

CONOCOPHILLIPS  
Form 10-Q  
November 02, 2006

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended September 30, 2006

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 001-32395

**ConocoPhillips**

*(Exact name of registrant as specified in its charter)*

**Delaware**  
*(State or other jurisdiction of  
incorporation or organization)*

**01-0562944**  
*(I.R.S. Employer  
Identification No.)*

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**600 North Dairy Ashford, Houston, TX 77079**

*(Address of principal executive offices) (Zip Code)*

**281-293-1000**

*(Registrant's telephone number, including area code)*

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

The registrant had 1,645,769,817 shares of common stock, \$.01 par value, outstanding at September 30, 2006.

CONOCOPHILLIPS

TABLE OF CONTENTS

	Page
<u>Part I Financial Information</u>	
<u>Item 1. Financial Statements</u>	
<u>Consolidated Income Statement</u>	1
<u>Consolidated Balance Sheet</u>	2
<u>Consolidated Statement of Cash Flows</u>	3
<u>Notes to Consolidated Financial Statements</u>	4
<u>Supplementary Information Condensed Consolidating Financial Information</u>	29
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	38
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	67
<u>Item 4. Controls and Procedures</u>	67
<u>Part II Other Information</u>	
<u>Item 1. Legal Proceedings</u>	68
<u>Item 1A. Risk Factors</u>	69
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	70
<u>Item 6. Exhibits</u>	70
<u>Signature</u>	71

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## PART I. FINANCIAL INFORMATION

## Item 1. FINANCIAL STATEMENTS

## Consolidated Income Statement

ConocoPhillips

	Millions of Dollars Three Months Ended September 30		Nine Months Ended September 30	
	2006	2005	2006	2005
<b>Revenues and Other Income</b>				
Sales and other operating revenues (1)	\$ 48,076	48,745	142,131	128,184
Equity in earnings of affiliates	1,196	872	3,320	2,626
Other income	313	42	537	381
<b>Total Revenues and Other Income</b>	<b>49,585</b>	<b>49,659</b>	<b>145,988</b>	<b>131,191</b>
<b>Costs and Expenses</b>				
Purchased crude oil, natural gas and products	30,551	34,508	93,454	88,603
Production and operating expenses	2,640	1,982	7,549	6,081
Selling, general and administrative expenses	650	612	1,826	1,690
Exploration expenses	197	140	443	432
Depreciation, depletion and amortization	2,137	1,049	5,282	3,075
Impairments	267		317	31
Taxes other than income taxes (1)	4,853	4,606	13,661	13,758
Accretion on discounted liabilities	74	46	207	135
Interest and debt expense	308	122	783	387
Foreign currency transaction (gains) losses	(50 )	34	(10 )	52
Minority interests	21	6	60	21
<b>Total Costs and Expenses</b>	<b>41,648</b>	<b>43,105</b>	<b>123,572</b>	<b>114,265</b>
Income from continuing operations before income taxes	7,937	6,554	22,416	16,926
Provision for income taxes	4,061	2,750	10,063	7,068
<b>Income From Continuing Operations</b>	<b>3,876</b>	<b>3,804</b>	<b>12,353</b>	<b>9,858</b>
Loss from discontinued operations		(4 )		(8 )
<b>Net Income</b>	<b>\$ 3,876</b>	<b>3,800</b>	<b>12,353</b>	<b>9,850</b>
<b>Income Per Share of Common Stock (dollars)</b>				
Basic				
Continuing operations	\$ 2.35	2.73	7.90	7.06
Discontinued operations				(.01 )
<b>Net Income</b>	<b>\$ 2.35</b>	<b>2.73</b>	<b>7.90</b>	<b>7.05</b>
Diluted				
Continuing operations	\$ 2.31	2.68	7.78	6.94
Discontinued operations				
<b>Net Income</b>	<b>\$ 2.31</b>	<b>2.68</b>	<b>7.78</b>	<b>6.94</b>
<b>Dividends Paid Per Share of Common Stock (dollars)</b>	<b>\$ .36</b>	<b>.31</b>	<b>1.08</b>	<b>.87</b>
<b>Average Common Shares Outstanding (in thousands)</b>				
Basic	1,652,623	1,393,943	1,564,423	1,396,180
Diluted	1,675,839	1,417,796	1,587,892	1,419,898

(1) Includes excise taxes on petroleum products sales:  
See Notes to Consolidated Financial Statements.

\$4,098      4,292      12,010      12,785



Consolidated Balance Sheet	ConocoPhillips	
	Millions of Dollars September 30 2006	December 31 2005
<b>Assets</b>		
Cash and cash equivalents	\$ 696	2,214
Accounts and notes receivable (net of allowance of \$85 million in 2006 and \$72 million in 2005)	12,064	11,168
Accounts and notes receivable related parties	981	772
Inventories	6,198	3,724
Prepaid expenses and other current assets	4,661	1,734
Total Current Assets	24,600	19,612
Investments and long-term receivables	19,530	15,726
Net properties, plants and equipment	86,127	54,669
Goodwill	31,930	15,323
Intangibles	1,093	1,116
Other assets	443	553
Total Assets	\$ 163,723	106,999
<b>Liabilities</b>		
Accounts payable	\$ 13,528	11,732
Accounts payable related parties	523	535
Notes payable and long-term debt due within one year	4,030	1,758
Accrued income and other taxes	5,416	3,516
Employee benefit obligations	1,184	1,212
Other accruals	2,673	2,606
Total Current Liabilities	27,354	21,359
Long-term debt	23,777	10,758
Asset retirement obligations and accrued environmental costs	5,583	4,591
Deferred income taxes	20,497	11,439
Employee benefit obligations	2,453	2,463
Other liabilities and deferred credits	2,362	2,449
Total Liabilities	82,026	53,059
<b>Minority Interests</b>	1,221	1,209
<b>Common Stockholders' Equity</b>		
Common stock (2,500,000,000 shares authorized at \$.01 par value)		
Issued (2006 1,702,225,866 shares; 2005 1,455,861,340 shares)		
Par value	17	14
Capital in excess of par	41,695	26,754
Grantor trusts (at cost: 2006 45,876,265 shares; 2005 45,932,093 shares)	(815 )	(778 )
Treasury stock (at cost: 2006 10,579,784 shares; 2005 32,080,000 shares)	(675 )	(1,924 )
Accumulated other comprehensive income	1,722	814
Unearned employee compensation	(153 )	(167 )
Retained earnings	38,685	28,018
Total Common Stockholders' Equity	80,476	52,731
Total	\$ 163,723	106,999

See Notes to Consolidated Financial Statements.



Consolidated Statement of Cash Flows	ConocoPhillips	
	Millions of Dollars Nine Months Ended September 30	
	2006	2005
<b>Cash Flows From Operating Activities</b>		
Income from continuing operations	\$ 12,353	9,858
Adjustments to reconcile income from continuing operations to net cash provided by continuing operations		
Non-working capital adjustments		
Depreciation, depletion and amortization	5,282	3,075
Impairments	317	31
Dry hole costs and leasehold impairments	141	211
Accretion on discounted liabilities	207	135
Deferred taxes	273	753
Undistributed equity earnings	(1,007 )	(1,682 )
Gain on asset dispositions	(64 )	(264 )
Other	(296 )	1
Working capital adjustments		
Decrease in aggregate balance of accounts receivable sold		(480 )
Decrease (increase) in other accounts and notes receivable	172	(1,269 )
Increase in inventories	(1,922 )	(1,275 )
Increase in prepaid expenses and other current assets	(669 )	(1,150 )
Increase in accounts payable	181	2,748
Increase in taxes and other accruals	911	2,267
Net cash provided by continuing operations	15,879	12,959
Net cash used in discontinued operations		(6 )
Net Cash Provided by Operating Activities	15,879	12,953
<b>Cash Flows From Investing Activities</b>		
Acquisition of Burlington Resources Inc.*	(14,285 )	
Capital expenditures and investments, including dry hole costs*	(11,513 )	(8,573 )
Proceeds from asset dispositions	246	608
Long-term advances/loans to affiliates and other	(632 )	(188 )
Collection of advances/loans to affiliates and other	115	159
Net cash used in continuing operations	(26,069 )	(7,994 )
Net cash used in discontinued operations		
Net Cash Used in Investing Activities	(26,069 )	(7,994 )
<b>Cash Flows From Financing Activities</b>		
Issuance of debt	15,263	333
Repayment of debt	(4,325 )	(1,845 )
Issuance of company common stock	145	377
Repurchase of company common stock	(675 )	(1,165 )
Dividends paid on company common stock	(1,684 )	(1,210 )
Other	(123 )	87
Net cash provided by (used in) continuing operations	8,601	(3,423 )
Net Cash Provided by (Used in) Financing Activities	8,601	(3,423 )
<b>Effect of Exchange Rate Changes on Cash and Cash Equivalents</b>	71	(120 )
<b>Net Change in Cash and Cash Equivalents</b>	(1,518 )	1,416
Cash and cash equivalents at beginning of period	2,214	1,387
Cash and Cash Equivalents at End of Period	\$ 696	2,803



*\*Net of cash acquired.*

*See Notes to Consolidated Financial Statements.*

3

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**Note 1 Interim Financial Information**

The interim-period financial information presented in the financial statements included in this report is unaudited and includes all known accruals and adjustments, in the opinion of management, necessary for a fair presentation of the consolidated financial position of ConocoPhillips and its results of operations and cash flows for such periods. All such adjustments are of a normal and recurring nature. The acquisition of Burlington Resources Inc. was reflected in our balance sheet beginning at March 31, 2006, and was reflected in our results of operations beginning April 1, 2006.

To enhance your understanding of these interim financial statements, see the consolidated financial statements and notes included in our 2005 Annual Report on Form 10-K.

**Note 2 Accounting Policies**

**Revenue Recognition** Revenues associated with sales of crude oil, natural gas, natural gas liquids, petroleum and chemical products, and other items are recognized when title passes to the customer, which is when the risk of ownership passes to the purchaser and physical delivery of goods occurs, either immediately or within a fixed delivery schedule that is reasonable and customary in the industry. Prior to April 1, 2006, revenues included the sales portion of transactions commonly called buy/sell contracts, in which physical commodity purchases and sales were contracted with the same counterparty to either obtain a different quality or grade of refinery feedstock supply, reposition a commodity (for example, where we entered into a contract with a counterparty to sell refined products or natural gas volumes at one location and purchase similar volumes at another location closer to our wholesale customer), or both in contemplation of one another.

Effective April 1, 2006, we implemented Emerging Issues Task Force (EITF) Issue No. 04-13, Accounting for Purchases and Sales of Inventory with the Same Counterparty. Issue No. 04-13 requires purchases and sales of inventory with the same counterparty and entered into in contemplation of one another to be combined and reported net (i.e., on the same income statement line). Exceptions to this are exchanges of finished goods for raw materials or work-in-progress within the same line of business, which are only reported net if the transaction lacks economic substance. The implementation of Issue No. 04-13 did not have a material impact on income from continuing operations or net income.

The table below shows the actual three months ended September 30, 2006, sales and other operating revenues, and purchased crude oil, natural gas and products under this new guidance, and the respective pro forma amounts included in this report had this new guidance been effective for all the periods prior to April 1, 2006.

	Millions of Dollars Three Months Ended September 30		Nine Months Ended September 30	
	Actual 2006	Pro Forma 2005	Pro Forma 2006	2005
Sales and other operating revenues	\$ 48,076	41,872	135,474	110,296
Purchased crude oil, natural gas and products	30,551	27,635	86,797	70,715

Revenues from the production of significant natural gas and crude oil properties, in which we have an interest with other producers, are recognized based on the actual volumes we sold during the period. Any differences between volumes sold and entitlement volumes, based on our net working interest, which are deemed to be non-recoverable through remaining production, are recognized as accounts receivable or accounts payable, as appropriate. Cumulative differences between volumes sold and entitlement volumes are generally not significant. Revenues associated with royalty fees from licensed technology are recorded based either upon volumes produced by the licensee or upon the successful completion of all substantive performance requirements related to the installation of licensed technology.

**Stock-Based Compensation** Effective January 1, 2003, we voluntarily adopted the fair-value accounting method prescribed by Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation. We used the prospective transition method, applying the fair-value accounting method and recognizing compensation expense equal to the fair-market value on the grant date for all stock options granted or modified after December 31, 2002.

Employee stock options granted prior to 2003 were accounted for under Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations; however, by the end of 2005, all of these awards had vested. Because the exercise price of our employee stock options equaled the market price of the underlying stock on the date of grant, generally no compensation expense was recognized under APB Opinion No. 25. The following table displays 2005 pro forma information as if provisions of SFAS No. 123 had been applied to all employee stock options granted:

	Millions of Dollars Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net income, as reported	\$ 3,800	9,850
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	71	144
Deduct: Total stock-based employee compensation expense determined under fair-value-based method for all awards, net of related tax effects	(72 )	(146 )
Pro forma net income	\$ 3,799	9,848
Earnings per share:		
Basic as reported	\$ 2.73	7.05
Basic pro forma	2.73	7.05
Diluted as reported	2.68	6.94
Diluted pro forma	2.68	6.94

Effective January 1, 2006, we adopted SFAS No. 123 (revised 2004), Share-Based Payment, (SFAS No. 123(R)). For information about our adoption of this new accounting standard, see Note 3 Changes in Accounting Principles.

**Note 3 Changes in Accounting Principles**

At its September 2005 meeting, the EITF reached a consensus on Issue No. 04-13, Accounting for Purchases and Sales of Inventory with the Same Counterparty, which requires purchases and sales of inventory with the same counterparty and entered into in contemplation of one another to be combined and reported net. We adopted Issue No. 04-13 effective April 1, 2006. For additional information, see the Revenue Recognition section of Note 2 Accounting Policies.

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123(R), which supercedes APB Opinion No. 25, Accounting for Stock Issued to Employees, and replaces SFAS No. 123, Accounting for Stock-Based Compensation. SFAS No. 123(R), which was effective January 1, 2006, prescribes the accounting for a wide range of share-based compensation arrangements, including options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans, and generally requires the fair value of share-based awards to be expensed. We adopted SFAS No. 123(R) on January 1, 2006, using the modified-prospective transition method provided under the Statement.

SFAS No. 123(R) permits the use of either the accelerated method or the straight-line method of recognizing expense for share-based awards subject to graded vesting (i.e., when portions of the award vest at different dates throughout the vesting period). In the past, we have used the accelerated recognition method for these awards, but concurrent with our adoption of SFAS No. 123(R), we elected to use the straight-line recognition method to account for new awards granted with graded vesting provisions.

Generally, our stock-based compensation programs provide accelerated vesting (i.e., a waiver of the remaining period of service required to earn an award) for awards held by employees at the time of their retirement. For awards granted prior to January 1, 2006, we recognize expense over the period of time during which the employee earns the award, accelerating the recognition of expense only when an employee actually retires.

For stock-based compensation awards granted after December 31, 2005, our adoption of SFAS No. 123(R) requires us to recognize expense over the shorter of the service period (i.e., the stated period of time required to earn the award), or the period beginning at the start of the service period and ending when an employee first becomes eligible for retirement. This change in recognition method shortens the period over which we recognize expense for most of our stock-based awards granted to employees who already are, or soon will be, eligible for retirement.

During the first nine months of 2006, the company granted approximately 3.2 million restricted stock units, with an average fair value of \$58.51 per unit, under the 2004 Omnibus Stock and Performance Incentive Plan, while restrictions lapsed in accordance with the terms of the plan on approximately 300,000 restricted stock units.

Also during the first nine months of 2006, the company granted approximately 1.8 million stock options, primarily under the 2004 Omnibus Stock and Performance Incentive Plan, with a weighted-average exercise price of \$59.33 and a weighted-average fair value of \$16.17 per option. The fair values were calculated using the Black-Scholes-Merton option-pricing model, with the following weighted-average assumptions: a risk-free interest rate of 4.63 percent, an expected dividend yield of 2.50 percent, a volatility factor of 26.1 percent and an expected life of 7.18 years. As of September 30, 2006, approximately 2,340 of these stock options were exercisable.

In addition to the above stock option activity, on March 31, 2006, in exchange for outstanding Burlington Resources Inc. stock options, the company granted approximately 3.6 million vested stock options, with an

average exercise price of \$23.40 per share, and approximately 1.3 million non-vested stock options, with an average exercise price of \$62.99 per share. The aggregate fair value of these options, as calculated with the Black-Scholes-Merton option-pricing model, was approximately \$164 million.

During the first nine months of 2006, approximately 6.0 million stock options were exercised with an average exercise price of \$24.11 per option, and approximately 6.6 million options became eligible for exercise.

Due in part to our having fully adopted the fair-value accounting method prescribed by SFAS No. 123 on January 1, 2003, the adoption of SFAS No. 123(R) did not have a material impact on our 2006 financial statements, nor do we expect it to have a material impact on our future financial statements.

In November 2004, the FASB issued SFAS No. 151, Inventory Costs, an amendment of ARB No. 43, Chapter 4. This Statement clarifies items such as abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage) be recognized as current-period charges. In addition, the Statement requires the allocation of fixed production overheads to the costs of conversion based on the normal capacity of the production facilities. We adopted this Statement effective January 1, 2006. The adoption did not have a material impact on our financial statements.

#### **Note 4 Acquisition of Burlington Resources Inc.**

On March 31, 2006, we completed the \$33.9 billion acquisition of Burlington Resources Inc., an independent exploration and production company that held a substantial position in North American natural gas proved reserves, production and exploratory acreage. We issued approximately 270.4 million shares of our common stock and paid approximately \$17.5 billion in cash. We acquired \$3.2 billion in cash and assumed \$4.3 billion of debt from Burlington Resources in the acquisition, including recognition of an increase of \$406 million to record the debt at its fair value. Results of operations attributable to Burlington Resources were included in our consolidated income statement beginning in the second quarter of 2006.

The acquisition of Burlington Resources added approximately 2 billion barrels of oil equivalent to our proved reserves.

The primary reasons for the acquisition and the principal factors contributing to a purchase price resulting in the recognition of goodwill were expanded growth opportunities in North American natural gas exploration and development, cost savings from the elimination of duplicate activities, and the sharing of best practices in the operations of both companies.

The \$33.9 billion purchase price was based on Burlington Resources shareholders receiving \$46.50 in cash and 0.7214 shares of ConocoPhillips common stock for each Burlington Resources share owned. ConocoPhillips issued approximately 270.4 million shares of common stock and approximately 3.6 million vested employee stock options in exchange for 374.8 million shares of Burlington Resources common stock and 2.5 million Burlington Resources vested stock options. The ConocoPhillips common stock was valued at \$59.85 per share, which was the weighted-average price of ConocoPhillips common stock for a five-day period beginning two available trading days before the public announcement of the transaction on the evening of December 12, 2005. The Burlington Resources vested stock options, whose fair value was determined using the Black-Scholes-Merton option-pricing model, were exchanged for ConocoPhillips stock options valued at \$146 million. Estimated transaction-related costs were \$56 million.

Also included in the acquisition was the replacement of 0.9 million non-vested Burlington Resources stock options and 0.4 million shares of non-vested restricted stock with 1.3 million non-vested ConocoPhillips stock options and 0.5 million non-vested ConocoPhillips restricted stock. In addition, 1.2 million

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Burlington Resources shares of common stock held by a consolidated grantor trust, related to a deferred compensation plan, were converted into 0.9 million ConocoPhillips common shares and were recorded as a reduction of common stockholders' equity.

The preliminary allocation of the purchase price to specific assets and liabilities was based, in part, upon a preliminary outside appraisal of the fair value of Burlington Resources assets. Over the next few months, we expect to receive the final outside appraisal of the long-lived assets and conclude the fair value determination of all other Burlington Resources assets and liabilities. The following table summarizes, based on the preliminary purchase price allocation described above, the fair values of the assets acquired and liabilities assumed as of March 31, 2006:

	<b>Millions of Dollars</b>
Cash and cash equivalents	\$ 3,238
Accounts and notes receivable	1,268
Inventories	241
Prepaid expenses and other current assets	148
Investments and long-term receivables	354
Properties, plants and equipment	28,546
Goodwill	16,705
Intangibles	107
Other assets	50
Total assets	\$ 50,657
Accounts payable	\$ 1,497
Notes payable and long-term debt due within one year	1,009
Accrued income and other taxes	952
Employee benefit obligations - current	225
Other accruals	68
Long-term debt	3,330
Asset retirement obligations	879
Accrued environmental costs	69
Deferred income taxes	8,007
Employee benefit obligations	334
Other liabilities and deferred credits	395
Common stockholders' equity	33,892
Total liabilities and equity	\$ 50,657

We assigned all of the Burlington Resources goodwill to the Worldwide Exploration and Production reporting unit. Of the \$16,705 million of goodwill, \$8,283 million relates to net deferred tax liabilities arising from differences between the allocated financial bases and deductible tax bases of the acquired assets. None of the goodwill is deductible for tax purposes.

Goodwill recorded in the acquisition is not subject to amortization, but will be tested periodically for impairment as required by SFAS No. 142, Goodwill and Other Intangible Assets.

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The following table presents actual results for the three-month period ended September 30, 2006, and the respective pro forma information as if the acquisition had occurred at the beginning of each year presented.

	Millions of Dollars		September 30		2005
	Three Months Ended		Nine Months Ended		
	Actual	Pro Forma	Actual	Pro Forma	
	2006	2005	2006	2006	
Sales and other operating revenues	\$ 48,076	50,348	144,036	132,699	
Income from continuing operations	3,876	4,157	12,747	10,428	
Net income	3,876	4,153	12,747	10,420	
Income from continuing operations per share of common stock					
Basic	2.35	2.50	7.71	6.26	
Diluted	2.31	2.46	7.60	6.16	
Net income per share of common stock					
Basic	2.35	2.50	7.71	6.25	
Diluted	2.31	2.46	7.60	6.16	

The unaudited pro forma information does not reflect any anticipated synergies that might be achieved from combining the operations. The pro forma information is not intended to reflect the actual results that would have occurred if the companies had been combined during the periods presented, nor is it intended to be indicative of the results of operations that may be achieved by ConocoPhillips in the future.

The pro forma adjustments include estimates and assumptions based on currently available information. We believe the estimates and assumptions are reasonable, and the significant effects of the transactions are properly reflected. However, actual results may differ materially from this pro forma financial information.

### Note 5 Restructuring

As a result of the acquisition of Burlington Resources Inc., we implemented a restructuring program in March 2006 to capture the synergies of combining the two companies. Under this program, which is expected to be completed by the end of March 2008, we recorded accruals totaling \$201 million for employee severance payments, site closings, incremental pension benefit costs associated with the workforce reductions, and employee relocations. Approximately 600 positions have been identified for elimination, most of which are in the United States. Of the total accrual, \$196 million is reflected in the Burlington Resources purchase price allocation as an assumed liability, and \$5 million (\$3 million after-tax) related to ConocoPhillips is reflected in selling, general and administrative expenses. Included in the total accruals of \$201 million is \$12 million related to pension benefits to be paid in conjunction with other retirement benefits over a number of future years. Benefit payments of \$87 million related to the non-pension accrual of \$189 million were made through September 2006, resulting in an ending liability balance of \$102 million. Of this amount, \$75 million is expected to be extinguished within one year.

**Note 6 Variable Interest Entities (VIEs)**

In June 2006, ConocoPhillips acquired a 24 percent interest in West2East Pipeline LLC, a company holding a 100 percent interest in Rockies Express Pipeline LLC. Rockies Express plans to construct a 1,633-mile natural gas pipeline from the Cheyenne Hub in Weld County, Colorado, to the Clarington Hub in eastern Ohio. Rockies Express is a VIE because a third party other than ConocoPhillips and our partners holds a significant voting interest in the company until project completion. We currently participate in the management committee of Rockies Express as a non-voting member. We are not the primary beneficiary of Rockies Express. We use the equity method of accounting for our investment in West2East Pipeline. At September 30, 2006, we had made no capital investment in West2East Pipeline.

In 2005, ConocoPhillips and OAO LUKOIL (LUKOIL) created the OOO Naryanmarnftegaz (NMNG) joint venture to develop resources in the Timan-Pechora region of Russia. The NMNG joint venture is a VIE because we and our related party, LUKOIL, have disproportionate interests. We have a 30 percent ownership interest with a 50 percent governance interest in the joint venture. We are not the primary beneficiary of the VIE. At September 30, 2006, the book value of our investment in the venture was \$869 million.

**Note 7 Inventories**

Inventories consisted of the following:

	Millions of Dollars September 30 2006	December 31 2005
Crude oil and petroleum products	\$ 5,416	3,183
Materials, supplies and other	782	541
	\$ 6,198	3,724

Inventories valued on the last-in, first-out (LIFO) basis totaled \$5,190 million and \$3,019 million at September 30, 2006, and December 31, 2005, respectively. The remainder of our inventories is valued under various methods, including first-in, first-out and weighted average. The excess of current replacement cost over LIFO cost of inventories amounted to \$4,046 million and \$3,958 million at September 30, 2006, and December 31, 2005, respectively.

**Note 8 Assets Held for Sale**

In April 2006, we announced the commencement of an asset rationalization program to evaluate our asset base to identify those assets that may no longer fit into our strategic plans or those that could bring more value by being monetized in the near term. During the third quarter of 2006, certain assets included in this program met the held-for-sale criteria of SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. Accordingly, in the third quarter of 2006, on those assets required, we reduced the carrying value of the assets held for sale to estimated fair value less costs to sell, resulting in an impairment of \$266 million before-tax (\$253 million after-tax). Further, we ceased depreciation, depletion and amortization of the properties, plants, and equipment associated with these assets from the dates they were classified as held for sale.



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At September 30, 2006, we reclassified \$2,385 million from non-current assets into the Prepaid expenses and other current assets line of our consolidated balance sheet and we reclassified \$593 million from non-current liabilities to current liabilities, consisting of \$323 million into Accrued income and other taxes and \$270 million into Other accruals.

The major classes of non-current assets and non-current liabilities held for sale at September 30, 2006, reclassified to current were:

	<b>Millions of Dollars</b>
<b>Assets</b>	
Investments and long-term receivables	\$ 172
Net properties, plants and equipment	1,926
Goodwill	160
Intangibles	16
Other assets	111
<b>Total assets reclassified</b>	<b>\$ 2,385</b>
Exploration and Production	\$ 1,577
Refining and Marketing	808
	<b>\$ 2,385</b>
<b>Liabilities</b>	
Asset retirement obligations and accrued environmental costs	\$ 251
Deferred income taxes	323
Employee benefit obligations	2
Other liabilities and deferred credits	17
<b>Total liabilities reclassified</b>	<b>\$ 593</b>
Exploration and Production	\$ 514
Refining and Marketing	79
	<b>\$ 593</b>

### Note 9 Investments and Long-Term Receivables

#### LUKOIL

We increased our ownership interest in LUKOIL to 19.0 percent at September 30, 2006, based on 850.6 million shares authorized and issued. For financial reporting under U.S. generally accepted accounting principles, certain treasury shares held by LUKOIL subsidiaries are not considered outstanding for determining our equity-method ownership interest in LUKOIL. Excluding these treasury shares (20.2 million of the 22.8 million treasury shares, based on latest available public data) from the denominator of our ownership calculation, our equity-method ownership interest at September 30, 2006, was 19.5 percent.

At September 30, 2006, the book value of our investment in ordinary shares of LUKOIL was \$8,532 million. Our share of the net assets of LUKOIL was estimated to be \$6,315 million. This basis difference of \$2,217 million is primarily being amortized on a unit-of-production basis. On September 30, 2006, the closing price of LUKOIL shares on the London Stock Exchange was \$75.50 per share, making the total market value of our LUKOIL investment \$12,202 million.

**Loans to Affiliated Companies**

As part of our normal ongoing business operations and consistent with normal industry practice, we invest and enter into numerous agreements with other parties to pursue business opportunities, which share costs and apportion risks among the parties as governed by the agreements. Included in such activity are loans made to certain affiliated companies. Significant loans to affiliated companies at September 30, 2006, included the following:

- \$457 million in loan financing, including accrued interest, to Freeport LNG for the construction of a liquefied natural gas (LNG) regasification facility. We expect to provide total financing of approximately \$630 million for the construction of the facility.
- \$167 million in loan financing, including accrued interest, to Varandey Terminal Company associated with the costs to expand an existing crude oil terminal operated by LUKOIL. Based on the current estimate from the operator, we assess our total obligation for the terminal expansion to be approximately \$350 million at current exchange rates.
- \$336 million of project financing, including accrued interest, to Qatargas 3, an integrated project to produce and liquefy natural gas from Qatar's North field. Our maximum exposure to this financing structure is \$1.2 billion.

**Note 10 Properties, Plants and Equipment**

Properties, plants and equipment included the following at September 30, 2006, and December 31, 2005:

	Millions of Dollars September 30, 2006			December 31, 2005		
	Gross PP&E	Accum. DD&A	Net PP&E	Gross PP&E	Accum. DD&A	Net PP&E
Exploration and Production (E&P)	\$ 87,126	19,970	67,156	53,907	16,200	37,707
Midstream	327	150	177	322	128	194
Refining and Marketing (R&M)	22,537	5,282	17,255	20,046	4,777	15,269
LUKOIL Investment						
Chemicals						
Emerging Businesses	931	85	846	865	61	804
Corporate and Other	1,204	511	693	1,192	497	695
	\$ 112,125	25,998	86,127	76,332	21,663	54,669

**Suspended Wells**

The following table reflects the net changes in suspended exploratory well costs during the first nine months of 2006:

	Millions of Dollars Nine Months Ended September 30, 2006
Beginning balance at January 1	\$ 339
Additions pending the determination of proved reserves	259
Reclassifications to proved properties	(11 )
Charged to dry hole expense	(5 )
Ending balance at September 30	582

The following table provides an aging of suspended well balances at September 30, 2006, and December 31, 2005:

	Millions of Dollars September 30 2006	December 31 2005
Exploratory well costs capitalized for a period of one year or less	\$ 362	183
Exploratory well costs capitalized for a period greater than one year	220	156
Ending balance	\$ 582	339
Number of projects with exploratory well costs capitalized for a period greater than one year	20	15

The following table provides a further aging of those exploratory well costs that have been capitalized for more than one year since the completion of drilling, as of September 30, 2006:

Project	Millions of Dollars Suspended Since					
	Total	2005	2004	2003	2002	2001
Alpine satellite Alaska (2)	\$ 21				21	
Kashagan Republic of Kazakhstan (1)	18			9		9
Kairan Republic of Kazakhstan (1)	13		13			
Aktote Republic of Kazakhstan (2)	19		7	12		
Gumusut Malaysia (2)	30	6	11	13		
Malikai Malaysia (2)	10		10			
Ubah Malaysia (1)	13	13				
Plataforma Deltana Venezuela (2)	21	6	15			
Hejre Denmark (2)	22	14				8
Eleven projects of less than \$10 million each (1)(2)	53	24	1	19	9	
Total of 20 projects	\$ 220	63	57	53	30	17

(1)Additional appraisal wells planned.

(2)Appraisal drilling complete; costs being incurred to assess development.

**Note 11 Goodwill**

Changes in the carrying amount of goodwill were as follows:

	Millions of Dollars		
	E&P	R&M	Total
Balance at December 31, 2005	\$ 11,423	3,900	15,323
Acquired (Burlington Resources)	<b>16,705</b>		<b>16,705</b>
Acquired (Wilhelmshaven refinery)		<b>224</b>	<b>224</b>
Goodwill allocated to assets held for sale	(43 )	(117 )	(160 )
Impairment of goodwill		(60 )	(60 )
Tax and other adjustments	(103 )	1	(102 )
<b>Balance at September 30, 2006</b>	<b>\$ 27,982</b>	<b>3,948</b>	<b>* 31,930</b>

*\*Consists of two reporting units: Worldwide Refining (\$2,216) and Worldwide Marketing (\$1,732).*

On March 31, 2006, we acquired Burlington Resources Inc., an independent exploration and production company. As a result of this acquisition, we recorded goodwill of \$16,705 million, all of which was aligned with our E&P segment. See Note 4 Acquisition of Burlington Resources Inc., for additional information.

On February 28, 2006, we acquired the Wilhelmshaven refinery, located in Wilhelmshaven, Germany. The purchase included the refinery, a marine terminal, rail and truck loading facilities and a tank farm, as well as another entity that provides commercial and administrative support to the refinery. As a result of this acquisition, we recorded goodwill of \$224 million, all of which was aligned with our R&M segment. The allocation of the purchase price to specific assets and liabilities was based on a combination of an outside appraiser's valuation for fixed assets and an internal estimate of the fair values of the various other assets and liabilities acquired. We are finalizing the fair value of certain liabilities. Over the next few months, the company expects to finalize the allocation of the purchase price to the specific assets and liabilities acquired and the calculations of deferred tax liabilities and goodwill.

**Note 12 Impairments**

In the third quarter of 2006, we recorded impairments of \$266 million associated with planned asset dispositions in our E&P and R&M segments, comprised of properties, plants and equipment (\$136 million), trademark intangibles (\$70 million), and goodwill (\$60 million). Impairments for the nine-month period of 2006 included a property impairment of \$40 million recorded as a result of our decision to withdraw an application for a license under the federal Deepwater Port Act, associated with a proposed LNG regasification terminal located offshore Alabama. We also impaired properties located offshore Australia due to increased accrued dismantlement and removal costs. In the nine-month period of 2005, we recorded property impairments related to planned asset dispositions in our E&P and Midstream segments. The impairments by segment were:

	Millions of Dollars Three Months Ended September 30		Nine Months Ended September 30	
	2006	2005	2006	2005
E&P	\$ 7		57	1
Midstream				30
R&M	260		260	
	\$ 267		317	31

**Note 13 Debt**

Our debt balance at September 30, 2006, was \$27.8 billion, compared with a debt balance of \$12.5 billion at year-end 2005, \$32.2 billion at March 31, 2006, and \$29.5 billion at June 30, 2006. The increase in the first quarter of 2006 reflects debt issuances of \$15.3 billion related to the acquisition of Burlington Resources Inc. and the assumption of \$4.3 billion of Burlington Resources debt, including the recognition of an increase of \$406 million to record the debt at its fair value. These increases in the first quarter of 2006 were partly offset by debt reductions during the second and third quarters of 2006.

In March 2006, we closed on two \$7.5 billion bridge facilities with a group of five banks to help fund the Burlington Resources acquisition. These bridge financings were both 364-day loan facilities with pricing and terms similar to our existing revolving credit facilities. These facilities were fully drawn in the funding of the acquisition.

In April 2006, we entered into and funded a \$5 billion five-year term loan, closed on a \$2.5 billion five-year revolving credit facility, increased the ConocoPhillips commercial paper program to \$7.5 billion, and issued \$3 billion of debt securities. The term loan and new credit facility were executed with a group of 36 banks with terms and pricing provisions similar to our other existing revolving credit facilities. The proceeds from the term loan, debt securities and issuances of commercial paper, together with our cash balances and cash provided from operations, were used to repay the \$15 billion bridge facilities during the second and third quarters of 2006.

The \$3 billion of debt securities were issued in early April 2006. Of this issuance, \$1 billion of Floating Rate Notes due April 11, 2007, were issued by ConocoPhillips, and \$1.25 billion of Floating Rate Notes due April 9, 2009, and \$750 million of 5.50% Notes due 2013, were issued by ConocoPhillips Australia Funding Company, a wholly owned subsidiary. ConocoPhillips guarantees the obligations of ConocoPhillips Australia Funding Company.

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At September 30, 2006, we had two revolving credit facilities totaling \$5 billion. Expiration dates for both facilities were extended one year in the third quarter of 2006 to October 2011. We also have a \$2.5 billion five-year revolving credit facility we entered into in April 2006. These facilities may be used as direct bank borrowings, as support for the ConocoPhillips \$7.5 billion commercial paper program, as support for the ConocoPhillips Qatar Funding Ltd. \$1.5 billion commercial paper program, or as support for issuances of letters of credit totaling up to \$750 million. The facilities are broadly syndicated among financial institutions and do not contain any material adverse change provisions or covenants requiring maintenance of specified financial ratios or ratings. The credit facilities contain a cross-default provision relating to our, or any of our consolidated subsidiaries', failure to pay principal or interest on other debt obligations of \$200 million or more. At September 30, 2006, and December 31, 2005, we had no outstanding borrowings under these credit facilities, but \$41 million and \$62 million, respectively, in letters of credit had been issued. Under both commercial paper programs there was \$3,470 million of commercial paper outstanding at September 30, 2006, compared with \$32 million at December 31, 2005. The commercial paper increase resulted from efforts to reduce the bridge facilities discussed above.

The following table reflects Burlington Resources debt assumed in the acquisition, including increases to record the debt at fair value (see Note 4 Acquisition of Burlington Resources Inc., for additional information about the acquisition). Balances at the March 31, 2006, acquisition date were:

	Millions of Dollars
5.60% Notes due 2006	\$ 500
6.60% Notes due 2007 <i>(1)</i>	129
5.70% Notes due 2007	350
9 7/8% Debentures due 2010	150
6.50% Notes due 2011	500
6.68% Notes due 2011	400
6.40% Notes due 2011	178
7 5/8% Debentures due 2013	100
9 1/8% Debentures due 2021	150
7.65% Debentures due 2023	88
8.20% Debentures due 2025	150
6 7/8% Debentures due 2026	67
7 3/8% Debentures due 2029	92
7.20% Notes due 2031	575
7.40% Notes due 2031	500
Capital lease	4
Unamortized premiums and discounts	406
Total debt assumed	4,339
Notes payable and long-term debt due within one year	(1,009 )
Long-term debt assumed	\$ 3,330

*(1) Notes are denominated in Canadian dollars and reported in U.S. dollars.*

Maturities at March 31, 2006, on Burlington Resources debt assumed, inclusive of net unamortized premiums and discounts, for the remainder of 2006 through 2010 were: \$650 million, \$377 million, \$27 million, \$25 million and \$175 million, respectively.

The amortization of the fair-value adjustment will result in the above fixed-rate notes having a weighted-average annual effective interest rate of 5.64 percent.

In October 2006, we redeemed our \$1.25 billion 5.45% Notes upon their maturity and redeemed our \$500 million 5.60% Notes due December 2006, and our \$350 million 5.70% Notes due March 2007, at a premium of \$1 million, plus accrued interest. In order to finance the maturity and call of the above notes, ConocoPhillips Canada Funding Company I, a wholly owned subsidiary, issued \$1.25 billion of 5.625% Notes due 2016, and ConocoPhillips Canada Funding Company II, a wholly owned subsidiary, issued \$500 million of 5.95% Notes due 2036, and \$350 million of 5.30% Notes due 2012. ConocoPhillips and ConocoPhillips Company guarantee the obligations of ConocoPhillips Canada Funding Company I and ConocoPhillips Canada Funding Company II.

In May 2006, we redeemed our \$240 million 7.625% Notes upon their maturity and redeemed our \$129 million 6.60% Notes due in 2007 at a premium of \$4 million, plus accrued interest.

#### **Note 14 Contingencies and Commitments**

In the case of all known contingencies, we accrue a liability when the loss is probable and the amount is reasonably estimable. We do not reduce these liabilities for potential insurance or third-party recoveries. If applicable, we accrue receivables for probable insurance or other third-party recoveries.

Based on currently available information, we believe it is remote that future costs related to known contingent liability exposures will exceed current accruals by an amount that would have a material adverse impact on our financial statements. As we learn new facts concerning contingencies, we reassess our position both with respect to accrued liabilities and other potential exposures. Estimates that are particularly sensitive to future changes include contingent liabilities recorded for environmental remediation, tax and legal matters. Estimated future environmental remediation costs are subject to change due to such factors as the uncertain magnitude of cleanup costs, the unknown time and extent of such remedial actions that may be required, and the determination of our liability in proportion to that of other responsible parties. Estimated future costs related to tax and legal matters are subject to change as events evolve and as additional information becomes available during administrative and litigation processes.

**Environmental** We are subject to federal, state and local environmental laws and regulations. These may result in obligations to remove or mitigate the effects on the environment of the placement, storage, disposal or release of certain chemical, mineral and petroleum substances at various sites. When we prepare our financial statements, we record accruals for environmental liabilities based on management's best estimates, using all information that is available at the time. We measure estimates and base liabilities on currently available facts, existing technology, and presently enacted laws and regulations, taking into consideration the likely effects of societal and economic factors. When measuring environmental liabilities, we also consider our prior experience in remediation of contaminated sites, the cleanup experience of other companies, and data released by the U.S. Environmental Protection Agency (EPA) or other organizations. We also consider unasserted claims in our determination of environmental liabilities and we accrue them in the period they become both probable and reasonably estimable.

Although liability of those potentially responsible for environmental remediation costs is generally joint and several for federal sites and frequently so for state sites, we are usually only one of many companies cited at a particular site. Due to the joint and several liabilities, we could be responsible for all of the cleanup costs related to any site at which we have been designated as a potentially responsible party. If we were solely responsible, the costs, in some cases, could be material to our, or one of our segments', results of operations, capital resources or liquidity. However, settlements and costs incurred in matters that previously have been resolved have not been material to our results of operations or financial condition. We have been successful

to date in sharing cleanup costs with other financially sound companies. Many of the sites at which we are potentially responsible are still under investigation by the EPA or the state agencies concerned. Prior to actual cleanup, those potentially responsible normally assess the site conditions, apportion responsibility and determine the appropriate remediation. In some instances, we may have no liability or may attain a settlement of liability. Where it appears that other potentially responsible parties may be financially unable to bear their proportionate share, we consider this inability in estimating our potential liability and adjust our accruals accordingly.

As a result of various acquisitions in the past, we assumed certain environmental obligations. Some of these environmental obligations are mitigated by indemnifications made by others for our benefit and some of the indemnifications are subject to dollar and time limits. We have not recorded accruals for any potential contingent liabilities that we expect to be funded by the prior owners under these indemnifications.

We are currently participating in environmental assessments and cleanups at numerous federal Superfund and comparable state sites. After an assessment of environmental exposures for cleanup and other costs, we make accruals on an undiscounted basis (except for those assumed in a purchase business combination, which we record on a discounted basis) for planned investigation and remediation activities for sites where it is probable that future costs will be incurred and these costs can be reasonably estimated. At September 30, 2006, our balance sheet included a total environmental accrual of \$1,034 million, compared with \$989 million at December 31, 2005. We expect to incur the majority of these expenditures within the next 30 years. In the future, we may be involved in additional environmental assessments, cleanups and proceedings.

**Legal Proceedings** We apply our knowledge, experience, and professional judgment to the specific characteristics of our cases, employing a litigation management process to manage and monitor the legal proceedings involving us. Our process facilitates the early evaluation and quantification of potential exposures in individual cases. This process also enables us to track those cases which have been scheduled for trial, as well as the pace of settlement discussions in individual matters. Based on our professional judgment and experience in using these litigation management tools and available information about current developments in all our cases, we believe there is only a remote likelihood that future costs related to known contingent liability exposures will exceed current accruals by an amount that would have a material adverse impact on our financial statements.

**Other Contingencies** We have contingent liabilities resulting from throughput agreements with pipeline and processing companies not associated with financing arrangements. Under these agreements, we may be required to provide any such company with additional funds through advances and penalties for fees related to throughput capacity not utilized. In addition, at September 30, 2006, we had performance obligations secured by letters of credit of \$1,039 million (of which \$41 million was issued under the provisions of our revolving credit facilities, and the remainder was issued as direct bank letters of credit) and various purchase commitments for materials, supplies, services, and items of permanent investment incident to the ordinary conduct of business.

#### **Note 15 Guarantees**

At September 30, 2006, we were liable for certain contingent obligations under various contractual arrangements as described below. We recognize a liability, at inception, for the fair value of our obligation as a guarantor for newly issued or modified guarantees. Unless the carrying amount of the liability is noted, we have not recognized a liability either because the guarantees were issued prior to December 31, 2002, or because the fair value of the obligation is immaterial.



### **Construction Completion Guarantees**

- In June 2006, we issued a guarantee for 24 percent of the \$2.0 billion in credit facilities of Rockies Express Pipeline LLC, which will be used to construct a natural gas pipeline across a portion of the United States. The maximum potential amount of future payments to third-party lenders under the guarantee is estimated to be \$480 million, which could become payable if the credit facility is fully utilized and Rockies Express Pipeline LLC fails to meet its obligations under the credit agreement. It is anticipated that construction completion will be achieved mid-2009, and refinancing will take place at that time, making the debt non-recourse. At September 30, 2006, the carrying value of the guarantee to third-party lenders was \$11 million. For additional information, see Note 6 Variable Interest Entities (VIEs).
- In December 2005, we issued a construction completion guarantee for 30 percent of the \$4.0 billion in loan facilities of Qatargas 3, which will be used to construct an LNG train in Qatar. Of the \$4.0 billion in loan facilities, ConocoPhillips has committed to provide \$1.2 billion. The maximum potential amount of future payments to third-party lenders under the guarantee is estimated to be \$850 million, which could become payable if the full debt financing is utilized and completion of the Qatargas 3 project is not achieved. The project financing will be non-recourse upon certified completion, which is expected by December 31, 2009. At September 30, 2006, the carrying value of the guarantee to the third-party lenders was \$11 million. For additional information, see Note 9 Investments and Long-Term Receivables.

### **Guarantees of Joint-Venture Debt**

- At September 30, 2006, we had guarantees outstanding for our portion of joint-venture debt obligations, which have terms of up to 12 years. The maximum potential amount of future payments under the guarantees is approximately \$160 million. Payment would be required if a joint venture defaults on its debt obligations.

### **Other Guarantees**

- The Mery Sweeny, L.P. (MSLP) joint-venture project agreement requires the partners in the venture to pay cash calls to cover operating expenses in the event the venture does not have enough cash to cover operating expenses after setting aside the amount required for debt service over the next 18 years. Although there is no maximum limit stated in the agreement, the intent is to cover short-term cash deficiencies should they occur. Our maximum potential future payments under the agreement are currently estimated to be \$100 million, assuming such a shortfall exists at some point in the future due to an extended operational disruption.
- In February 2003, we entered into two agreements establishing separate guarantee facilities of \$50 million each for two LNG ships. Subject to the terms of each such facility, we will be required to make payments should the charter revenue generated by the respective ship fall below certain specified minimum thresholds, and we will receive payments to the extent that such revenues exceed those thresholds. The net maximum future payments that we may have to make over the 20-year terms of the two agreements could be up to \$100 million in total. To the extent we receive any such payments, our actual gross payments over the 20 years could exceed that amount. In the event either ship is sold or a total loss occurs, we also may have recourse to the sales or insurance proceeds to recoup payments made under the guarantee facilities.
- We have other guarantees with maximum future potential payment amounts totaling \$260 million, which consist primarily of dealer and jobber loan guarantees to support our marketing business, a guarantee to fund the short-term cash liquidity deficits of a lubricants joint venture, three small construction completion guarantees, a

guarantee supporting a lease assignment on a corporate aircraft, a guarantee associated with a pending lawsuit and guarantees of the lease payment

19

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obligations of a joint venture. The carrying amount recorded for these other guarantees, at September 30, 2006, was \$50 million. These guarantees generally extend up to 15 years and payment would be required only if the dealer, jobber or lessee goes into default, if the lubricants joint venture has cash liquidity issues, if construction projects are not completed, if guaranteed parties default on lease payments, or if an adverse decision occurs in the pending lawsuit.

### Indemnifications

Over the years, we have entered into various agreements to sell ownership interests in certain corporations and joint ventures and have sold several assets, including downstream and midstream assets, certain exploration and production assets, and downstream retail and wholesale sites, giving rise to qualifying indemnifications. Agreements associated with these sales include indemnifications for taxes, environmental liabilities, permits and licenses, employee claims, real estate indemnity against tenant defaults, and litigation. The terms of these indemnifications vary greatly. The majority of these indemnifications are related to environmental issues, the term is generally indefinite and the maximum amount of future payments is generally unlimited. The carrying amount recorded for these indemnifications, at September 30, 2006, was \$456 million. We amortize the indemnification liability over the relevant time period, if one exists, based on the facts and circumstances surrounding each type of indemnity. In cases where the indemnification term is indefinite, we will reverse the liability when we have information the liability is essentially relieved or amortize the liability over an appropriate time period as the fair value of our indemnification exposure declines. Although it is reasonably possible future payments may exceed amounts recorded, due to the nature of the indemnifications, it is not possible to make a reasonable estimate of the maximum potential amount of future payments. Included in the carrying amount recorded were \$337 million of environmental accruals for known contamination that is included in asset retirement obligations and accrued environmental costs at September 30, 2006. For additional information about environmental liabilities, see Note 14 Contingencies and Commitments.

### Note 16 Financial Instruments and Derivative Contracts

Derivative assets and liabilities were:

	Millions of Dollars	
	September 30 2006	December 31 2005
<b>Derivative Assets</b>		
Current	\$ 995	674
Long-term	139	193
	\$ 1,134	867
<b>Derivative Liabilities</b>		
Current	\$ 910	1,002
Long-term	187	443
	\$ 1,097	1,445

These derivative assets and liabilities appear as prepaid expenses and other current assets, other assets, other accruals, or other liabilities and deferred credits on the balance sheet.

**Note 17 Comprehensive Income**

Comprehensive income was:

	Millions of Dollars Three Months Ended September 30		Nine Months Ended September 30	
	2006	2005	2006	2005
Net income	\$ 3,876	3,800	12,353	9,850
After-tax changes in:				
Minimum pension liability adjustment				(1 )
Foreign currency translation adjustments	(32 )	13	906	(579 )
Unrealized loss on securities				(1 )
Hedging activities	(5 )	(1 )	2	4
Comprehensive income	\$ 3,839	3,812	13,261	9,273

Accumulated other comprehensive income in the equity section of the balance sheet was:

	Millions of Dollars	
	September 30 2006	December 31 2005
Minimum pension liability adjustment	\$ (123 )	(123 )
Foreign currency translation adjustments	1,851	945
Deferred net hedging loss	(6 )	(8 )
Accumulated other comprehensive income	\$ 1,722	814

**Note 18 Supplemental Cash Flow Information**

	Millions of Dollars Nine Months Ended September 30	
	2006	2005
<b>Non-Cash Investing and Financing Activities</b>		
Acquisition of Burlington Resources Inc. by issuance of stock	\$ 16,343	
Investment in properties, plants and equipment of businesses through the assumption of non-cash liabilities		261
Fair market value of properties, plants and equipment received in a nonmonetary exchange transaction		138
<b>Cash Payments</b>		
Interest	\$ 514	300
Income taxes	9,313	4,996

**Note 19 Employee Benefit Plans****Pension and Postretirement Plans**

Three Months Ended	Millions of Dollars				Other Benefits	
	Pension Benefits				September 30	
	September 30 2006		2005		2006	2005
	U.S.	Int l.	U.S.	Int l.		
<b>Components of Net Periodic Benefit Cost</b>						
Service cost	\$ 44	22	37	16	4	5
Interest cost	54	34	43	30	12	12
Expected return on plan assets	(43 )	(31 )	(31 )	(26 )		
Amortization of prior service cost	2	2	1	2	4	5
Recognized net actuarial loss (gain)	22	10	14	8	(4 )	(2 )
Net periodic benefit costs	\$ 79	37	64	30	16	20

Nine Months Ended	Millions of Dollars				Other Benefits	
	Pension Benefits				September 30	
	September 30 2006		2005		2006	2005
	U.S.	Int l.	U.S.	Int l.		
<b>Components of Net Periodic Benefit Cost</b>						
Service cost	\$ 130	65	113	53	11	15
Interest cost	157	99	130	94	35	37
Expected return on plan assets	(126 )	(91 )	(94 )	(82 )		
Amortization of prior service cost	7	6	3	6	14	15
Recognized net actuarial loss (gain)	66	30	41	25	(12 )	(4 )
Net periodic benefit costs	\$ 234	109	193	96	48	63

We recognized pension settlement losses of \$2 million in the first nine months of 2005, all of which was recorded in the third quarter.

For our heritage ConocoPhillips plans, we made the following contributions during the first nine months of 2006: \$398 million to our domestic qualified and non-qualified plans and \$86 million to our international benefit plans. For our heritage Burlington Resources plans, we contributed \$14 million to our domestic plans for the period from April through September 2006. At the end of 2005, we estimated that during 2006, we would contribute approximately \$415 million to our domestic qualified and non-qualified benefit plans and \$115 million to our international benefit plans. We currently expect 2006 contributions to the heritage ConocoPhillips plans to be \$435 million for domestic and \$125 million for international. For the heritage Burlington Resources plans, we expect to contribute \$20 million during the period April through December 2006, including the \$14 million noted above.

The projected benefit obligation and asset value of the pension plans acquired from Burlington Resources were \$303 million and \$246 million, respectively. The accumulated postretirement benefit obligation of the postretirement medical plans acquired from Burlington Resources was \$36 million.

**Note 20 Related Party Transactions**

Significant transactions with related parties were:

	Millions of Dollars		Nine Months Ended	
	Three Months Ended September 30 2006	2005*	September 30 2006	2005*
Operating revenues (a)	\$ 2,364	2,116	6,550	5,594
Purchases (b)	1,830	1,560	5,056	4,498
Operating expenses and selling, general and administrative expenses (c)	103	99	285	288
Net interest income (d)	19	10	49	29

\*Certain amounts reclassified to conform to current year presentation.

(a) We sell natural gas to Duke Energy Field Services, LLC (DEFS) and crude oil to the Malaysian Refining Company Sdn. Bhd (MRC), among others, for processing and marketing. Natural gas liquids, solvents and petrochemical feedstocks are sold to Chevron Phillips Chemical Company LLC (CPChem), gas oil and hydrogen feedstocks are sold to Excel Paralubes, and refined products are sold primarily to CFJ Properties and Getty Petroleum Marketing, Inc. (a subsidiary of LUKOIL). Also, we charge several of our affiliates, including CPChem, MSLP, and Hamaca Holding LLC, for the use of common facilities, such as steam generators, waste and water treaters, and warehouse facilities.

(b) We purchase natural gas and natural gas liquids from DEFS and CPChem for use in our refinery processes and other feedstocks from various affiliates. We purchase upgraded crude oil from Petrozuata C.A. and refined products from MRC. We also pay fees to various pipeline equity companies for transporting finished refined products and a price upgrade to MSLP for heavy crude processing. We purchase base oils and fuel products from Excel Paralubes for use in our refinery and specialty businesses.

(c) We pay processing fees to various affiliates. Additionally, we pay crude oil transportation fees to pipeline equity companies.

(d) We pay and/or receive interest to/from various affiliates, including the Phillips 66 Capital II trust. See Note 9 Investments and Long-Term Receivables, for additional information on loans to affiliated companies.

Elimination amounts related to our equity percentage share of profit or loss on the above transactions were not material.

**Note 21 Segment Disclosures and Related Information**

We have organized our reporting structure based on the grouping of similar products and services, resulting in six operating segments:

1) E&P This segment primarily explores for, produces and markets crude oil, natural gas and natural gas liquids on a worldwide basis. At September 30, 2006, our E&P operations were producing in the United States, Norway, the United Kingdom, the Netherlands, Canada, Nigeria, Venezuela, Ecuador, Argentina, offshore Timor Leste in the Timor Sea, Australia, China, Indonesia, Algeria,

Libya, the United Arab Emirates, Vietnam, and Russia. The E&P segment's U.S. and international operations are disclosed separately for reporting purposes.

- 2) **Midstream** Through both consolidated and equity interests, this segment gathers and processes natural gas produced by ConocoPhillips and others, and fractionates and markets natural gas liquids, primarily in the United States and Trinidad. The Midstream segment primarily consists of our equity investment in DEFS. Through June 30, 2005, our equity ownership in DEFS was 30.3 percent. In July 2005, we increased our ownership interest to 50 percent.
- 3) **R&M** This segment purchases, refines, markets and transports crude oil and petroleum products, mainly in the United States, Europe and Asia. At September 30, 2006, we owned 12 refineries in the United States, one in the United Kingdom, one in Ireland, one in Germany, and had equity interests in one refinery in Germany, two in the Czech Republic, and one in Malaysia. The R&M segment's U.S. and international operations are disclosed separately for reporting purposes.
- 4) **LUKOIL Investment** This segment represents our investment in the ordinary shares of LUKOIL, an international, integrated oil and gas company headquartered in Russia. At September 30, 2006, our ownership interest, based on authorized and issued shares, was 19.0 percent, and our equity-method ownership interest was 19.5 percent. See Note 9 Investments and Long-Term Receivables, for additional information.
- 5) **Chemicals** This segment manufactures and markets petrochemicals and plastics on a worldwide basis. The Chemicals segment consists of our 50 percent equity investment in CPChem.
- 6) **Emerging Businesses** This segment includes the development of new businesses outside our traditional operations. These activities include gas-to-liquids (GTL) operations, power generation, technology solutions such as sulfur removal technologies, and emerging technologies, such as renewable fuels and emission management technologies.

Corporate and Other includes general corporate overhead, interest income and expense, discontinued operations, certain eliminations, acquisition-related costs, and various other corporate activities. Corporate assets include all cash and cash equivalents.

We evaluate performance and allocate resources based on net income. Intersegment sales are at prices that approximate market.

## Analysis of Results by Operating Segment

	Millions of Dollars		Nine Months Ended	
	Three Months Ended September 30	2005	September 30 2006	2005
<b>Sales and Other Operating Revenues</b>				
E&P				
United States	\$ 9,040	8,388	27,157	22,913
International	6,552	5,742	21,076	14,980
Intersegment eliminations U.S.	(1,564 )	(1,069 )	(4,286 )	(2,960 )
Intersegment eliminations international	(1,869 )	(1,204 )	(5,244 )	(3,196 )
E&P	12,159	11,857	38,703	31,737
Midstream				
Total sales	1,012	910	3,212	2,781
Intersegment eliminations	(265 )	(216 )	(796 )	(643 )
Midstream	747	694	2,416	2,138
R&M				
United States	25,240	27,773	73,681	71,749
International	10,107	8,442	27,819	22,597
Intersegment eliminations U.S.	(211 )	(168 )	(612 )	(405 )
Intersegment eliminations international	(5 )	(2 )	(14 )	(8 )
R&M	35,131	36,045	100,874	93,933
LUKOIL Investment				
Chemicals	3	3	10	10
Emerging Businesses*				
Total sales	167	159	483	445
Intersegment eliminations	(133 )	(108 )	(361 )	(297 )
Emerging Businesses	34	51	122	148
Corporate and Other	2	3	6	8
Other Adjustments*		92		210
Consolidated sales and other operating revenues	\$ 48,076	48,745	142,131	128,184

\*Sales and other operating revenues for the Emerging Businesses segment have been restated to reflect intersegment eliminations on sales from the Immingham power plant (Emerging Businesses segment) to the Humber refinery (R&M segment). Since these amounts were not material to the consolidated income statement, the other adjustments line above is required to reconcile the restated Emerging Businesses revenues to the consolidated income statement.



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	Millions of Dollars		Nine Months Ended	
	Three Months Ended		September 30	
	September 30		September 30	
	2006	2005	2006	2005
<b>Net Income (Loss)</b>				
E&P				
United States	\$ 995	1,107	3,476	2,965
International	909	1,181	4,285	3,039
Total E&P	1,904	2,288	7,761	6,004
Midstream	169	88	387	541
R&M				
United States	1,444	1,096	3,174	2,602
International	20	294	388	598
Total R&M	1,464	1,390	3,562	3,200
LUKOIL Investment	487	267	1,123	525
Chemicals	142	13	394	209
Emerging Businesses	11		7	(16 )
Corporate and Other	(301 )	(246 )	(881	