were distributed to Tenneco.

Capital Commitments – Commitments for authorized expenditures totaled approximately $115 million at December 31, 2000. It is anticipated that the majority of these expenditures will be funded over the next 12 months from existing cash and short-term investments, internally generated cash, and borrowings.

Liquidity – The company's management believes that cash flow from operations along with borrowing capacity under its existing credit facilities will be sufficient to meet capital requirements.

At the time of the spin-off, the company exercised its right to make a one-time draw under a $1.5 billion term-loan facility in the amount of $300 million at a floating interest rate based on LIBOR, adjusted for reserve requirements, plus a specified margin. All amounts borrowed under this facility were repaid in the first quarter of 2000 following the sale of the majority of the company's equity interest in PCA.

In conjunction with the spin-off, the company entered into a 5-year, $750 million revolving-credit agreement and a 364-day, $250 million revolving-credit agreement. Effective September 27, 2000, the 364-day agreement was extended for an additional 364-day period, and the total availability under the agreement was increased to $300 million, of which $265 million has been committed. As of December 31, 2000, the company was in full compliance with financial and other covenants in these agreements.

Year 1999 compared with 1998

Results of Continuing Operations

Sales

(Dollars in millions)	1999	1998	Change
Consumer and Foodservice/ Food Packaging	$ 2,217	$ 2,116	4.8%
Protective and Flexible Packaging	896	835	7.3
Other	–	6	–
Total	$ 3,113	$ 2,957	5.3%

Sales grew 5.3% in 1999, reflecting volume growth of 7%. Excluding the negative impact of foreign-currency exchange rates, sales increased 6.1%. Sales growth was lower than volume gains because of a decline in selling prices in the first half of 1999.

Sales of the Consumer and Foodservice/Food Packaging business advanced 4.8% in 1999, driven principally by volume increases of 7%. In 1999, sales of Protective and Flexible Packaging products increased 7.3%, primarily as a result of volume growth of 10%. Excluding the negative impact of foreign-currency exchange rates, this segment's sales grew 10.1%.

Operating Income (Loss) - (Income (Loss) before Interest Expense, Income Taxes, and Minority Interest)

(Dollars in millions)	1999	1998	Change
Consumer and Foodservice/ Food Packaging	$ 192	$ 268	(28.4)%
Protective and Flexible Packaging	(2)	60	–
Other	(203)	(45)	–
Total	$ (13)	$ 283	–%

The $13 million operating loss in 1999 included restructuring and other charges of $183 million and spin-off transaction expenses of $136 million. Operating income in 1998 was $283 million, which included restructuring charges of $32 million. Excluding the effect of these unusual items, operating income by segment was as follows:

(Dollars in millions)	1999	1998	Change
Consumer and Foodservice/ Food Packaging	$ 258	$ 277	(6.9)%
Protective and Flexible Packaging	75	69	8.7
Other	(27)	(31)	12.9
Total	$ 306	$ 315	(2.9)%

Excluding the impact of unusual items, operating income was $306 million in 1999, a decline of 2.9% from the prior year, as the favorable impact of 7% volume growth and restructuring savings was more than offset by a decline in the spread between selling prices and material costs and higher corporate data center costs.

The Consumer and Foodservice/Food Packaging segment's operating income declined 6.9% in 1999, as the favorable impact of 7% volume growth was more than offset by a decline in gross margin because of a rapid escalation in raw material costs.

Operating income for the Protective and Flexible Packaging segment increased 8.7% in 1999, principally because of a 10% growth in volume and the positive effect of cost reduction initiatives. Excluding the negative impact of foreign-currency exchange rates, operating income improved 13% in 1999.

The operating loss in the Other segment was reduced to $27 million in 1999, from $31 million in 1998, as a result of reductions in corporate overhead costs and higher pension income, offset partially by an increase in expenses associated with operating the corporate data center.

Interest Expense, Net of Interest Capitalized – Prior to the spin-off, corporate debt of Tenneco and related interest expense was allocated to Pactiv, and changes in allocated debt and after-tax allocated interest costs were recorded as a component of Pactiv's combined equity.

Interest expense from continuing operations increased to $146 million in 1999 from $133 million in 1998, primarily as a result of higher allocated corporate debt and interest costs related to the realignment of debt in connection with the spin-off.

Income Taxes – Pactiv's effective tax rate for 1999 was 29.6% (benefit), compared with 44.7% for 1998. Excluding the effect of restructuring and other charges and spin-off transaction expenses, the effective tax rate for 1999 was 43.3%, compared with 43.4% for 1998.

Income (Loss) from Continuing Operations – The company recorded a net loss from continuing operations of $112 million, or $0.67 per share, in 1999, compared with net income of $82 million, or $0.49 per share, the previous year. Excluding restructuring and other charges and spin-off transaction costs, net income was $93 million, or $0.55 per share, in 1999, while 1998's net income was $102 million, or $0.61 per share.

Discontinued Operations and Extraordinary Loss

The company incurred a net loss from discontinued operations of $193 million, or $1.15 per share, in 1999, which was comprised principally of an after-tax loss of $206 million on the sale of the paperboard packaging operation. Discontinued operations generated after-tax income of $57 million in 1998, primarily reflecting the effect of favorable containerboard pricing on results of the paperboard packaging business.

In 1999, the company incurred an after-tax extraordinary loss of $7 million, or $0.04 per share, as a result of the early retirement of debt in connection with the contribution of the containerboard assets to the PCA joint venture.

Liquidity and Capital Resources

Capitalization

December 31 (In millions)	**1999**	**1998**
Short-term debt, including		
current maturities of long-term debt	$ 325	$ 595
Long-term debt	1,741	1,312
Debt allocated to discontinued operations	–	548
Total debt	2,066	2,455
Minority interest	20	14
Shareholders' equity	1,350	1,776
Total capitalization	$ 3,436	$ 4,245

Pactiv's ratio of debt to total capitalization was 60.1% and 57.8% at December 31, 1999, and December 31, 1998, respectively. Total debt declined $389 million in 1999, reflecting the company's contribution of its containerboard assets to the PCA joint venture. Shareholders' equity declined $426 million in 1999 as a result of distributions made to Tenneco and the net loss recorded for the year.

Cash Flows

(In millions)	**1999**	**1998**
Cash provided (used) by:		
Operating activities	$ (31)	$ 577
Investing activities	(994)	(514)
Financing activities	1,030	(67)

Cash used by operating activities was $31 million in 1999, while $577 million was generated from operations in 1998. The $608 million decrease in 1999 was comprised of $341 million from continuing operations and $267 million from discontinued operations. The decrease in cash from continuing operations was driven primarily by restructuring and spin-off transaction payments and higher working capital. The decline in cash from discontinued operations was attributable principally to the repurchase of accounts receivable of the containerboard business previously sold to a third party in connection with the formation of the PCA joint venture and lower selling prices in the containerboard business.

Investing activities used $994 million of cash in 1999, an increase of $480 million from 1998's level. This increase was driven by the purchase of assets used by the containerboard business in contemplation of their contribution to the PCA joint venture, offset partially by lower spending on acquisitions and capital projects, and proceeds received from the sale of other businesses.

Pactiv borrowed $1.8 billion in the second quarter of 1999 in connection with the formation of the PCA joint venture and used $1.2 billion of the proceeds to acquire assets used by the containerboard business under operating leases and timber cutting rights and to purchase previously sold accounts receivable of this business. The remaining proceeds ($600 million) from these borrowings, together with $306 million in cash received from the sale of the containerboard and folding carton businesses, were used to retire Tenneco's short-term debt. Excluding these transactions, cash provided by financing activities was $724 million in 1999. Responsibility for the $1.8 billion borrowings was transferred to PCA in connection with the formation of the joint venture. This reduction of debt is shown in the statement of cash flows as a non-cash financing activity.

Changes In Accounting Principles

In April 1998, the American Institute of Certified Public Accountants (AICPA) issued Statement of Position (SOP) 98-5, Reporting on the Costs of Start-Up Activities, which requires that start-up costs be expensed as incurred. This standard also requires that previously capitalized start-up costs be expensed as a cumulative effect of change in accounting principle upon adoption. The company adopted SOP 98-5 January 1, 1999, and recorded a related after-tax charge of $32 million (net of a $9 million tax benefit), or $0.19 per share, to expense previously capitalized start-up costs of its foreign and administrative service operations. If SOP 98-5 had been applied retroactively, net income for the year ended December 31, 1998, would have been reduced $14 million (net of an $8 million tax benefit), or $0.08 per share.

In June 1998, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 133, Accounting for Derivative Instruments and Hedging Activities. In June 1999, the FASB issued SFAS No. 137, Accounting for Derivative Instruments and Hedging Activities – Deferral of the Effective Date of SFAS No. 133. In June 2000, the FASB issued SFAS No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities, an amendment to SFAS No. 133. SFAS No. 133, as amended, establishes accounting and reporting standards that require derivative instruments, including certain derivative instruments embedded in other contracts, be recorded as either assets or liabilities measured at fair value and that changes in derivative instruments' fair value be recognized currently in earnings unless specific hedge-accounting criteria are met. In adopting SFAS No.

133 on January 1, 2001, the company was not required to record a transition adjustment. The adoption of SFAS No. 133 did not have a material effect on the earnings or financial position of the company.

In May 2000, the FASB's Emerging Issues Task Force (EITF) reached a consensus on Issue No. 00-14, Accounting for Certain Sales Incentives. This issue addresses the recognition, measurement, and income-statement classification of various types of sales incentives, including discounts, coupons, rebates, and free products. Upon adopting EITF No. 00-14, which is required effective with the second quarter of 2001, the company will be required to reclassify as deductions from sales certain of these expenses that historically have been included in selling, general, and administrative costs. If this reclassification had been made for 2000, 1999, and 1998, sales and selling, general, and administrative costs would have been reduced by approximately $32 million, $26 million, and $29 million, respectively.

In July 2000, the EITF reached a consensus on Issue 1 of No. 00-10, Accounting for Shipping and Handling Fees and Costs, which requires that any amounts billed to customers for shipping and handling be classified as sales. In September 2000, the EITF reached a consensus on Issue 2 of No. 00-10, which precludes the recording of shipping and handling costs as deductions from sales. With the company's fourth-quarter 2000 adoption of EITF No. 00-10, freight costs previously recorded as deductions from sales were reclassified as cost of sales for all periods presented herein.

In January 2001, the EITF reached a consensus on Issue 3 of No. 00-22, Accounting for 'Points' and Certain Other Time-Based or Volume-Based Sales Incentive Offers, and Offers for Free Products or Services to be Delivered in the Future. This consensus requires that certain rebate offers and free products that are delivered subsequent to a single exchange transaction be recognized when incurred and reported as a reduction of sales. The company currently is evaluating the potential impact of this pronouncement on its consolidated financial statements.

Euro Conversion

The formation of the European Monetary Union resulted in the adoption of a common currency, the euro, by 11 European nations. The euro is being adopted over a 3-year transition period which commenced January 1, 1999. Pactiv believes it is on course to becoming fully "euro ready" on or before the conclusion of the 3-year period. The company believes that the costs associated with transitioning to the euro will not be material.

Derivative Financial Instruments

The company is exposed to market risks related to changes in foreign-currency exchange rates, interest rates, and commodity prices. To manage these risks, the company, from time to time, enters into various hedging contracts in accordance with the company's policies and procedures. The company does not use hedging instruments for trading purposes and is not a party to any transactions involving leveraged derivatives.

Foreign-Currency Exchange

The company uses foreign-currency forward contracts to hedge its exposure to adverse changes in exchange rates, primarily related to the euro, British pound, and Canadian dollar. Hedging is accomplished through the use of financial instruments, with related gains or losses offsetting gains or losses on underlying assets or liabilities.

In managing foreign-currency risk, the company aggregates existing positions and hedges residual exposures through third-party derivative contracts. The following table summarizes foreign-currency forward contracts in effect at December 31, 2000, all of which will mature in 2001.

(In millions, except settlement rates)		Notional amount in foreign currency	Weighted-average settlement rate	Notional amount in U.S. dollars
Euros	– Purchase	3	0.942	$ 2
	– Sell	(177)	0.942	(167)
Canadian dollars	– Purchase	–	0.667	–
	– Sell	(18)	0.667	(12)
British pounds	– Purchase	14	1.493	21
	– Sell	(14)	1.493	(21)
U.S. dollars	– Purchase	185	1.000	185
	– Sell	(14)	1.000	(14)

Interest Rates

Following the realignment of debt in connection with the spin-off, the company is exposed to interest-rate risk on certain of its debt instruments. Pactiv utilizes revolving-credit facilities that bear interest at a floating rate based on LIBOR. Amounts outstanding under these facilities aggregated $381 million at December 31, 2000. In addition, the company has issued public-debt securities with fixed interest rates and original maturity dates ranging from 6 to 28 years, and for which amounts outstanding totaled $1,189 million at December 31, 2000. Should the company decide to redeem these securities prior to their stated maturity, it would incur costs based on the fair value of the securities at that time.

The following table provides information about Pactiv's financial instruments that are sensitive to interest-rate risks.

	Estimated maturity dates						
(In millions)	2001	2002	2003	2004	2005	Thereafter	Total
Facilities with floating interest rates based on LIBOR							
5-year revolving-credit facility	$ –	$ –	$ –	$ 381	$ –	$ –	$ 381
Debt securities with fixed interest rates							
Long-term debt securities	1	3	3	2	300	880	1,189

In conjunction with the debt realignment, the company entered into an interest-rate swap to hedge its exposure to interest-rate movements. The company settled this swap in November 1999, incurring a $43 million loss, which is being recognized as additional interest expense over the average life of the underlying debt. The company has no other interest-rate swaps.

Commodities

The company purchases commodities such as resin, paper, and aluminum at market prices and does not currently use financial instruments to hedge commodity prices.

In December 2000, the company entered into forward contracts with third parties to fix a portion of the cost of natural gas used internally. In December 1999, the company entered into a 5-year agreement with one of its vendors to purchase certain materials at prices within a specified range. This agreement does not include minimum purchase commitments.

The statements and other information (including the tables) in the derivative financial instruments section of this report constitute forward-looking statements.

Management's Discussion of Financial Responsibility

Management is responsible for the preparation, integrity, and objectivity of the financial statements and other financial data in this report. The financial statements have been prepared in conformity with generally accepted accounting principles using the best available information and exercising judgments.

Management believes that the company's system of internal controls provides reasonable assurance as to the integrity and reliability of the financial statements and is adequate to safeguard company assets. The internal control system relies on written policies and procedures, requires appropriate division of responsibilities, is supported by careful selection and training of professional financial managers, and is maintained through a comprehensive, risk-based internal audit program. Pactiv is dedicated to maintaining high standards of ethics, integrity, and social responsibility in the conduct of its business, and uses ongoing education, communications, and review programs to support this dedication.

The company's financial statements have been audited by Arthur Andersen LLP, an independent public accounting firm, which was selected by the audit committee of the board of directors. Management has made available to Arthur Andersen all of the company's financial and other records, allowing it to provide an objective, independent assessment of the fairness of reporting of operating results and financial condition. Arthur Andersen's report follows.

The board of directors, through its audit committee consisting solely of outside directors, meets periodically with Arthur Andersen, representatives of management, and the company's internal auditors to discuss accounting, auditing, financial, and other matters. The internal and independent auditors have unrestricted access to the audit committee to discuss their audit work as well as their assessment of the quality of the company's financial reporting and internal control system.

Richard L. Wambold

Chairman and Chief Executive Officer

Andrew A. Campbell

Senior Vice President and Chief Financial Officer

Report of Independent Public Accountants

To the Board of Directors and Shareholders of Pactiv Corporation:

We have audited the accompanying statements of financial position of Pactiv Corporation (a Delaware corporation) and consolidated and combined subsidiaries as of December 31, 2000, and 1999, and the related statements of income (loss), retained earnings, cash flows, changes in shareholders' equity, and comprehensive income (loss) for each of the three years ended December 31, 2000. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Pactiv Corporation and consolidated and combined subsidiaries as of December 31, 2000, and 1999, and the results of its operations and its cash flows for the three years ended December 31, 2000, in conformity with accounting principles generally accepted in the United States.

As explained in note 3 to the financial statements referred to above, effective January 1, 1999, the company changed its method of accounting for the costs of start-up activities.

Arthur Andersen LLP

Chicago, Illinois

January 29, 2001