Phillips 66
Form 10-Q
May 02, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
(Mark One)

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2013

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: 001-35349
Phillips 66
(Exact name of registrant as specified in its charter)

Delaware	45-3779385
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

3010 Briarpark Drive, Houston, Texas 77042
(Address of principal executive offices) (Zip Code)
281-293-6600
(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 [X] No [ ]
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes [X] No [ ]
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.
Large accelerated filer [X] Accelerated filer [ ] Non-accelerated filer [ ] Smaller reporting company [ ]
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes [ ] No [X]
The registrant had 619,232,443 shares of common stock, $.01 par value, outstanding as of March 31, 2013.

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PART I. FINANCIAL INFORMATION
Item 1. FINANCIAL STATEMENTS

Consolidated Statement of Income Phillips 66

	Millions of Dollars Three Months Ended March 31	
	2013	2012
Revenues and Other Income		
Sales and other operating revenues*	$41,263	45,783
Equity in earnings of affiliates	1,039	734
Net gain on dispositions	1	2
Other income	23	1
Total Revenues and Other Income	42,326	46,520
Costs and Expenses		
Purchased crude oil and products	35,264	40,328
Operating expenses	978	1,092
Selling, general and administrative expenses	332	349
Depreciation and amortization	245	216
Impairments	24	43
Taxes other than income taxes*	3,324	3,420
Accretion on discounted liabilities	6	5
Interest and debt expense	70	13
Foreign currency transaction (gains) losses	2	(15)
Total Costs and Expenses	40,245	45,451
Income before income taxes	2,081	1,069
Provision for income taxes	671	431
Net income	1,410	638
Less: net income attributable to noncontrolling interests	3	2
Net Income Attributable to Phillips 66	$1,407	636
Net Income Attributable to Phillips 66 Per Share of Common Stock (dollars)**		
Basic	$2.25	1.01
Diluted	2.23	1.00
Dividends Paid Per Share of Common Stock (dollars)	$0.3125	—
Average Common Shares Outstanding (in thousands)**		
Basic	625,030	627,628
Diluted	631,288	634,645
* Includes excise taxes on petroleum products sales:	$3,258	3,321

**See Note 10—Earnings Per Share.
See Notes to Consolidated Financial Statements.

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Consolidated Statement of Comprehensive Income Phillips 66

	Millions of Dollars Three Months Ended March 31	
	2013	2012
Net Income	$ 1,410	638
Other comprehensive income (loss)		
Defined benefit plans		
Actuarial gain/loss:		
Amortization to net income of net actuarial loss	26	2
Plans sponsored by equity affiliates	(13)	3
Income taxes on defined benefit plans	(3)	(2)
Defined benefit plans, net of tax	10	3
Foreign currency translation adjustments	(322)	54
Income taxes on foreign currency translation adjustments	4	(20)
Foreign currency translation adjustments, net of tax	(318)	34
Hedging activities by equity affiliates	—	1
Income taxes on hedging activities by equity affiliates	—	—
Hedging activities by equity affiliates, net of tax	—	1
Other Comprehensive Income (Loss), Net of Tax	(308)	38
Comprehensive Income	1,102	676
Less: comprehensive income attributable to noncontrolling interests	3	2
Comprehensive Income Attributable to Phillips 66	$ 1,099	674

See Notes to Consolidated Financial Statements.

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Consolidated Balance Sheet Phillips 66

	Millions of Dollars	
	March 31 2013	December 31 2012
Assets		
Cash and cash equivalents	$4,753	3,474
Accounts and notes receivable (net of allowance of $49 million in 2013 and $50 million in 2012)	8,388	8,593
Accounts and notes receivable—related parties	1,522	1,810
Inventories	5,811	3,430
Prepaid expenses and other current assets	696	655
Total Current Assets	21,170	17,962
Investments and long-term receivables	10,498	10,471
Net properties, plants and equipment	15,257	15,407
Goodwill	3,344	3,344
Intangibles	727	724
Other assets	155	165
Total Assets	$51,151	48,073
Liabilities		
Accounts payable	$11,920	9,731
Accounts payable—related parties	1,218	979
Short-term debt	13	13
Accrued income and other taxes	1,010	901
Employee benefit obligations	238	441
Other accruals	552	417
Total Current Liabilities	14,951	12,482
Long-term debt	6,958	6,961
Asset retirement obligations and accrued environmental costs	703	740
Deferred income taxes	5,507	5,444
Employee benefit obligations	1,339	1,325
Other liabilities and deferred credits	315	315
Total Liabilities	29,773	27,267
Equity		
Common stock (2,500,000,000 shares authorized at $.01 par value)		
Issued (2013—633,238,946 shares; 2012—631,149,613 shares)		
Par value	6	6
Capital in excess of par	18,775	18,726
Treasury stock (at cost: 2013—14,006,503 shares; 2012—7,603,896 shares)	(738)	(356)
Retained earnings	3,923	2,713
Accumulated other comprehensive loss	(622)	(314)
Total Stockholders' Equity	21,344	20,775
Noncontrolling interests	34	31
Total Equity	21,378	20,806
Total Liabilities and Equity	$51,151	48,073

See Notes to Consolidated Financial Statements.

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Consolidated Statement of Cash Flows Phillips 66

	Millions of Dollars	
	Three Months Ended March 31	
	2013	2012
Cash Flows From Operating Activities		
Net income	$1,410	638
Adjustments to reconcile net income to net cash provided by (used in) operating activities		
Depreciation and amortization	245	216
Impairments	24	43
Accretion on discounted liabilities	6	5
Deferred taxes	81	169
Undistributed equity earnings	77	(349)
Net gain on dispositions	(1)	(2)
Other	(34)	(178)
Working capital adjustments		
Decrease (increase) in accounts and notes receivable	285	(1,291)
Decrease (increase) in inventories	(2,442)	(1,518)
Decrease (increase) in prepaid expenses and other current assets	(71)	(183)
Increase (decrease) in accounts payable	2,466	1,996
Increase (decrease) in taxes and other accruals	167	93
Net Cash Provided by (Used in) Operating Activities	2,213	(361)
Cash Flows From Investing Activities		
Capital expenditures and investments	(387)	(218)
Proceeds from asset dispositions	9	6
Collection of advances/loans—related parties	55	—
Net Cash Used in Investing Activities	(323)	(212)
Cash Flows From Financing Activities		
Contributions from ConocoPhillips	—	891
Issuance of debt	—	5,794
Repayment of debt	(3)	(7)
Change in restricted cash	—	(6,050)
Issuance of common stock	(6)	—
Repurchase of common stock	(382)	—
Dividends paid on common stock	(194)	—
Other	—	(55)
Net Cash Provided by (Used in) Financing Activities	(585)	573
Effect of Exchange Rate Changes on Cash and Cash Equivalents	(26)	—
Net Change in Cash and Cash Equivalents	1,279	—
Cash and cash equivalents at beginning of period	3,474	—
Cash and Cash Equivalents at End of Period	$4,753	—

See Notes to Consolidated Financial Statements.

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Consolidated Statement of Changes in Equity Phillips 66

	Millions of Dollars							
	Attributable to Phillips 66							
	Common Stock							
	Par Value	Capital in Excess of Par	Treasury Stock	Retained Earnings	Net Parent Company Investment	Accum. Other Comprehensive Income (Loss)	Noncontrolling Interests	Total
December 31, 2011	$—	—	—	—	23,142	122	29	23,293
Net income	—	—	—	—	636	—	2	638
Net transfers from ConocoPhillips	—	—	—	—	974	—	—	974
Other comprehensive income	—	—	—	—	—	38	—	38
March 31, 2012	$—	—	—	—	24,752	160	31	24,943
December 31, 2012	$6	18,726	(356)	2,713	—	(314)	31	20,806
Net income	—	—	—	1,407	—	—	3	1,410
Other comprehensive loss	—	—	—	—	—	(308)	—	(308)
Cash dividends paid on common stock	—	—	—	(194)	—	—	—	(194)
Repurchase of common stock	—	—	(382)	—	—	—	—	(382)
Benefit plan activity	—	52	—	(3)	—	—	—	49
Distributions to noncontrolling interests and other	—	(3)	—	—	—	—	—	(3)
March 31, 2013	$6	18,775	(738)	3,923	—	(622)	34	21,378

	Shares in Thousands	
	Common Stock Issued	Treasury Stock
December 31, 2012	631,150	7,604
Repurchase of common stock	—	6,403
Shares issued—stock-based compensation	2,089	—
March 31, 2013	633,239	14,007

See Notes to Consolidated Financial Statements.

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Note 1—Separation and Basis of Presentation

The Separation
On April 4, 2012, the ConocoPhillips Board of Directors approved the separation of its downstream businesses (as defined below) into an independent, publicly traded company named Phillips 66. In accordance with the Separation and Distribution Agreement, the two companies were separated by ConocoPhillips distributing to its stockholders all 625,272,302 shares of common stock of Phillips 66 after the market closed on April 30, 2012 (the Separation). Each ConocoPhillips stockholder received one share of Phillips 66 stock for every two shares of ConocoPhillips stock. Following the Separation, ConocoPhillips retained no ownership interest in Phillips 66, and each company has had separate public ownership, boards of directors and management.

Basis of Presentation
Prior to the Separation, our results of operations, financial position and cash flows consisted of ConocoPhillips' refining, marketing and transportation operations; its natural gas gathering, processing, transmission and marketing operations, primarily conducted through its equity investment in DCP Midstream, LLC (DCP Midstream); its petrochemical operations, conducted through its equity investment in Chevron Phillips Chemical Company LLC (CPChem); its power generation operations; and an allocable portion of its corporate costs (together, the “downstream businesses”). These financial statements have been presented as if the downstream businesses had been combined for the 2012 period presented. All intercompany transactions and accounts within the downstream businesses were eliminated. The statement of income for the period prior to the Separation includes expense allocations for certain corporate functions historically performed by ConocoPhillips and not allocated to its operating segments, including allocations of general corporate expenses related to executive oversight, accounting, treasury, tax, legal, procurement and information technology. These allocations were based primarily on specific identification of time and/or activities associated with the downstream businesses, employee headcount or capital expenditures, and our management believes the assumptions underlying the allocations were reasonable. The combined financial statements may not necessarily reflect all of the actual expenses that would have been incurred had we been a stand-alone company during the period presented prior to the Separation. All financial information presented after the Separation represents the consolidated results of operations, financial position and cash flows of Phillips 66. Accordingly:

- Our consolidated statements of income, comprehensive income and cash flows for the three months ended March 31, 2013, consist entirely of the consolidated results of Phillips 66. Our consolidated statements of income, comprehensive income and cash flows for the three months ended March 31, 2012, consist entirely of the combined results of the downstream businesses.

- Our consolidated balance sheet at March 31, 2013, and December 31, 2012, consists of the consolidated balances of Phillips 66.

Effective January 1, 2013, we changed the organizational structure of the internal financial information reviewed by our chief executive officer, and determined this resulted in a change in the composition of our operating segments. The primary effects of this reporting reorganization were:

- We disaggregated the former Refining and Marketing (R&M) segment into two separate operating segments titled "Refining" and "Marketing and Specialties."

- We moved our transportation and power businesses from the former R&M segment to the Midstream and Marketing and Specialties (M&S) segments, respectively.

The new segment alignment is presented for the first quarter of 2013, with the prior period recast for comparability.

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Note 2—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 necessary, in the opinion of management, for a fair presentation of the consolidated financial position of Phillips 66 and its results of operations and cash flows for the periods presented. Unless otherwise specified, all such adjustments are of a normal and recurring nature. Certain notes and other information have been condensed or omitted from the interim financial statements included in this report. Therefore, these interim financial statements should be read in conjunction with the consolidated financial statements and notes included in our 2012 Annual Report on Form 10-K. The results of operations for the three months ended March 31, 2013, are not necessarily indicative of the results to be expected for the full year.

Note 3—Variable Interest Entities (VIEs)

We hold significant variable interests in VIEs that have not been consolidated because we are not considered the primary beneficiary. Information on these VIEs follows:

Merey Sweeny, L.P. (MSLP) is a limited partnership that owns a delayed coker and related facilities at the Sweeny Refinery. As discussed more fully in Note 6—Investments, Loans and Long-Term Receivables, in August 2009 a call right was exercised to acquire the 50 percent ownership interest in MSLP of the co-venturer, Petróleos de Venezuela S.A. (PDVSA). That exercise has been challenged, and the dispute is being arbitrated. Because the exercise has been challenged by PDVSA, we continue to use the equity method of accounting for MSLP, and the VIE analysis below is based on the ownership and governance structure in place prior to the exercise of the call right. MSLP is a VIE because, in securing lender consents in connection with the Separation, we provided a 100 percent debt guarantee to the lender of the 8.85% senior notes issued by MSLP. PDVSA did not participate in the debt guarantee. In our VIE assessment, this disproportionate debt guarantee, plus other liquidity support provided jointly by us and PDVSA independently of equity ownership, results in MSLP not being exposed to all potential losses. We have determined we are not the primary beneficiary while our call exercise is in dispute because under the partnership agreement the co-venturers jointly direct the activities of MSLP that most significantly impact economic performance. At March 31, 2013, our maximum exposure represented the outstanding principal debt balance of $233 million. Our book value in MSLP at March 31, 2013, was $59 million.

We have a 50 percent ownership interest with a 50 percent governance interest in Excel Paralubes (Excel). Excel is a VIE because, in securing lender consents in connection with the Separation, ConocoPhillips provided a 50 percent debt guarantee to the lender of the 7.43% senior secured bonds issued by Excel. We provided a full indemnity to ConocoPhillips for this debt guarantee. Our co-venturer did not participate in the debt guarantee. In our assessment of the VIE, this debt guarantee, plus other liquidity support up to $60 million provided jointly by us and our co-venturer independently of equity ownership, results in Excel not being exposed to all potential losses. We have determined we are not the primary beneficiary because we and our co-venturer jointly direct the activities of Excel that most significantly impact economic performance. We continue to use equity method accounting for this investment. At March 31, 2013, our maximum exposure represented 50 percent of the outstanding principal debt balance of $164 million, or $82 million, plus half of the $60 million liquidity support, or $30 million. Our book value in Excel at March 31, 2013, was $110 million.

Note 4—Inventories

Inventories consisted of the following:

	Millions of Dollars	
	March 31 2013	December 31 2012
Crude oil and petroleum products	$5,517	3,138
Materials and supplies	294	292
	$5,811	3,430

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Inventories valued on the last-in, first-out (LIFO) basis totaled $5,387 million and $2,987 million at March 31, 2013, and December 31, 2012, respectively. The estimated excess of current replacement cost over LIFO cost of inventories amounted to approximately $8,100 million and $7,700 million at March 31, 2013, and December 31, 2012, respectively.

Note 5—Assets Held for Sale or Sold

In the first quarter of 2013, we entered into an agreement to sell our E-Gas™ Technology business. The business is included in our M&S segment and at March 31, 2013, had a net carrying value of approximately $13 million, including a goodwill allocation.

In March 2013, corporate property with a carrying amount of $50 million was classified as held for sale and included in the "Prepaid expenses and other current assets" line of our consolidated balance sheet.

Note 6—Investments, Loans and Long-Term Receivables

Equity Investments
Summarized 100 percent financial information for WRB Refining LP (WRB) and CPChem were as follows:

	Millions of Dollars Three Months Ended March 31	
	2013	2012
Revenues	$8,137	8,535
Income before income taxes	1,768	1,099
Net income	1,750	1,082

Loans and Long-Term Receivables
In 2012, we entered into a market-based shareholder financing agreement for up to $100 million with the Malaysian Refining Company Sdn. Bhd. (MRC). At December 31, 2012, MRC had drawn the total $100 million facility. In the first quarter of 2013, MRC remitted $55 million and at March 31, 2013, the balance on the facility was $45 million. On April 19, 2013, MRC repaid the outstanding loan balance. The advance was recorded as a short-term related party advance with interest income recorded in equity earnings to offset the corresponding interest expense by MRC.

Other
MSLP owns a delayed coker and related facilities at the Sweeny Refinery. MSLP processes long residue, which is produced from heavy sour crude oil, for a processing fee. Fuel-grade petroleum coke is produced as a by-product and becomes the property of MSLP. Prior to August 28, 2009, MSLP was owned 50/50 by ConocoPhillips and PDVSA. Under the agreements that govern the relationships between the partners, certain defaults by PDVSA with respect to supply of crude oil to the Sweeny Refinery triggered the right to acquire PDVSA’s 50 percent ownership interest in MSLP, which was exercised on August 28, 2009. PDVSA has initiated arbitration with the International Chamber of Commerce challenging the exercise of the call right and claiming it was invalid. The arbitral tribunal held hearings on the merits of the dispute in December 2012, and post-hearing briefs were exchanged in March 2013. We expect a final ruling in the third quarter of 2013. We continue to use the equity method of accounting for our investment in MSLP.

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Note 7—Properties, Plants and Equipment

Our investment in properties, plants and equipment (PP&E), with the associated accumulated depreciation and amortization (Accum. D&A), was:

	Millions of Dollars					
	March 31, 2013			December 31, 2012		
	Gross PP&E	Accum. D&A	Net PP&E	Gross PP&E	Accum. D&A	Net PP&E
Midstream	$2,533	1,045	1,488	2,460	1,016	1,444
Chemicals	—	—	—	—	—	—
Refining	18,216	6,219	11,997	17,989	5,913	12,076
Marketing and Specialties	2,274	922	1,352	2,500	1,078	1,422
Corporate and Other	762	342	420	880	415	465
	$23,785	8,528	15,257	23,829	8,422	15,407

Note 8—Goodwill

Effective January 1, 2013, we realigned our operating segments and determined that goodwill (which, prior to the realignment, had been assigned 100 percent to our former R&M segment) should now be assigned to three of the realigned operating segments—Midstream, Refining and M&S. We further determined that, for the Midstream segment, Transportation constituted a reporting unit. For Refining and M&S segments, we determined the goodwill reporting unit was at the operating segment level, due to the economic similarities of the components of those segments.

Goodwill was reassigned to the realigned reporting units using a relative fair value approach. Goodwill impairment testing was completed and no impairment recognition was required.

The carrying amount of goodwill reflecting the segment realignment was as follows:

	Millions of Dollars	
	March 31 2013	December 31 2012
Midstream	$518	518
Refining	1,934	1,934
Marketing and Specialties	892	892
	$3,344	3,344

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Note 9—Impairments

The three-month periods ended March 31, 2013 and 2012, included the following before-tax impairment charges:

	Millions of Dollars Three Months Ended March 31	
	2013	2012
Midstream	$—	1
Refining	—	42
Marketing and Specialties	15	—
Corporate and Other	9	—
	$24	43

During the first quarter of 2013, we recorded a $15 million held-for-use impairment in our M&S segment, primarily related to PP&E associated with our planned exit from the composite graphite business.

During the first quarter of 2012, we recorded a $42 million held-for-sale impairment in our Refining segment related to equipment formerly associated with the canceled Wilhelmshaven Refinery upgrade project.

Note 10—Earnings Per Share

The numerator of basic earnings per share (EPS) is net income attributable to Phillips 66, reduced by noncancelable dividends paid on unvested share-based employee awards during the vesting period (participating securities). The denominator of basic EPS is the sum of the daily weighted-average number of common shares outstanding during the periods presented and fully vested stock and unit awards that have not yet been issued as common stock. The numerator of diluted EPS is also based on net income attributable to Phillips 66, which is reduced only by dividend equivalents paid on participating securities for which the dividends are more dilutive than the participation of the awards in the earnings of the periods presented. To the extent unvested stock, unit or option awards and vested unexercised stock options are dilutive, they are included with the weighted-average common shares outstanding in the denominator. Treasury stock is excluded from the denominator in both basic and diluted EPS.

On April 30, 2012, 625.3 million shares of our common stock were distributed to ConocoPhillips stockholders in conjunction with the Separation. For comparative purposes, and to provide a more meaningful calculation of weighted-average shares outstanding, we have assumed this amount to be outstanding as of the beginning of each period prior to the Separation presented in the calculation of weighted-average shares. In addition, we have assumed the fully vested stock and unit awards outstanding at April 30, 2012, were also outstanding for each of the periods presented prior to the Separation, resulting in a weighted-average basic share count of 627.6 million shares; and we have assumed the dilutive securities outstanding at April 30, 2012, were also outstanding for each period prior to the Separation, resulting in a weighted-average dilutive share count of 634.6 million shares.

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	Three Months Ended March 31	
	2013	2012
Basic EPS Calculation		
Allocation of earnings:		
Net income attributable to Phillips 66 (millions)	$1,407	636
Income allocated to participating securities (millions)	(1)	—
Income available to common stockholders (millions)	$1,406	636
Weighted-average common shares outstanding—basic (thousands)	625,030	627,628
Earnings per share—basic	$2.25	1.01
Diluted EPS Calculation		
Allocation of earnings:		
Net income attributable to Phillips 66 (millions)	$1,407	636
Income allocated to participating securities (millions)	—	—
Income available to common stockholders (millions)	$1,407	636
Weighted-average common shares outstanding—basic (thousands)	625,030	627,628
Dilutive effect of stock-based compensation (thousands)	6,258	7,017
Weighted-average common shares outstanding—diluted (thousands)	631,288	634,645
Earnings per share—diluted	$2.23	1.00

Note 11—Debt

At both March 31, 2013, and December 31, 2012, we had no direct outstanding borrowings under our $4.0 billion revolving credit agreement or our $1.2 billion trade receivables securitization facility. However, as of both March 31, 2013, and December 31, 2012, $51 million in letters of credit had been issued that were supported by the revolving credit agreement, and $166 million in letters of credit had been issued that were collateralized by trade receivables held by a subsidiary under our trade receivables securitization facility. Accordingly, as of March 31, 2013, we had an aggregate $5.0 billion of total capacity available under these facilities.

Note 12—Guarantees

At March 31, 2013, 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 below, 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. In addition, unless otherwise stated, we are not currently performing with any significance under the guarantee and expect future performance to be either immaterial or have only a remote chance of occurrence.

Guarantees of Joint Venture Debt
In April 2012, in connection with the Separation, we issued a guarantee for 100 percent of the 8.85% senior notes issued by MSLP in July 1999. At March 31, 2013, the maximum potential amount of future payments to third parties

under the guarantee is estimated to be $233 million, which could become payable if MSLP fails to meet its obligations under the senior note agreement.

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At March 31, 2013, we had other guarantees outstanding for our portion of certain joint venture debt obligations, which have terms of up to 12 years. The maximum potential amount of future payments under the guarantees is approximately $108 million. Payment would be required if a joint venture defaults on its debt obligations.

Other Guarantees

We have residual value guarantees associated with leases with maximum future potential payments totaling approximately $275 million. We have other guarantees with maximum future potential payment amounts totaling $379 million, which consist primarily of guarantees to fund the short-term cash liquidity deficits of certain joint ventures, third parties related to prior asset dispositions, and guarantees of the lease payment obligations of a joint venture. These guarantees generally extend up to 11 years or life of the venture.

Indemnifications

Over the years, we have entered into various agreements to sell ownership interests in certain corporations, joint ventures and assets that gave rise to qualifying indemnifications. Agreements associated with these sales include indemnifications for taxes, litigation, environmental liabilities, permits and licenses, and employee claims, and real estate indemnity against tenant defaults. 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 indemnifications at March 31, 2013, was $328 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 recorded carrying amount were $129 million of environmental accruals for known contamination that are included in asset retirement obligations and accrued environmental costs at March 31, 2013. For additional information about environmental liabilities, see Note 13—Contingencies and Commitments.

Indemnification and Release Agreement

In conjunction with, and effective as of, the Separation, we entered into the Indemnification and Release Agreement with ConocoPhillips. This agreement governs the treatment between ConocoPhillips and us of aspects relating to indemnification, insurance, litigation responsibility and management, and litigation document sharing and cooperation arising in connection with the Separation. Generally, the agreement provides for cross-indemnities principally designed to place financial responsibility for the obligations and liabilities of our business with us and financial responsibility for the obligations and liabilities of ConocoPhillips' business with ConocoPhillips. The agreement also establishes procedures for handling claims subject to indemnification and related matters.

Note 13—Contingencies and Commitments

A number of lawsuits involving a variety of claims have been made against Phillips 66 that arose in the ordinary course of business. We also may be required 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 active and inactive sites. We regularly assess the need for accounting recognition or disclosure of these contingencies. In the case of all known contingencies (other than those related to income taxes), we accrue a liability when the loss is probable and the amount is reasonably estimable. If a range of amounts can be reasonably estimated and no amount within the range is a better estimate than any other amount, then the minimum of the range is accrued. We do not reduce these liabilities for potential insurance or third-party recoveries. If applicable, we record receivables for probable insurance or other third-party recoveries. In the case of income-tax-related contingencies, we use a cumulative probability-weighted loss

accrual in cases where sustaining a tax position is less than certain.

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 consolidated financial statements. As we learn new facts concerning contingencies, we reassess our position both with respect to accrued liabilities and other potential exposures. Estimates 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 the administrative and litigation processes.

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Environmental

We are subject to international, federal, state and local environmental laws and regulations. When we prepare our consolidated financial statements, we record accruals for environmental liabilities based on management's best estimates, using all information available at the time. We measure estimates and base liabilities on currently available facts, existing technology, and presently enacted laws and regulations, taking into account stakeholder and business considerations. When measuring environmental liabilities, we also consider our prior experience in remediation of contaminated sites, other companies' cleanup experience, and data released by the U.S. Environmental Protection Agency (EPA) or other organizations. We consider unasserted claims in our determination of environmental liabilities, and we accrue them in the period they are 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 cleanup costs related to any site at which we have been designated as a potentially responsible party. 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 proportional share, we consider this inability in estimating our potential liability, and we 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 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 those acquired in a purchase business combination, which we record on a discounted basis) for planned investigation and remediation activities for sites where it is probable future costs will be incurred and these costs can be reasonably estimated. At March 31, 2013, our consolidated balance sheet included a total environmental accrual of $515 million, compared with $530 million at December 31, 2012. We expect to incur a substantial amount of these expenditures within the next 30 years. We have not reduced these accruals for possible insurance recoveries. In the future, we may be involved in additional environmental assessments, cleanups and proceedings.

Legal Proceedings

Our legal organization applies its knowledge, experience and professional judgment to the specific characteristics of our cases, employing a litigation management process to manage and monitor the legal proceedings against us. Our process facilitates the early evaluation and quantification of potential exposures in individual cases. This process also enables us to track those cases that have been scheduled for trial and/or mediation. Based on professional judgment and experience in using these litigation management tools and available information about current developments in all our cases, our legal organization regularly assesses the adequacy of current accruals and determines if adjustment of existing accruals, or establishment of new accruals, are required.

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.

At March 31, 2013, we had performance obligations secured by letters of credit of $1,683 million (of which $166 million were issued under the trade receivables securitization facility, $51 million were issued under the provisions of

our revolving credit facility, and the remainder were issued as direct bank letters of credit) related to various purchase and other commitments incident to the ordinary conduct of business.

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Note 14—Derivatives and Financial Instruments

Derivative Instruments
We use financial and commodity-based derivative contracts to manage exposures to fluctuations in foreign currency exchange rates and commodity prices or to capture market opportunities. Since we are not currently using cash-flow hedge accounting, all gains and losses, realized or unrealized, from commodity derivative contracts have been recognized in the consolidated statement of income. Gains and losses from derivative contracts held for trading not directly related to our physical business, whether realized or unrealized, have been reported net in “Other income” on our consolidated statement of income. Cash flows from all our derivative activity for the periods presented appear in the operating section of the consolidated statement of cash flows.

Purchase and sales contracts with fixed minimum notional volumes for commodities that are readily convertible to cash (e.g., crude oil and gasoline) are recorded on the balance sheet as derivatives unless the contracts are eligible for, and we elect, the normal purchases and normal sales exception (i.e., contracts to purchase or sell quantities we expect to use or sell over a reasonable period in the normal course of business). We generally apply this normal purchases and normal sales exception to eligible crude oil, refined product, natural gas and power commodity purchase and sales contracts; however, we may elect not to apply this exception (e.g., when another derivative instrument will be used to mitigate the risk of the purchase or sales contract but hedge accounting will not be applied, in which case both the purchase or sales contract and the derivative contract mitigating the resulting risk will be recorded on the balance sheet at fair value).

Our derivative instruments are held at fair value on our consolidated balance sheet. For further information on the fair value of derivatives, see Note 15—Fair Value Measurements.

Commodity Derivative Contracts—We operate in the worldwide crude oil, refined products, natural gas liquids (NGL), natural gas and electric power markets and are exposed to fluctuations in the prices for these commodities. These fluctuations can affect our revenues, as well as the cost of operating, investing and financing activities. Generally, our policy is to remain exposed to the market prices of commodities; however, we use futures, forwards, swaps and options in various markets to balance physical systems, meet customer needs, manage price exposures on specific transactions, and do a limited, immaterial amount of trading not directly related to our physical business. We also use the market knowledge gained from these activities to capture market opportunities such as moving physical commodities to more profitable locations, storing commodities to capture seasonal or time premiums, and blending commodities to capture quality upgrades. Derivatives may be used to optimize these activities, which may move our risk profile away from market average prices.

The following table indicates the balance sheet line items that include the fair values of commodity derivative assets and liabilities presented net (i.e., commodity derivative assets and liabilities with the same counterparty are netted where the right of setoff exists); however, the balances in the following table are presented gross. For information on the impact of counterparty netting and collateral netting, see Note 15—Fair Value Measurements.

	Millions of Dollars	
	March 31 2013	December 31 2012
Assets		
Prepaid expenses and other current assets	$814	767
Other assets	9	3
Liabilities		
Other accruals	825	766
Other liabilities and deferred credits	12	3

Hedge accounting has not been used for any items in the table.

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The gains (losses) from commodity derivatives incurred, and the line items where they appear on our consolidated statement of income, were:

	Millions of Dollars Three Months Ended March 31	
	2013	2012
Sales and other operating revenues	$(6)	(166)
Equity in earnings of affiliates	2	—
Other income	3	7
Purchased crude oil and products	89	21

Hedge accounting has not been used for any item in the table.

The table below summarizes our material net exposures resulting from outstanding commodity derivative contracts. These financial and physical derivative contracts are primarily used to manage price exposure on our underlying operations. The underlying exposures may be from non-derivative positions such as inventory volumes. Financial derivative contracts may also offset physical derivative contracts, such as forward sales contracts. As of March 31, 2013, and December 31, 2012, the percentage of our derivative contract volume expiring within the next 12 months was 99 percent for both periods.

	Open Position Long/(Short)	
	March 31 2013	December 31 2012
Commodity		
Crude oil, refined products and NGL (millions of barrels)	(21)	(8)

Credit Risk

Financial instruments potentially exposed to concentrations of credit risk consist primarily of over-the-counter (OTC) derivative contracts and trade receivables.

The credit risk from our OTC derivative contracts, such as forwards and swaps, derives from the counterparty to the transaction. Individual counterparty exposure is managed within predetermined credit limits and includes the use of cash-call margins when appropriate, thereby reducing the risk of significant nonperformance. We also use futures, swaps and option contracts that have a negligible credit risk because these trades are cleared with an exchange clearinghouse and subject to mandatory margin requirements until settled; however, we are exposed to the credit risk of those exchange brokers for receivables arising from daily margin cash calls, as well as for cash deposited to meet initial margin requirements.

Our trade receivables result primarily from the sale of products from, or related to, our refinery operations and reflect a broad national and international customer base, which limits our exposure to concentrations of credit risk. The majority of these receivables have payment terms of 30 days or less. We continually monitor this exposure and the creditworthiness of the counterparties and recognize bad debt expense based on historical write-off experience or specific counterparty collectability. Generally, we do not require collateral to limit the exposure to loss; however, we will sometimes use letters of credit, prepayments, and master netting arrangements to mitigate credit risk with counterparties that both buy from and sell to us, as these agreements permit the amounts owed by us or owed to others

to be offset against amounts due us.

Certain of our derivative instruments contain provisions that require us to post collateral if the derivative exposure exceeds a threshold amount. We have contracts with fixed threshold amounts and other contracts with variable threshold amounts that are contingent on our credit rating. The variable threshold amounts typically decline for lower credit ratings, while both the variable and fixed threshold amounts typically revert to zero if our credit ratings fall below investment grade. Cash is the primary collateral in all contracts; however, many contracts also permit us to post letters of credit as collateral.

The aggregate fair values of all derivative instruments with such credit-risk-related contingent features that were in a liability position were not material at March 31, 2013, or December 31, 2012.

Note 15—Fair Value Measurements

Fair Values of Financial Instruments
We used the following methods and assumptions to estimate the fair value of financial instruments:

- Cash and cash equivalents: The carrying amount reported on the balance sheet approximates fair value.
- Accounts and notes receivable: The carrying amount reported on the balance sheet approximates fair value.
- Debt: The carrying amount of our floating-rate debt approximates fair value. The fair value of our fixed-rate debt is estimated based on quoted market prices as a Level 2 fair value.
- Commodity swaps: Fair value is estimated based on forward market prices and approximates the exit price at period end. When forward market prices are not available, fair value is estimated using the forward prices of a similar commodity with adjustments for differences in quality or location.
- Futures: Fair values are based on quoted market prices obtained from the New York Mercantile Exchange, the InterContinental Exchange Futures, or other traded exchanges.
- Forward-exchange contracts: Fair values are estimated by comparing the contract rate to the forward rate in effect at the end of the respective reporting periods and approximating the exit price at those dates.

We carry certain assets and liabilities at fair value, which we measure at the reporting date using an exit price (i.e., the price that would be received to sell an asset or paid to transfer a liability), and disclose the quality of these fair values based on the valuation inputs used in these measurements under the following hierarchy:

- Level 1: Fair value measured with unadjusted quoted prices from an active market for identical assets or liabilities.

- Level 2: Fair value measured with: 1) adjusted quoted prices from an active market for similar assets; or 2) other valuation inputs that are directly or indirectly observable.

- Level 3: Fair value measured with unobservable inputs that are significant to the measurement.

We classify the fair value of an asset or liability based on the lowest level of input significant to its measurement; however, the fair value of an asset or liability initially reported as Level 3 will be subsequently reported as Level 2 if the unobservable inputs become inconsequential to its measurement or corroborating market data becomes available. Conversely, an asset or liability initially reported as Level 2 will be subsequently reported as Level 3 if corroborating market data becomes unavailable. We made no material transfers in or out of Level 1 during the three-month period ending March 31, 2013.

Recurring Fair Value Measurements
Financial assets and liabilities recorded at fair value on a recurring basis consist primarily of investments to support nonqualified deferred compensation plans and derivative instruments. The deferred compensation investments are measured at fair value using unadjusted prices available from national securities exchanges; therefore, these assets are categorized as Level 1 in the fair value hierarchy. We value our exchange-traded commodity derivatives using closing prices provided by the exchange as of the balance sheet date, and these are classified as Level 1 in the fair value hierarchy. Where exchange-provided prices are adjusted, non-exchange quotes are used, or when the instrument lacks sufficient liquidity, we generally classify those exchange-cleared contracts as Level 2. OTC financial swaps and physical commodity forward purchase and sales contracts are generally valued using quotations provided by brokers and price index developers such as Platts and Oil Price Information Service. These quotes are corroborated with market data and are classified as Level 2. In certain less liquid markets or for longer-term contracts, forward prices are not as readily available. In these circumstances, OTC swaps and physical commodity purchase and sales contracts are valued using internally developed methodologies that consider historical relationships among various commodities that result in management's best estimate of fair value. These contracts are classified as Level 3. Financial OTC and

physical commodity options are valued using industry-standard models that consider various assumptions, including quoted forward prices for commodities, time value, volatility factors, and contractual prices for the underlying instruments, as well as other relevant economic measures. The degree to which these inputs are observable in the forward markets determines whether the options are classified as Level 2 or 3. We use a mid-market pricing convention (the mid-point between bid and ask prices). When appropriate, valuations are adjusted to reflect credit considerations, generally based on available market evidence.

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The following tables display the fair value hierarchy for our material financial assets and liabilities either accounted for or disclosed at fair value on a recurring basis. These values are determined by treating each contract as the fundamental unit of account; therefore, derivative assets and liabilities with the same counterparty are shown gross (i.e., without the effect of netting where the legal right of setoff exists) in the hierarchy sections of these tables. These tables also show that our Level 3 activity is not material.

We have master netting arrangements for all of our exchange-cleared derivative instruments, the majority of our OTC derivative instruments, and certain physical commodity forward contracts (primarily pipeline crude oil deliveries). The following tables show these contracts on a net basis in the column "Effect of Counterparty Netting." We have no contracts that are subject to master netting arrangements that are reflected gross on the balance sheet.

The carrying values and fair values by hierarchy of our material financial instruments, either carried or disclosed at fair value, and derivative assets and liabilities, including any effects of master netting agreements or collateral, were:

	Millions of Dollars March 31, 2013 Fair Value Hierarchy								
	Level 1	Level 2	Level 3	Total Fair Value of Gross Assets & Liabilities	Effect of Counterparty Netting	Effect of Collateral Netting	Difference in Carrying Value and Fair Value	Net Carrying Value Presented on the Balance Sheet	Cash Collateral Received or Paid, Not Offset on Balance Sheet
Commodity Derivative Assets									
Exchange-cleared instruments	$513	217	—	730	(723)	(3)	—	4	(3)
OTC instruments	—	22	—	22	(14)	—	—	8	—
Physical forward contracts*	—	69	2	71	—	—	—	71	—
Rabbi trust assets	58	—	—	58	N/A	N/A	—	58	N/A
	$571	308	2	881	(737)	(3)	—	141	
Commodity Derivative Liabilities									
Exchange-cleared instruments	$530	255	—	785	(723)	(62)	—	—	—
OTC instruments	—	25	—	25	(14)	—	—	11	—
Physical forward contracts*	—	25	2	27	—	—	—	27	—
Floating-rate debt	1,050	—	—	1,050	N/A	N/A	—	1,050	N/A
Fixed-rate debt, excluding capital leases**	—	6,611	—	6,611	N/A	N/A	(696)	5,915	N/A
	$1,580	6,916	2	8,498	(737)	(62)	(696)	7,003	

*Physical forward contracts may have a larger value on the balance sheet than disclosed in the fair value hierarchy when the remaining contract term at the reporting date is greater than 12 months and the short-term portion is an asset

while the long-term portion is a liability, or vice versa.
**We carry fixed-rate debt on the balance sheet at amortized cost.

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	Millions of Dollars December 31, 2012 Fair Value Hierarchy								
	Level 1	Level 2	Level 3	Total Fair Value of Gross Assets & Liabilities	Effect of Counterparty Netting	Effect of Collateral Netting	Difference in Carrying Value and Fair Value	Net Carrying Value Presented on the Balance Sheet	Cash Collateral Received or Paid, Not Offset on Balance Sheet
Commodity Derivative Assets									
Exchange-cleared instruments	$380	309	—	689	(672)	(8)	—	9	—
OTC instruments	—	15	—	15	(7)	—	—	8	—
Physical forward contracts*	—	61	2	63	4	—	—	67	—
Rabbi trust assets	50	—	—	50	N/A	N/A	—	50	N/A
	$430	385	2	817	(675)	(8)	—	134	
Commodity Derivative Liabilities									
Exchange-cleared instruments	$392	329	—	721	(672)	(42)	—	7	(7)
OTC instruments	—	13	—	13	(7)	—	—	6	—
Physical forward contracts*	—	31	1	32	4	—	—	36	—
Floating-rate debt	1,050	—	—	1,050	N/A	N/A	—	1,050	N/A
Fixed-rate debt, excluding capital leases**	—	6,508	—	6,508	N/A	N/A	(590)	5,918	N/A
	$1,442	6,881	1						