# FINANCIAL REVIEW

## Basis of Presentation

Financial statements for all periods presented in this report are prepared on a consolidated basis in accordance with generally accepted accounting principles consistently applied. All per-share information is presented on a diluted basis unless otherwise noted. Certain reclassifications have been made to prior-years' financial information to conform to current-year presentation.

On October 12, 2005, we completed the sale of most of our worldwide protective- and flexible-packaging businesses to Pregis Corporation. We have reported the operating results of the affected businesses as income (loss) from discontinued operations in the Consolidated Statement of Income for all periods presented. In our Consolidated Statement of Financial Position, the assets and liabilities of these businesses have been classified as assets from discontinued operations and liabilities from discontinued operations, respectively.

These divested businesses historically were included in our Protective and Flexible Packaging segment. In conjunction with the sale of these entities, we reviewed our reporting segments in accordance with the Statement of Financial Accounting Standards (SFAS) No. 131, "Disclosures About Segments of an Enterprise and Related Information." Based on our review, we included the retained portions of the protective- and flexible-packaging businesses in our Foodservice/Food Packaging segment for all periods presented in this report. The principal business retained produces egg packaging for food processors. This operation was previously managed by the protective- and flexible-packaging business. Subsequent to the sale, this unit is managed as part of our foodservice/food packaging business, along with our North American egg packaging product line.

Following the divestiture, we have three reporting segments:

- Consumer Products manufactures and sells disposable plastic, foam, molded-fiber, pressed-paperboard, and aluminum packaging products to consumer markets, such as grocery stores, mass merchandisers, and discount chains. Products include waste bags, food-storage bags, and disposable tableware and cookware. We sell many of our consumer products under well-known trademarks, such as Hefty®.
- Foodservice/Food Packaging manufactures and sells foam, clear plastic, aluminum, pressed-paperboard, and molded-fiber packaging to customers in the food distribution channel who prepare and process food for consumption. Customers include restaurants and other institutional foodservice outlets, food processors, and grocery chains.
- Other relates to corporate and administrative-service operations and retiree-benefit income and expense.

The accounting policies of the reporting segments are the same as those for Pactiv as a whole. Where discrete financial information is not available by segment, reasonable allocations of expenses and assets/liabilities are used.

## Restructuring and Other

In the first quarter of 2004, we announced a restructuring program to reduce manufacturing capacity and overhead costs and to reinvest a portion of the related savings in strategic growth initiatives. Implementation of the program resulted in the elimination of approximately 850 salaried and hourly positions worldwide. The total cost of the restructuring program was approximately $85 million, $54 million after tax, or $0.35 per share, covering severance, asset write-offs, and other, which consisted principally of asset-removal costs. The majority of the program was executed in the second quarter of 2004. After-tax cash payments related to the restructuring and other actions totaled $4 million in 2005, and $9 million in 2004. No further charges related to this program are anticipated.

The following summarizes impacts of the restructuring and related actions.

| (In millions) | Severance | Asset write-offs | Other (1) | Total |
|---|---|---|---|---|
| Accrued restructuring balance at January 1, 2004 | $ — | $ — | $ — | $ — |
| Additions/adjustments to the account | | | | |
| Consumer Products | 4 | — | — | 4 |
| Foodservice/Food Packaging | 11 | 24 | 37 | 72 |
| Other | — | — | 3 | 3 |
| Total additions/adjustments | 15 | 24 | 40 | 79 |
| Cash payments | (12) | — | (33) | (45) |
| Charges against asset accounts | — | (24) | — | (24) |
| Accrued restructuring balance at December 31, 2004 | $ 3 | $ — | $ 7 | $ 10 |
| Additions/adjustments to the account | | | | |
| Consumer Products | 1 | — | — | 1 |
| Foodservice/Food Packaging | (1) | 7 | (1) | 5 |
| Total additions/adjustments | — | 7 | (1) | 6 |
| Cash payments | (3) | — | (4) | (7) |
| Charges against asset accounts | — | (7) | — | (7) |
| **Accrued restructuring balance at December 31, 2005** | **$ —** | **$ —** | **$ 2** | **$ 2** |
| Cumulative restructuring costs at December 31, 2005 | | | | |
| Consumer Products | **$ 5** | **$ —** | **$ —** | **$ 5** |
| Foodservice/Food Packaging | **10** | **31** | **36** | **77** |
| Other | **—** | **—** | **3** | **3** |
| Total | **$ 15** | **$ 31** | **$ 39** | **$ 85** |

*(1) Consists principally of asset-removal costs, including asbestos insulation abatement and associated expenses at the company's closed molded-fiber facility in the United Kingdom.*

## Executive Overview

### Business

Our primary business involves the manufacture and sale of consumer and specialty-packaging products for the consumer and foodservice/food packaging markets. We operate 40 manufacturing facilities in 4 countries.

Consumer products include plastic, aluminum, and paper-based products, such as waste bags, food-storage bags, and disposable tableware and cookware. These products are sold under such well-known brand names as Hefty®, Baggies®, Hefty® OneZip®, Hefty® Cinch Sak®, Hefty® The Gripper®, Hefty® Zoo Pals®, Kordite®, EZ Foil™, and Hefty® Serve 'n Store®.

Foodservice and food-packaging products include foam, clear plastic, aluminum, pressed-paperboard, and molded-fiber packaging for customers in the food-distribution channel. Customers include wholesalers, supermarkets, restaurants, and packer processors, who prepare and process food for consumption.

We sell our products to a wide array of customers worldwide. Customers include grocery stores, mass merchandisers, discount chains, restaurants, distributors, and fabricators. Costs incurred in connection with the manufacture and sale of these products are recorded in either cost of sales or selling, general, and administrative expenses.

Greater than 80% of our sales comes from products made from different types of plastic resins, principally polystyrene, polyethylene, polypropylene, and amorphous polyethylene terephthalate (APET).

We have pension plans that cover substantially all of our employees. In addition, in conjunction with our spin-off from Tenneco Inc. (Tenneco) in 1999, we became the sponsor of retirement plans covering participating employees of certain former subsidiaries and affiliates of Tenneco. We record net pension plan income as an offset to selling, general, and administrative expenses. However, when assessing our performance and returns, we typically exclude the effect of pension income and pension assets and liabilities.

Several opportunities and challenges may influence our continued growth.

Near-term risks include:

- The impact of energy-cost volatility on resin costs
- The ability to increase selling prices
- The continued effectiveness of our productivity and procurement initiatives

Longer-term risks include:

- Potential changes in consumer demand
- Possible supplier and customer consolidations
- Potential increases in foreign-based competition
- Possible growth in market share of unbranded products

We expect to continue to be successful by:

- Adjusting selling prices to offset resin-price movements
- Implementing aggressive cost-management and productivity programs
- Leveraging our existing products into new distribution channels
- Introducing innovative new products
- Making strategic acquisitions

### Significant Trends and Other Matters

The principal raw materials used to manufacture our products are plastic resins, principally polystyrene and polyethylene. Average industry prices for polystyrene were approximately 16% higher in 2005 than in 2004, driven principally by higher oil and benzene costs. In 2005, average industry prices for polyethylene rose approximately 29% compared with 2004, primarily fueled by higher natural gas prices. In response to the significant escalation in resin costs, we raised selling prices in many areas of our business during 2005, which was effective in offsetting resin-cost increases.

Resin costs will likely continue to be a source of uncertainty for us in the near-term, as oil prices remain near their historic highs. We are closely monitoring the resin marketplace in order to respond quickly to any raw material cost increases.

Our business is sensitive to other energy-related cost movements, particularly with respect to transportation, logistics, and utility costs. Historically, we have been able to mitigate higher energy-related costs with productivity improvements and other cost reductions. Future significant energy-related cost increases may not be fully offset by our productivity initiatives.

New consumer product lines launched in 2005 included Hefty® Serve 'n Store® tableware, Hefty® Easy Grip™ cups, and Hefty® EZ Ovenware™ Casserole Pans. Our launch costs were on plan and reduced operating income by approximately $45 million in 2005. We will continue to support these new items in 2006; however, related spending is expected to have about one-half the impact on operating income in 2006 as it did in 2005.

On November 28, 2005, our board of directors decided to replace stock options as a part of our long-term compensation program with performance shares. There are two primary reasons for this change. The first is to more closely align long-term incentive compensation with Pactiv's actual performance as measured by performance drivers under our performance share program. The second is to more accurately reflect the true cost of such compensation in our income statement. As part of this change, the board accelerated the vesting of all unvested stock options, representing 1,567,088 shares, to November 28, 2005, in order not to distort the true expense of our long-term incentive compensation program going forward. Because the exercise prices of these options were above the market value of Pactiv stock on November 28, 2005, we did not record expense from this action. In 2005, approximately 590,000 performance shares were granted compared with approximately 220,000 shares in 2004. As a result, we recorded approximately $1 million of additional compensation expense, net of tax, in 2005 compared with 2004. We expect to grant a similar number of performance shares in 2006 and 2007. We anticipate that this change in our long-term compensation program will result in related costs, net of tax, being approximately $3 million and $5 million higher in 2006 and 2007 than in 2005, respectively. However, it is important to note that the projected increase in long-term compensation costs is less than would have been the case if we had continued with stock options and began to expense them in 2006, as required by SFAS No. 123(R), "Share-Based Payments."

## Year 2005 compared with 2004

### Results of Continuing Operations

**Sales**

| (In millions) | 2005 | 2004 | Increase (decrease) Amount | Increase (decrease) Percent |
|---|---|---|---|---|
| Consumer Products | **$ 989** | $ 934 | $ 55 | 5.9% |
| Foodservice/Food Packaging | **1,767** | 1,610 | 157 | 9.8 |
| Total | **$2,756** | $2,544 | $ 212 | 8.3% |

Total sales increased in 2005 on flat volume. Excluding the positive impact of foreign-currency exchange rates ($5 million) and acquisitions ($51 million), sales grew 6.1%, driven mainly by the impact of pricing actions to offset increased resin costs.

Sales for the Consumer Products business increased in 2005 primarily as a result of price increases. Sales growth was driven by an increase in tableware, with the introduction of Hefty® Serve 'n Store® plates and bowls and Hefty® Easy Grip™ cups, along with the broad-based impact of pricing actions to offset increased resin costs.

Foodservice/Food Packaging segment sales growth in 2005 was primarily a result of price increases implemented to offset the impact of higher polystyrene costs. Volume gains from acquisitions offset volume declines in the base business.

**Operating Income**

| (In millions) | 2005 | 2004 | Increase (decrease) Amount | Increase (decrease) Percent |
|---|---|---|---|---|
| Consumer Products | **$ 112** | $ 175 | $ (63) | (36.0)% |
| Foodservice/Food Packaging | **186** | 112 | 74 | 66.1 |
| Other | **2** | 10 | (8) | (80.0) |
| Total | **$ 300** | $ 297 | $ 3 | 1.0% |

Total operating income increased in 2005 as a result of lower restructuring costs and positive spread (the difference between selling prices and raw material costs), offset partially by higher new product launch costs, and higher manufacturing and logistics costs.

The following tables summarize the impact of restructuring and other charges on 2005 and 2004 operating income by segment.

**Operating Income – twelve months ended December 31, 2005**

| (In millions) | GAAP basis | Restructuring and other charges | Excluding restructuring and other charges |
|---|---|---|---|
| Consumer Products | $ 112 | $ 1 | $ 113 |
| Foodservice/Food Packaging | 186 | 5 | 191 |
| Other | 2 | — | 2 |
| Total | $ 300 | $ 6 | $ 306 |

**Operating income – twelve months ended December 31, 2004**

| (In millions) | GAAP basis | Restructuring and other charges | Excluding restructuring and other charges |
|---|---|---|---|
| Consumer Products | $ 175 | $ 4 | $ 179 |
| Foodservice/Food Packaging | 112 | 72 | 184 |
| Other | 10 | 3 | 13 |
| Total | $ 297 | $ 79 | $ 376 |

We believe focusing on operating income excluding the effect of restructuring and other charges is a meaningful alternative way of evaluating our operating results. The restructuring and other charges relate to actions that will have an ongoing effect on our company. Considering such charges as being applicable to only 2005 and 2004 could make our operating performance in those periods more difficult to evaluate when compared with other periods in which there were no such charges. We use operating income excluding restructuring and other charges to evaluate operating performance and, along with other factors, to determine management compensation.

The following table summarizes operating income excluding restructuring and other charges for 2005 and 2004.

| (In millions) | 2005 | 2004 | Increase (decrease) Amount | Percent |
|---|---|---|---|---|
| Consumer Products | $ 113 | $ 179 | $ (66) | (36.9)% |
| Foodservice/Food Packaging | 191 | 184 | 7 | 3.8 |
| Other | 2 | 13 | (11) | (84.6) |
| Total | $ 306 | $ 376 | $ (70) | (18.6)% |

Total operating income excluding restructuring and other charges was down versus 2004. The decline primarily reflected higher new-product launch, raw-material, energy-related, and logistics costs, which were partially offset by the effect of price increases.

Operating income excluding restructuring and other charges for the Consumer Products business was down compared with 2004. The decline primarily was due to increased new-product launch expenses, higher plastic-resin and other energy-related costs, and increased logistics costs, which were partially offset by higher selling prices and productivity gains.

Operating income excluding restructuring and other charges for the Foodservice/Food Packaging business increased from 2004. The increase primarily reflected favorable spread, the benefit of the Newspring acquisition, and productivity gains, offset, in part, by higher energy-related and logistics costs.

Operating income excluding restructuring and other charges for the Other segment decreased from 2004, principally due to higher compensation-related expenses and a decrease in noncash pension income.

**Income Taxes –** Our effective tax rate for 2005 was 36.0%, compared with 36.2% for 2004.

**Income from Continuing Operations –** We recorded income from continuing operations of $143 million, or $0.96 per share, in 2005, compared with $138 million, or $0.90 per share, in 2004. Current-period results included restructuring and other charges of $4 million after tax, or $0.03 per share, and noncash pension income of $34 million after tax, or $0.23 per share. Prior period results included restructuring and other charges of $50 million after tax, or $0.32 per share, and noncash pension income of $35 million after tax, or $0.23 per share.

### Discontinued Operations

**Income (Loss) from Discontinued Operations –** Income (loss) from discontinued operations (see "Basis of Presentation" on page 18) includes an allocation of interest expense for all periods presented. Amounts allocated were based on the ratio of the net assets of discontinued operations to the company's total net assets plus consolidated debt. For 2005, interest expense was allocated through October 12, the date of sale of the protective- and flexible-packaging businesses. Amounts allocated were $11 million for 2005 and $15 million for 2004. The buyer of the businesses did not assume the debt of the discontinued operations. In addition, we do not have any debt repayment requirements as a result of the sale.

On October 22, 2004, the American Jobs Creation Act of 2004 (the Act) was signed into law. The Act provided for a special one-time tax deduction of 85% of certain foreign earnings that we repatriate. In the fourth quarter of 2005, we repatriated $147 million of the accumulated foreign earnings of our discontinued foreign operations, and recorded a related tax expense of $5 million.

Income (loss) from discontinued operations was as follows:

| (In millions) | Jan 1-Oct 12, 2005 | Jan 1-Dec 31, 2004 |
|---|---|---|
| Sales | $ 695 | $ 839 |
| Income from operations, net of tax of $13 and $12, respectively | 18 | 17 |
| Professional fees and other costs associated with the sale of the businesses | (15) | — |
| Goodwill impairment, net of tax of $12 | (37) | — |
| Estimated loss on sale of businesses, net of tax expense of $28 million | (50) | — |
| Tax on repatriated foreign earnings | (5) | — |
| Net income (loss) from discontinued operations | $ (89)(a) | $ 17 |

*(a) Includes amounts booked in the three-month period ended December 31, 2005, to record (1) an additional $8 million loss on the sale of the businesses, reflecting revised estimates, and (2) a $5 million reduction in a previously recorded estimate of income-tax expense on repatriated earnings of foreign subsidiaries.*

Assets and liabilities from discontinued operations were as follows:

| December 31 (In millions) | 2005 | 2004 |
|---|---|---|
| Accounts and notes receivable, net | $ — | $ 127 |
| Inventories | — | 95 |
| Other current assets | — | 4 |
| Property, plant, and equipment, net | — | 308 |
| Other long-term assets | — | 205 |
| Total assets from discontinued operations | $ — | $ 739 |
| Accounts payable | $ — | $ 64 |
| Accrued expense and other | 20 | 41 |
| Long-term liabilities | — | 40 |
| Total liabilities from discontinued operations | $ 20 | $ 145 |

We have retained responsibility for certain liabilities related to the businesses sold. These included income taxes through October 12, 2005, certain royalty payments, and the costs of closing a facility in Europe. These costs were included in the calculation of the loss on the sale of the businesses.

### Cumulative Effect of Changes in Accounting Principles

In January 2003, the Financial Accounting Standards Board (FASB) issued Financial Interpretation (FIN) No. 46, "Consolidation of Variable Interest Entities." We adopted FIN No. 46 effective December 31, 2003. This required us to recognize, as a cumulative effect of change in accounting principle, depreciation expense on assets leased under our synthetic-lease arrangement from lease inception to December 31, 2003. Consolidation of the variable-interest entity (VIE) associated with our synthetic-lease facility lowered 2004 net income by $3 million, or $0.02 per share.

See "Changes in Accounting Principles" on page 25 for further information.

### Liquidity and Capital Resources

**Capitalization**

| December 31 (In millions) | 2005 | 2004 | Increase (decrease) |
|---|---|---|---|
| Short-term debt, including current maturities of long-term debt | $ 3 | $ 471 | $ (468) |
| Long-term debt | 869 | 869 | — |
| Total debt | 872 | 1,340 | (468) |
| Minority interest | 9 | 9 | — |
| Shareholders' equity | 820 | 1,083 | (263) |
| Total capitalization | $1,701 | $2,432 | $ (731) |

The ratio of total debt to total capitalization declined to 51.3% at December 31, 2005, from 55.1% at December 31, 2004. Short-term debt declined $468 million from December 31, 2004, to December 31, 2005. The decline reflected the payment of our $169 million synthetic-lease facility balance in January 2005, and the repayment of $299 million of notes that became due in December 2005.

Shareholders' equity declined $263 million in 2005 as detailed below.

| (In millions) | |
|---|---|
| Shareholders' equity at December 31, 2004 | $1,083 |
| Increase (decrease) | |
| Additional minimum pension liability | (141) |
| Unfavorable foreign-currency translation adjustments | (56) |
| Stock repurchases | (164) |
| Net income | 54 |
| Issuance of common stock in connection with the administration of employee-benefit plans | 44 |
| Shareholders' equity at December 31, 2005 | $ 820 |

**Cash Flows –** Cash flows for continuing and discontinued operations were as follows:

| (In millions) | 2005 | 2004 | Increase (decrease) |
|---|---|---|---|
| Cash provided (used) by: | | | |
| Operating activities | $ 266 | $ 366 | $ (100) |
| Investing activities | 283 | (91) | 374 |
| Financing activities | (595) | (197) | (398) |

The decrease in cash provided by operating activities was driven primarily by higher new-product launch costs, higher working capital requirements, and a decline in cash generated from discontinued operations.

Investing activities provided cash of $283 million in 2005, reflecting proceeds of $524 million from the sale of the protective- and flexible-packaging businesses and other asset sales, partially offset by capital expenditures of $143 million and the acquisition of Newspring for $98 million. In 2004, investing activities used $91 million of cash, principally for capital expenditures of $100 million.

Cash used by financing activities was $595 million in 2005, driven primarily by the repurchase of company stock ($164 million) and the repayment of debt ($468 million), offset partially by the issuance of company stock in connection with the administration of employee-benefit plans ($28 million). Financing activities used $197 million of cash in 2004, primarily related to the repurchase of company stock ($230 million), offset partially by the issuance of company stock in connection with the administration of employee-benefit plans ($33 million).

**Capital Commitments –** Commitments for authorized capital expenditures totaled approximately $50 million at December 31, 2005. It is anticipated that the majority of these expenditures will be funded over the next 12 months from existing cash and short-term investments and internally generated cash.

**Contractual Obligations –** We enter into arrangements that obligate us to make future payments under long-term contracts. Our long-term contractual obligations at December 31, 2005, are summarized below.

| | | Due in | | | |
|---|---|---|---|---|---|
| (In millions) | Total | Less than 1 year | 1–3 years | 3–5 years | More than 5 years |
| Long-term debt obligations (1) | $1,966 | $ 71 | $ 229 | $ 126 | $1,540 |
| Operating-lease obligations | 78 | 22 | 29 | 15 | 12 |
| Purchase obligations (2) | 778 | 492 | 284 | 1 | 1 |
| Other long-term liabilities (3) | 184 | 24 | 37 | 30 | 93 |
| Total | $3,006 | $ 609 | $ 579 | $ 172 | $1,646 |

*(1)Includes fixed-rate debentures, plus related interest-payment obligations based on rates in effect at December 31, 2005.*

*(2)Includes open capital commitments, amounts related to the purchase of minimum quantities of raw materials at current market prices under supply agreements and other long-term vendor agreements with specific payment provisions and early termination penalties.*

*(3)Includes undiscounted workers' compensation obligations, and undiscounted and unfunded post-retirement medical and supplemental pension-funding requirements.*

**Liquidity and Off-Balance-Sheet Financing** – We use various sources of funding to manage liquidity. Sources of liquidity include cash flow from operations and a 5-year, $600 million revolving-credit facility, none of which was outstanding at December 31, 2005. We were in full compliance with financial and other covenants of our revolving-credit agreement at year-end 2005. We also use an asset-securitization program as off-balance-sheet financing. No amount was securitized under this program as of December 31, 2005, while $10 million was securitized at December 31, 2004. Termination of the asset-securitization program would require us to increase our debt or decrease our cash balance by an amount corresponding to the level of sold receivables at such time.

As a result of the Gulf Coast hurricanes, an industry-wide supply disruption of resin materials occurred. We successfully managed our business through this disruption, minimizing the impact on our customers. However, our inventory levels were lower than normal at year-end 2005. In the first half of 2006, we will be rebuilding our inventories, which may require additional cash usage.

We have pension plans that cover substantially all of our employees. Funding of the qualified U.S. plan is determined by the Employee Retirement Income Security Act (ERISA). Based on long-term projections and regulations in existence at December 31, 2005, we do not expect to be required to contribute cash to this plan through at least 2014.

We believe that cash flow from operations, available cash reserves, and the ability to obtain cash under our credit facilities and asset-securitization program will be sufficient to meet current and future liquidity and capital requirements. We do not expect the sale of substantially all of our protective- and flexible-packaging businesses to have a significant impact on future liquidity.

## Year 2004 compared with 2003

### Results of Continuing Operations

**Sales**

| | | | Increase (decrease) | |
|---|---|---|---|---|
| (In millions) | 2004 | 2003 | Amount | Percent |
| Consumer Products | $ 934 | $ 888 | $ 46 | 5.2% |
| Foodservice/Food Packaging | 1,610 | 1,491 | 119 | 8.0 |
| Total | $2,544 | $2,379 | $ 165 | 6.9% |

Total sales increased in 2004. Excluding the positive impact of foreign-currency exchange rates ($8 million) and acquisitions ($55 million), sales grew 4.3%, driven primarily by price increases and volume growth in the base business.

Sales for the Consumer Products business increased in 2004, reflecting strong volume growth. Volume growth was broad-based, led by an increase in tableware and the introduction of new products, including Hefty® Ultra-Flex™ waste bags and a line of cups.

Foodservice/Food Packaging segment sales growth in 2004 was driven by broad-based volume gains including acquisitions ($65 million) and higher selling prices ($54 million). Selling-price increases were implemented to offset the impact of significant increases in polystyrene costs.

**Operating Income**

| | | | Increase (decrease) | |
|---|---|---|---|---|
| (In millions) | 2004 | 2003 | Amount | Percent |
| Consumer Products | $ 175 | $ 195 | $ (20) | (10.3)% |
| Foodservice/Food Packaging | 112 | 193 | (81) | (42.0) |
| Other | 10 | 33 | (23) | (69.7) |
| Total | $ 297 | $ 421 | $ (124) | (29.5)% |

Total operating income decreased in 2004, driven by the recording of restructuring and other charges of $79 million, as well as the unfavorable effect of higher plastic-resin and other energy-related costs, increased marketing-support expenditures, and lower noncash pension income, offset partially by the positive impact of selling-price increases, volume gains, restructuring-program benefits, and productivity improvements.

The following tables summarize the impact of restructuring and other charges on 2004 and 2003 operating income.

**Operating income – twelve months ended December 31, 2004**

| (In millions) | GAAP basis | Restructuring and other charges | Excluding restructuring and other charges |
|---|---|---|---|
| Consumer Products | $ 175 | $ 4 | $ 179 |
| Foodservice/Food Packaging | 112 | 72 | 184 |
| Other | 10 | 3 | 13 |
| Total | $ 297 | $ 79 | $ 376 |

**Operating income – twelve months ended December 31, 2003**

| (In millions) | GAAP basis | Restructuring and other charges | Excluding restructuring and other charges |
|---|---|---|---|
| Consumer Products | $ 195 | $ — | $ 195 |
| Foodservice/Food Packaging | 193 | (1) | 192 |
| Other | 33 | — | 33 |
| Total | $ 421 | $ (1) | $ 420 |

We believe focusing on operating income excluding the effect of restructuring and other charges is a meaningful alternative way of evaluating our operating results. The restructuring and other charges relate to actions that will have an ongoing effect on our company. To consider such charges as being applicable to only 2004 and 2003 could make our operating performance in those periods more difficult to evaluate when compared with other periods in which there were no such charges. We use operating income excluding restructuring and other charges to evaluate operating performance and, along with other factors, to determine management compensation.

The following table summarizes operating income excluding restructuring and other charges for 2004 and 2003.

| (In millions) | 2004 | 2003 | Increase (decrease) Amount | Increase (decrease) Percent |
|---|---|---|---|---|
| Consumer Products | $ 179 | $ 195 | $ (16) | (8.2)% |
| Foodservice/Food Packaging | 184 | 192 | (8) | (4.2) |
| Other | 13 | 33 | (20) | (60.6) |
| Total | $ 376 | $ 420 | $ (44) | (10.5)% |

Total operating income excluding restructuring and other charges was down versus 2003. Increased plastic-resin and other energy-related costs, higher marketing-support expenses, and lower noncash pension income were only partially offset by higher selling prices, volume growth, restructuring savings, and productivity gains.

Operating income excluding restructuring and other charges for the Consumer Products business declined compared with 2003, as higher plastic-resin and other energy-related costs and increased advertising and promotional expenses were only partially offset by increased volume, higher selling prices, and productivity gains.

Operating income excluding restructuring and other charges for the Foodservice/Food Packaging business was down from 2003, reflecting the unfavorable impact of higher plastic-resin and other energy-related costs, offset, in part, by selling price increases, higher volume, and productivity improvements.

Operating income excluding restructuring and other charges for the Other segment decreased from 2003, principally because of a decline in noncash pension income.

**Income Taxes –** Our effective tax rate for 2004 was 36.2%, compared with 38.0% for 2003, reflecting the positive impact of tax-planning strategies.

**Income from Continuing Operations –** We recorded income from continuing operations of $138 million, or $0.90 per share, in 2004, compared with $176 million, or $1.10 per share, in 2003. Our 2004 results included restructuring and other charges of $50 million after tax, or $0.32 per share, and noncash pension income of $35 million after tax, or $0.23 per share. Results in 2003 included charges for the Tenneco Packaging litigation settlement and related matters of $35 million after tax, or $0.22 per share, and noncash pension income of $44 million after tax, or $0.27 per share.

## Discontinued Operations

**Income (Loss) from Discontinued Operations –** Income (loss) from discontinued operations (see “Basis of Presentation” on page 18) includes an allocation of interest expense for all periods presented. Amounts allocated were based on the ratio of the net assets of discontinued operations to the company’s total net assets plus consolidated debt. Amounts allocated were $15 million for 2004, and $13 million for 2003.

Operating results for discontinued operations were as follows:

| For the years ending December 31 (In millions) | 2004 | 2003 |
|---|---|---|
| Sales | $ 839 | $ 761 |
| Income before tax | 29 | 29 |

Assets and liabilities from discontinued operations were as follows:

| December 31 (In millions) | 2004 | 2003 |
|---|---|---|
| Accounts and notes receivable, net | $ 127 | $ 109 |
| Inventories | 95 | 86 |
| Other current assets | 4 | 5 |
| Property, plant and equipment, net | 308 | 306 |
| Other long-term assets | 205 | 199 |
| Total assets from discontinued operations | $ 739 | $ 705 |
| Accounts payable | $ 64 | $ 52 |
| Accrued expense and other | 41 | 32 |
| Long-term liabilities | 40 | 40 |
| Total liabilities from discontinued operations | $ 145 | $ 124 |

## Cumulative Effect of Changes in Accounting Principles

Upon adopting FIN No. 46 on December 31, 2003, we consolidated a VIE associated with properties covered by our synthetic-lease facility. This resulted in an increase in long-term debt and property, plant, and equipment of $169 million and $150 million, respectively. Consolidation of the VIE also required us to recognize, as a cumulative effect of change in accounting principle, depreciation expense on the leased assets from lease inception to December 31, 2003, of $19 million, $12 million after tax, or $0.07 per share. In 2004, consolidation of the VIE lowered net income by $3 million, or $0.02 per share.

See “Changes in Accounting Principles” for further information.

## Changes In Accounting Principles

In January 2003, the FASB issued FIN No. 46, which addresses accounting for VIEs. VIEs are defined as separate legal structures that either do not have equity investors with voting rights or have equity investors with voting rights that do not provide sufficient financial resources for entities to support their activities. FIN No. 46 requires that (1) companies consolidate VIEs if they are required to recognize the majority of such entities' gains and losses and (2) disclosures be made regarding VIEs that companies are not required to consolidate but in which they have a significant variable interest. We adopted FIN No. 46 on December 31, 2003. See "Cumulative Effect of Changes in Accounting Principles" for further information.

In December 2004, the FASB issued SFAS No. 123(R), "Share-Based Payment," which requires that the fair value of all share-based payments to employees, including stock options, be recognized in financial statements. SFAS No. 123(R) superceded Accounting Principles Board Opinion No. 25 (APB No. 25), "Accounting for Stock Issued to Employees." APB No. 25 required that the "intrinsic value" method be used in determining compensation expense for share-based payments to employees. Under SFAS No. 123(R), employee-compensation expense is based on the grant-date fair value of awards. Expense is recognized in the Statement of Income over the period during which recipients of awards are required to provide service (normally the vesting period).

SFAS No. 123(R) will be adopted using the modified prospective method as of January 1, 2006. The impact if SFAS No. 123(R) had been adopted in prior periods is similar to amounts shown under the "Stock Based Compensation" section of Note 2.

SFAS No. 123(R) also requires that the benefits of tax deductions in excess of recognized compensation costs be reported as cash flow from financing activities, rather than as cash flow from operating activities. It is not possible to predict these amounts, since they depend on the timing of employee stock-option exercises. Amounts recognized for such "excess" tax deduction benefits were $6 million in 2005, $6 million in 2004, and $3 million in 2003.

## Critical Accounting Policies

Following are our accounting policies that involve the exercise of considerable judgment and the use of estimates. These have the most significant impact on our financial condition and results of operations.

### Revenue Recognition

We recognize sales when the risks and rewards of ownership have transferred to the customer, which is generally considered to have occurred as products are shipped. In arriving at net sales, we estimate the amount of deductions from sales that are likely to be earned or taken by customers in conjunction with incentive programs. These include volume rebates, early payment discounts, and coupon redemptions. Estimates are based on historical trends and are reviewed quarterly for possible revision. The amount of sales deductions reflected in net sales for the 12 months ended December 31, 2005, are reasonable. In the event that future sales-deduction trends vary significantly from past or expected trends, reported sales may increase or decrease by a material amount.

### Inventory Valuation

Our inventories are stated at the lower of cost or market. A portion of inventories (62% and 67% at December 31, 2005, and 2004, respectively) is valued using the last-in, first-out (LIFO) method of accounting. Given the volatility of our costs of raw materials (primarily plastic resins), we prefer the LIFO method because it reflects the current cost of inventories in cost of sales. If we had valued inventories using the first-in, first-out (FIFO) accounting method as of January 1, 2003, net income would have been $1 million, or $0.01 per share, higher in 2003; $32 million, or $0.21 per share, higher in 2004; and $2 million, or $0.01 per share, higher in 2005.

We periodically review inventory balances to identify slow-moving and/or obsolete items. This determination is based on a number of factors, including new-product introductions, changes in consumer-demand patterns, and historical usage trends.

### Pension Plans

We account for pension plans in accordance with requirements of SFAS No. 87, "Employers' Accounting for Pensions." Pretax pension-plan income was $54 million in 2005, $56 million in 2004, and $70 million in 2003. Pension income is included in the Statement of Income as an offset to selling, general, and administrative expenses. We estimate that our noncash pretax pension income will decline to $42 million in 2006.

Projections of pension income are based on a number of factors, including estimates of future returns on pension-plan assets; assumptions pertaining to the amortization of actuarial gains/losses; expectations regarding employee compensation; and assumptions related to participant turnover, retirement age, and life expectancy.

In developing our assumption regarding the rate of return on pension-plan assets, we estimate future returns on various classes of assets, risk-free rates of return, and long-term inflation rates. Since inception in 1971, our U.S. qualified pension plan's annual rate of return on assets has averaged 11%. Historically, the plan has invested approximately 70% of assets in equity securities and 30% in fixed-income investments. After considering all of these factors, we concluded that the use of a 9% rate-of-return on assets assumption was appropriate for 2005. Holding all other assumptions constant, a one-half percentage-point change in the rate-of-return on assets assumption would impact our pretax pension income by approximately $19 million.

The discount-rate assumption for our U.S. plan is based on the composite yield on a portfolio of high-quality corporate bonds constructed with durations to match the plan's future benefit obligations. In this connection, the discount-rate assumption for our U.S. plan at our September 30 measurement date was 5.7% for 2005, and 6.25% for 2004. Holding all other assumptions constant, a one-half percentage-point change in the discount rate would impact our pretax pension income by approximately $4 million.

We use a market-related method for calculating the value of plan assets. This method recognizes the difference between actual and expected returns on plan assets over a 5-year period. Resulting unrecognized gains or losses, along with other actuarial gains and losses, are amortized using the "corridor approach" discussed in SFAS No. 87.

## Derivative Financial Instruments

We are exposed to market risks related to changes in foreign-currency exchange rates, interest rates, and commodity prices. To manage these risks we may enter into various hedging contracts in accordance with established policies and procedures. We do not use hedging instruments for trading purposes and are not a party to any transactions involving leveraged derivatives.

### Foreign-Currency Exchange

We use foreign-currency forward contracts to hedge our exposure to adverse changes in exchange rates, primarily related to the British pound and the euro. Associated gains or losses offset gains or losses on underlying assets or liabilities.

In managing foreign-currency risk, we aggregate existing positions and hedge residual exposures through third-party derivative contracts. The following table summarizes foreign-currency forward contracts in effect at December 31, 2005, all of which will mature in 2006.

| (In millions, except settlement rates) | Notional amount in foreign currency | Exchange rate | Notional amount in U.S. dollars |
|---|---|---|---|
| British pounds | | | |
| Purchase | 2 | 1.723 | 3 |
| Sell | (8) | 1.723 | (14) |
| Euros | | | |
| Purchase | 12 | 1.185 | 14 |
| Sell | (2) | 1.185 | (2) |

### Interest Rates

At December 31, 2005, we had public-debt securities of $875 million outstanding, with fixed interest rates and maturity dates ranging from 2 to 22 years. Should we decide to redeem these securities prior to their stated maturity, we would incur costs based on the fair value of the securities at that time. In addition, we had other floating-rate debt of $3 million outstanding at December 31, 2005.

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

| (In millions) | 2006 | 2007 | Thereafter | Total |
|---|---|---|---|---|
| Fixed-rate debt | $ — | $ 99 | $ 776 | $ 875 |
| Average interest rate | | 8.0% | 8.1% | 7.9% |
| Fair value | $ — | $ 101 | $ 886 | $ 987 |
| Floating-rate debt | $ 3 | $ — | $ — | $ 3 |
| Average interest rate | 4.8% | | | 4.8% |
| Fair value | $ 3 | $ — | $ — | $ 3 |

Prior to our spin-off from Tenneco, we entered into an interest-rate swap to hedge our exposure to interest-rate movements. We settled this swap in November 1999, incurring a $43 million loss, which is being recognized as additional interest expense over the life of the underlying debt.

## Report of Management

Our 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 judgment.

We believe that our 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. We are dedicated to maintaining high standards of ethics, integrity, and social responsibility in the conduct of our business, and use ongoing education, communications, and review programs to support this dedication.

Our financial statements have been audited by Ernst & Young LLP, an independent auditing firm, which was selected by the audit committee of the board of directors. Our management has made available to Ernst & Young 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. Ernst & Young's report follows.

The board of directors, through its audit committee consisting solely of outside directors, meets periodically with Ernst & Young, representatives of management, and our 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 our financial reporting and internal-control system.

Richard L. Wambold

Chairman and Chief Executive Officer

Andrew A. Campbell

Senior Vice President and Chief Financial Officer

## Management's Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining effective internal control over financial reporting (as defined in Rules 13a-15(f) under the Securities Exchange Act of 1934). Our internal control over financial reporting is designed to provide reasonable assurance to our management and board of directors regarding the preparation and fair presentation of published financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

We assessed the effectiveness of our internal controls over financial reporting as of December 31, 2005. In making this assessment, we used the criteria set forth in the Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on our assessment using those criteria, we concluded that Pactiv's internal control over financial reporting at December 31, 2005, was effective.

Our assessment of the effectiveness of internal control over financial reporting as of December 31, 2005, has been audited by Ernst & Young LLP, the independent registered public accounting firm who also audited the company's consolidated financial statements. Ernst & Young's attestation report on management's assessment of the company's internal control over financial reporting appears on page 29.

## Report of Independent Registered Public Accounting Firm

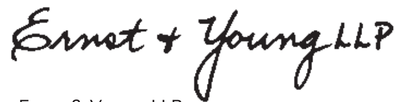
The Board of Directors and Shareholders of Pactiv Corporation:

We have audited the accompanying consolidated statements of financial position of Pactiv Corporation and consolidated subsidiaries (the company) as of December 31, 2005 and 2004, and the related consolidated statements of income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2005. 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 the standards of the Public Company Accounting Oversight Board (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 consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Pactiv Corporation and consolidated subsidiaries at December 31, 2005 and 2004, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Pactiv Corporation's internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 15, 2006 expressed an unqualified opinion thereon.




Ernst & Young LLP

Chicago, Illinois

March 15, 2006

## Report of Independent Registered Public Accounting Firm on Internal Control Over Financial Reporting

The Board of Directors and Shareholders of Pactiv Corporation:

We have audited management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting, that Pactiv Corporation and consolidated subsidiaries (the "company") maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Pactiv Corporation's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

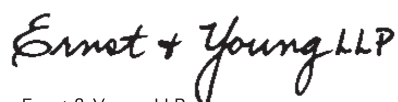
We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Pactiv Corporation maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Pactiv Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statements of financial position of Pactiv Corporation and consolidated subsidiaries as of December 31, 2005 and 2004, and the related consolidated statements of income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2005, and our report dated March 15, 2006 expressed an unqualified opinion thereon.




Ernst & Young LLP

Chicago, Illinois

March 15, 2006