

CONOCOPHILLIPS
Form 10-Q
November 01, 2007

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**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, 2007

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.)

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 1,599,556,644 shares of common stock, \$.01 par value, outstanding at September 30, 2007.

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Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. FINANCIAL STATEMENTS****Consolidated Income Statement****ConocoPhillips**

	Millions of Dollars			
	Three Months Ended		Nine Months Ended	
	September 30		September 30	
	2007	2006	2007	2006
Revenues and Other Income				
Sales and other operating revenues*	\$ 46,062	48,076	134,752	142,131
Equity in earnings of affiliates	1,314	1,196	3,749	3,320
Other income	557	313	1,696	537
Total Revenues and Other Income	47,933	49,585	140,197	145,988
Costs and Expenses				
Purchased crude oil, natural gas and products	30,862	30,551	88,397	93,454
Production and operating expenses	2,620	2,640	7,669	7,549
Selling, general and administrative expenses	569	650	1,700	1,826
Exploration expenses	218	197	739	443
Depreciation, depletion and amortization	2,052	2,137	6,092	5,282
Impairment expropriated assets			4,588	
Impairments	188	267	285	317
Taxes other than income taxes*	4,583	4,853	13,654	13,661
Accretion on discounted liabilities	81	74	241	207
Interest and debt expense	391	308	1,017	783
Foreign currency transaction gains	(20)	(50)	(198)	(10)
Minority interests	25	21	65	60
Total Costs and Expenses	41,569	41,648	124,249	123,572
Income before income taxes	6,364	7,937	15,948	22,416
Provision for income taxes	2,691	4,061	8,428	10,063
Net Income	\$ 3,673	3,876	7,520	12,353
Net Income Per Share of Common Stock				
<i>(dollars)</i>				
Basic	\$ 2.26	2.35	4.60	7.90
Diluted	2.23	2.31	4.54	7.78
Dividends Paid Per Share of Common Stock				
<i>(dollars)</i>				
	\$.41	.36	1.23	1.08

Average Common Shares Outstanding (*in thousands*)

Basic	1,622,456	1,652,623	1,635,128	1,564,423
Diluted	1,644,267	1,675,839	1,657,244	1,587,892

**Includes excise taxes on petroleum products sales:*

	\$ 3,954	4,098	11,864	12,010
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See Notes to Consolidated Financial Statements.

Table of Contents**Consolidated Balance Sheet****ConocoPhillips**

	Millions of Dollars	
	September	December
	30	31
	2007	2006
Assets		
Cash and cash equivalents	\$ 1,379	817
Accounts and notes receivable (net of allowance of \$64 million in 2007 and \$45 million in 2006)	11,867	13,456
Accounts and notes receivable related parties	1,911	650
Inventories	5,312	5,153
Prepaid expenses and other current assets	3,170	4,990
Total Current Assets	23,639	25,066
Investments and long-term receivables	30,145	19,595
Loans and advances related parties	1,598	1,118
Net properties, plants and equipment	87,407	86,201
Goodwill	29,374	31,488
Intangibles	899	951
Other assets	365	362
Total Assets	\$ 173,427	164,781
Liabilities		
Accounts payable	\$ 14,629	14,163
Accounts payable related parties	1,628	471
Notes payable and long-term debt due within one year	405	4,043
Accrued income and other taxes	4,741	4,407
Employee benefit obligations	740	895
Other accruals	1,935	2,452
Total Current Liabilities	24,078	26,431
Long-term debt	21,471	23,091
Asset retirement obligations and accrued environmental costs	6,561	5,619
Joint venture acquisition obligation related party	6,445	
Deferred income taxes	20,924	20,074
Employee benefit obligations	3,419	3,667
Other liabilities and deferred credits	2,416	2,051
Total Liabilities	85,314	80,933
Minority Interests	1,180	1,202

Common Stockholders Equity

Common stock (2,500,000,000 shares authorized at \$.01 par value)

Issued (2007 1,717,176,211 shares; 2006 1,705,502,609 shares)

Par value	17	17
Capital in excess of par	42,554	41,926
Grantor trusts (at cost: 2007 43,259,722 shares; 2006 44,358,585 shares)	(746)	(766)
Treasury stock (at cost: 2007 74,359,845 shares; 2006 15,061,613 shares)	(5,479)	(964)
Accumulated other comprehensive income	3,930	1,289
Unearned employee compensation	(133)	(148)
Retained earnings	46,790	41,292
 Total Common Stockholders Equity	 86,933	 82,646
 Total	 \$ 173,427	 164,781

See Notes to Consolidated Financial Statements.

Table of Contents**Consolidated Statement of Cash Flows****ConocoPhillips**

	Millions of Dollars	
	Nine Months Ended	
	September 30	
	2007	2006
Cash Flows From Operating Activities		
Net income	\$ 7,520	12,353
Adjustments to reconcile net income to net cash provided by operating activities		
Non-working capital adjustments		
Depreciation, depletion and amortization	6,092	5,282
Impairment expropriated assets	4,588	
Impairments	285	317
Dry hole costs and leasehold impairments	355	141
Accretion on discounted liabilities	241	207
Deferred taxes	55	273
Undistributed equity earnings	(1,472)	(1,007)
Gain on asset dispositions	(1,316)	(64)
Other	28	(296)
Working capital adjustments*		
Decrease in accounts and notes receivable	411	172
Increase in inventories	(334)	(1,922)
Decrease (increase) in prepaid expenses and other current assets	430	(669)
Increase in accounts payable	1,052	181
Decrease (increase) in taxes and other accruals	(305)	911
Net Cash Provided by Operating Activities	17,630	15,879
Cash Flows From Investing Activities		
Acquisition of Burlington Resources Inc.**		(14,285)
Capital expenditures and investments, including dry hole costs**	(7,907)	(11,513)
Proceeds from asset dispositions	3,057	246
Long-term advances/loans to affiliates	(449)	(632)
Collection of advances/loans to affiliates	66	115
Other	24	
Net Cash Used in Investing Activities	(5,209)	(26,069)
Cash Flows From Financing Activities		
Issuance of debt	824	15,263
Repayment of debt	(6,141)	(4,325)
Issuance of company common stock	251	145
Repurchase of company common stock	(4,501)	(675)
Dividends paid on company common stock	(2,009)	(1,684)
Other	(289)	(123)

Net Cash Provided by (Used in) Financing Activities	(11,865)	8,601
Effect of Exchange Rate Changes on Cash and Cash Equivalents	6	71
Net Change in Cash and Cash Equivalents	562	(1,518)
Cash and cash equivalents at beginning of period	817	2,214
Cash and Cash Equivalents at End of Period	\$ 1,379	696

* *Net of acquisition and disposition of businesses.*

** *Net of cash acquired.*

See Notes to Consolidated Financial Statements.

Table of Contents**Notes to Consolidated Financial Statements****ConocoPhillips****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 2006 Annual Report on Form 10-K.

Note 2 Changes in Accounting Principles

Effective April 1, 2006, we implemented Emerging Issues Task Force 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 net income.

The table below shows the actual nine months ended September 30, 2007, sales and other operating revenues, and purchased crude oil, natural gas and products under Issue No. 04-13, and the respective pro forma amounts had this new guidance been effective for the period included in this report prior to April 1, 2006.

	Millions of Dollars Nine Months Ended September 30	
	Actual	Pro Forma
	2007	2006
Sales and other operating revenues	\$ 134,752	135,474
Purchased crude oil, natural gas and products	88,397	86,797

In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109 (FIN 48). This Interpretation provides guidance on recognition, classification and disclosure concerning uncertain tax liabilities. The evaluation of a tax position requires recognition of a tax benefit if it is more likely than not it will be sustained upon examination. We adopted FIN 48 effective January 1, 2007. The adoption did not have a material impact on our consolidated financial statements.

At January 1, 2007, we had unrecognized tax benefits of \$912 million. Included in this balance was \$468 million which, if recognized, would affect our effective tax rate.

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We recognize accrued interest related to unrecognized tax benefits in interest expense, and penalties in production and operating expenses. At January 1, 2007, accrued liabilities for interest and penalties totaled \$99 million, net of accrued income taxes. See Note 21 Income Taxes, for additional information about income taxes.

Note 3 Acquisition of Burlington Resources Inc.

On March 31, 2006, ConocoPhillips 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.

The final allocation of the purchase price to specific assets and liabilities was completed in the first quarter of 2007. It was based on the final outside appraisal of the fair value of Burlington Resources long-lived assets and the conclusion of the fair value determination of all other Burlington Resources assets and liabilities.

The following table summarizes the final purchase price allocation of the fair value of the assets acquired and liabilities assumed as of March 31, 2006:

	Millions of Dollars
Cash and cash equivalents	\$ 3,238
Accounts and notes receivable	1,432
Inventories	229
Prepaid expenses and other current assets	108
Investments and long-term receivables	268
Properties, plants and equipment	28,176
Goodwill	16,787
Intangibles	107
Other assets	46
Total Assets	\$ 50,391
Accounts payable	\$ 1,487
Notes payable and long-term debt due within one year	1,009
Accrued income and other taxes	697
Employee benefit obligations - current	248
Other accruals	254
Long-term debt	3,330
Asset retirement obligations	730
Accrued environmental costs	174
Deferred income taxes	7,849
Employee benefit obligations	347
Other liabilities and deferred credits	397
Common stockholders' equity	33,869
Total Liabilities and Equity	\$ 50,391

All of the goodwill was assigned to the Worldwide Exploration and Production reporting unit. Of the \$16,787 million of goodwill, \$7,953 million relates to net deferred tax liabilities arising from differences

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between the allocated financial bases and deductible tax bases of the acquired assets. None of the goodwill is deductible for tax purposes.

The following table presents pro forma information for the nine months ended September 30, 2006, as if the acquisition had occurred at the beginning of 2006.

	Millions of Dollars
Pro Forma	
Sales and other operating revenues	\$ 144,036
Net income	12,747
Net income per share of common stock (<i>dollars</i>)	
Basic	7.71
Diluted	7.60

The pro forma information is not intended to reflect the actual results that would have occurred if the companies had been combined during the period presented, nor is it intended to be indicative of the results of operations that may be achieved by ConocoPhillips in the future.

Note 4 Restructuring

In connection with the acquisition of Burlington Resources, we implemented a restructuring program as part of the effort to capture the synergies of combining the two companies. Under this program, we recorded accruals totaling \$230 million in 2006 for employee severance payments, site closings, incremental pension benefit costs associated with workforce reductions, and employee relocations. Approximately 600 positions were identified for elimination during 2006, most of which were in the United States. During 2007, an additional 35 positions were identified for elimination.

Of the total accrual, \$224 million was reflected in the Burlington Resources purchase price allocation as an assumed liability, and \$6 million related to ConocoPhillips was reflected in selling, general and administrative expenses in 2006. The following table summarizes activity related to the non-pension portion of the accrual in the first nine months of 2007:

	Millions of Dollars
Balance at December 31, 2006	\$ 120
Benefit payments	(57)
Adjustments	17
Balance at September 30, 2007*	\$ 80

**Includes current liabilities of \$35 million. All workforce reductions are expected to be completed by March 2008. Some costs for site closings, continuation of employee benefits, and employee relocations are expected to extend beyond one year from September 30, 2007.*

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In June 2006, ConocoPhillips acquired a 24 percent interest in West2East Pipeline LLC (West2East), a company holding a 100 percent interest in Rockies Express Pipeline LLC (Rockies Express). West2East is a VIE, but we are not the primary beneficiary. We use the equity method of accounting for our investment. We issued a guarantee for 24 percent of the \$2 billion in credit facilities of Rockies Express. In addition, we have a guarantee for 24 percent of \$600 million of Floating Rate Notes due 2009 issued by Rockies Express in September 2007. See Note 13 Guarantees, for additional information.

In June 2005, ConocoPhillips and OAO LUKOIL (LUKOIL) created the OOO Naryanmarneftegaz (NMNG) joint venture to develop resources in the Timan-Pechora province of Russia. The NMNG joint venture is a VIE, but we are not the primary beneficiary. We use the equity method of accounting for this investment. At September 30, 2007, the book value of our investment in the venture was \$1,403 million.

See Note 11 Debt, for information about the liquidation of Phillips 66 Capital II.

Note 6 Inventories

Inventories consisted of the following:

	Millions of Dollars	
	September 30 2007	December 31 2006
Crude oil and petroleum products	\$ 4,500	4,351
Materials, supplies and other	812	802
	\$ 5,312	5,153

Inventories valued on the last-in, first-out (LIFO) basis totaled \$4,156 million and \$4,043 million at September 30, 2007, and December 31, 2006, 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 \$5,977 million and \$4,178 million at September 30, 2007, and December 31, 2006, respectively.

Note 7 Assets Held for Sale

In 2006, we commenced asset rationalization efforts that led to the classification of certain assets as held for sale under Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. Accordingly, at December 31, 2006, we classified \$3,051 million of non-current assets and \$604 million of non-current liabilities as current assets and current liabilities, respectively.

During the first nine months of 2007, a portion of these held-for-sale assets were sold, additional assets met the held-for-sale criteria, and other assets no longer met the held-for-sale criteria. As a result, at September 30, 2007, we classified \$1,352 million of non-current assets as Prepaid expenses and other current assets on our consolidated balance sheet and we classified \$193 million of non-current liabilities as current liabilities, consisting of \$142 million in Accrued income and other taxes and \$51 million in Other accruals. We expect the disposal of these assets to be substantially completed by the end of 2008.

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The major classes of non-current assets and non-current liabilities held for sale at September 30, 2007, classified as current were:

	Millions of Dollars
Assets	
Investments and long-term receivables	\$ 53
Net properties, plants and equipment	1,215
Goodwill	65
Intangibles	2
Other assets	17
 Total assets reclassified	 \$ 1,352
 Exploration and Production (E&P)	 \$ 214
Refining and Marketing (R&M)	1,138
	\$ 1,352
 Liabilities	
Asset retirement obligations and accrued environmental costs	\$ 28
Deferred income taxes	142
Other liabilities and deferred credits	23
 Total liabilities reclassified	 \$ 193
 E&P	 \$ 29
R&M	164
	\$ 193

Note 8 Investments, Loans and Long-Term Receivables**Investments in Venezuela**

See the Expropriated Assets section of Note 10 Impairments, for information on the complete impairment of our investments in the Hamaca and Petrozuata projects.

EnCana Business Ventures

In October 2006, we announced a business venture with EnCana Corporation (EnCana) to create an integrated North American heavy-oil business. The transaction closed on January 3, 2007, and consists of two 50/50 business ventures, a Canadian upstream general partnership, FCCL Oil Sands Partnership (FCCL), and a U.S. downstream limited liability company, WRB Refining LLC (WRB). We use the equity method of accounting for both entities, with the operating results of our investment in FCCL reflecting its use of the full-cost method of accounting for oil and gas exploration and development activities.

FCCL's operating assets consist of the Foster Creek and Christina Lake steam-assisted gravity drainage bitumen projects, both located in the eastern flank of the Athabasca oil sands in northeast Alberta. A subsidiary of EnCana is the operator and managing partner of FCCL. We are obligated to contribute \$7.5 billion, plus accrued interest, to FCCL over a 10-year period beginning in 2007. For additional information on this obligation, see Note 17 Joint Venture Acquisition Obligation.

WRB's operating assets consist of the Wood River and Borger refineries, located in Roxana, Illinois, and Borger, Texas, respectively. As a result of our contribution of these two assets to WRB, a basis difference of \$5.0 billion was created due to the fair value of the contributed assets recorded by WRB exceeding their

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historic book value. The difference is amortized and recognized as a benefit evenly over a period of 25 years, which is the estimated remaining useful life of the refineries at the closing date. The basis difference at September 30, 2007, was approximately \$4.9 billion. We are the operator and managing partner of WRB. EnCana is obligated to contribute \$7.5 billion, plus accrued interest, to WRB over a 10-year period beginning in 2007. For the Wood River refinery, operating results are shared 50/50 starting upon formation. For the Borger refinery, we are entitled to 85 percent of the operating results in 2007, 65 percent in 2008, and 50 percent in all years thereafter.

LUKOIL

Our ownership interest in LUKOIL was 20.0 percent at September 30, 2007, based on 851 million issued shares. For financial reporting under U.S. generally accepted accounting principles, treasury shares held by LUKOIL are not considered outstanding for determining our equity-method ownership interest in LUKOIL. Our ownership interest, based on estimated shares outstanding, was 20.5 percent at September 30, 2007.

At September 30, 2007, the book value of our ordinary share investment in LUKOIL was \$10,496 million. Our share of the net assets of LUKOIL was estimated to be \$7,939 million. This basis difference of \$2,557 million is primarily being amortized on a unit-of-production basis and recognized as a reduction of earnings. On September 30, 2007, the closing price of LUKOIL shares on the London Stock Exchange was \$83.00 per share, making the total market value of our LUKOIL investment \$14,119 million.

Loans to Related Parties

As part of our normal ongoing business operations and consistent with 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, 2007, included the following:

\$648 million in loan financing, including \$74 million of accrued interest, to Freeport LNG for the construction of a liquefied natural gas (LNG) facility. We expect to provide loan financing of approximately \$631 million for the construction of the facility, excluding accrued interest.

\$303 million in loan financing, including \$25 million of accrued interest, to Varandey Terminal Company associated with the costs of a terminal expansion. We expect our total obligation for the terminal expansion to be approximately \$410 million at current exchange rates, excluding interest to be accrued during construction.

\$608 million of project financing, including \$34 million of 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, excluding accrued interest.

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The company's investment in properties, plants and equipment (PP&E), with accumulated depreciation, depletion and amortization (Accum. DD&A), was:

	Millions of Dollars					
	September 30, 2007			December 31, 2006		
	Gross PP&E	Accum. DD&A	Net PP&E	Gross PP&E	Accum. DD&A	Net PP&E
E&P	\$ 99,574	28,799	70,775	88,592	21,102	67,490
Midstream	332	167	165	330	157	173
R&M	19,252	4,506	14,746	22,115	5,199	16,916
LUKOIL Investment Chemicals						
Emerging Businesses	1,167	130	1,037	1,006	98	908
Corporate and Other	1,355	671	684	1,229	515	714
	\$ 121,680	34,273	87,407	113,272	27,071	86,201

Suspended Wells

The following table reflects the net changes in suspended exploratory well costs during the first nine months of 2007:

Millions of
Dollars
Nine Months
Ended