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COP - Q4 2014 ConocoPhillips Earnings Call

EVENT DATE/TIME: JANUARY 29, 2015 / 5:00PM GMT

OVERVIEW:

Co. reported 4Q14 adjusted earnings of $742m or $0.60 a share.

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PRESENTATION

Operator

Welcome to the fourth quarter 2014 ConocoPhillips earnings conference call. My name is Christine, and I will be your operator for today's call. At this time, all participants are in a listen-only mode. Later, we will conduct a question and answer session. Please note that this conference is being recorded. I will now turn the call over to Ellen DeSanctis, Vice President Investor Relations and Communications. You may begin.

Ellen DeSanctis - *ConocoPhillips - VP of IR and Communications*

Thanks, Christine, and greetings to everybody. Joining me in the room today are Ryan Lance, our Chairman and CEO; Jeff Sheets, our EVP of Finance and Chief Financial Officer; and Matt Fox, our EVP of E&P.

Really three quick very administrative points before we launch into our remarks here. We will make some forward-looking statements this morning. The risks and uncertainties in our future performance are covered on page 2 of today's deck and in our periodic filings with the SEC. This information can also be found on our website.

Next, if you haven't done so, save the date for our 2015 Analyst Meeting on April 8 in New York City. We will be providing some additional logistical details on that event soon.

And then, finally, during Q&A this morning, we're going to limit questions to one with a follow-up so we can accommodate the call queue. We appreciate your support there. So, now let me turn the call over to Ryan.

Ryan Lance - *ConocoPhillips - Chairman and CEO*

Thank you, Ellen, and thanks to all our call participants this morning. So, I'll start by making a few quick comments about 2014, then I'll jump into our view of 2015 and the actions we're taking to manage through this current period of very low prices. Of course we're also spending a lot of time thinking about the future beyond 2015. It's a bit early to talk about that today but, as Ellen mentioned, we'll speak to that at our April Analyst Meeting where we'll be ready to address our longer-term view of the sector and how we're positioned to succeed.

So, if you turn to slide 4, this is our company level said/did chart that we show during every quarterly call. Certainly 2014 seems like old news, but I think it's important to spend a minute recapping our results for the year. Operationally, we hit our volume targets and achieved 4% year on year growth, and I think that's a pretty big accomplishment for a company our size. The growth came from the startup of five major projects, ongoing ramp-up in the Eagle Ford and the Bakken, and a successful turnaround season across our operations. We also discovered two new oil plays in offshore Senegal.

Financially, we generated $6.6 billion of adjusted earnings or $5.30 per share for the year. This includes fourth-quarter adjusted earnings of $742 million, or $0.60 a share, obviously reflecting weak fourth-quarter prices. We ended the year with $5.1 billion of cash on the balance sheet and also exceeded our price-normalized cash margin growth target with more than an 8% improvement.

On the strategic front, we achieved a strong organic reserve replacement ratio of 124%. And, by the way, the three-year average organic reserve replacement ratio is 153%. We completed the final piece of our announced asset disposition program with the closing of the Nigeria sale, and we increased our dividend by 5.8%. That's a quick summary. The key take-away here is that we did what we said we would do, not just in 2014 but also the past three years since the launch as an independent E&P company. We executed our stated plan almost to the letter. And in the last quarter, oil and gas prices began their accelerated decline, so let me discuss what that price decline means for our company in 2015, if you'll turn to slide 5.

There's a lot of debate right now about the duration of the current low oil prices, but we're assuming that they'll stay low for 2015 and we're taking decisive actions accordingly. Our actions are driven by our priorities, which are unchanged since the time of the spin. The dividend remains our top priority for capital allocation. The next highest priority remains getting to cash flow neutrality in 2017. With these priorities in mind, we're going to use our capital and our balance sheet flexibility to manage through this downturn.

So, first, capex. This morning we announced a further reduction in 2015 capital to $11.5 billion. That's $2 billion lower than the $13.5 billion that we announced in early December. This means we cut capital by a third relative to 2014 spending. In making these cuts, we're exercising flexibility we've built over the past few years, coring up the portfolio, adding scalable, unconventional inventory with a low cost of supply, and executing the vast majority of our major project spending, and that's why we can adjust our capital program while preserving future investment opportunities. And in 2016, you'll see more capital flexibility as additional major project spending continues to roll off. At our revised capital level, we still expect to deliver 2% to 3% growth in 2015 versus 2014.

Now, in addition to conserving capital through scope reductions, we're aggressively identifying and capturing cost savings through our supply chain efforts. At this time, our revised $11.5 billion budget anticipates capturing about $500 million of deflation in 2015. Most of this will come from our Lower 48 unconventional business. Now, my management and myself, we review two dozen categories of costs globally every month, and we're actively pursuing additional cost reductions for this year and beyond. As one of the largest purchasers of industry goods and services globally, we expect to benefit significantly in future years before any sustained deflationary cycle. We're also looking beyond supply chain to reduce costs through self-help efforts. As an example in Europe, we recently announced operating costs and G&A reductions and we'll see additional cost reductions that are being implemented across the rest of the company.

In addition to managing opex and capex, one of the flexibility levers we're prepared to use in 2015 is our balance sheet. We're coming into this cycle in a strong position and that will serve us well. We have cash on hand and a significant capacity that we can use, and Jeff will provide more detail on those plans. So, we're taking the 2015 challenge head on. We're conserving capex. We're aggressively pursuing supply chain and self-help cost reductions. We'll utilize our financial capacity as needed. We've adjusted rapidly to avoid jeopardizing our dividend or our ability to achieve cash flow neutrality by 2017. These decisive actions, combined with our flexibility, should put us in a good stead to manage through this downturn. So, now let me turn the call over to Jeff and Matt, and then I'll come back for a few closing comments.

Jeff Sheets - *ConocoPhillips - EVP of Finance and CFO*

Thanks, Ryan. As Ryan mentioned, our full-year 2014 adjusted earnings were $6.6 billion. Our full-year earnings slide is in the appendix, but I'll quickly cover fourth-quarter earnings. Fourth-quarter 2014 adjusted earnings were $742 million, or $0.60 a share. Our operational performance was overshadowed by a roughly 20% drop in realized prices compared to prior periods, and a previously announced dry hole in Angola. A segment breakdown of earnings is shown in the lower right with more detail provided in supplemental data on our website.

There's one special item to note. In the fourth quarter, an agreement to terminate our long-term obligations at the Freeport LNG terminal took effect. The ins and outs for the income statement and cash flow are shown in the appendix, but as a result of the transaction, the company anticipates saving about $50 million annually over the next 18 years, so this was a good long-term economic decision.

On slide 8, I'll cover our 2014 production from continuing operations. We achieved two important milestones in 2014, namely hitting our growth targets for production and margin growth. Our production growth for the year, excluding Libya, was 4% from 1472 to 1532 million BOE per day. The impact from downtime and dispositions was small, and compared to last year our net growth was over 60,000 BOE per day, primarily from liquids, and areas with favorable fiscals.

We also achieved our cash margin growth target and that's shown on slide 9. For 2014, we achieved an 8% cash margin improvement when normalized on 2013 prices. Despite lower prices, we're not going to lose our focus on cash margins and, in fact, it's as important as ever.

Next, I'll review our 2014 cash flow waterfall on slide 10. We started the year with $6.5 billion in cash and short-term investments and generated about $16 billion of cash from operating activities. We've captured about $1.2 billion of net proceeds from dispositions, mostly from Nigeria. Our 2014 capital expenditures were about $17 billion. After accounting for dividends and debt, we ended the year with $5.1 billion in cash.

Next, I'll address the balance sheet flexibility we're prepared to exercise in 2015 as needed. So, if you'll turn to slide 11. We've consistently spoken in the last several years about our plans to grow at a moderate rate while paying a strong dividend to our shareholders. The growth in our cash flow was moving us to a position where cash from operations would fund our capital and the dividend in 2017 with the shortfalls and cash flows funded largely by asset sale proceeds. With much lower commodity prices, we, like the rest of the industry, need to manage an environment with reduced cash flow. As Ryan mentioned, even with this dramatic downturn, we remain committed to our strong dividend and reaching cash flow neutrality in 2017, and that's true across a wide range of commodity prices.

As Ryan also noted, the first action we've taken is to exercise flexibility in our capital program, which becomes more flexible over the next couple of years. So, to achieve our priorities, we will also be using our strong balance sheet capacity, both cash balances and increased borrowings, to provide funding this year and next. So, let me tell you how we're thinking about this. We ended 2015 with $5.1 billion of cash on our balance sheet and we need about $1 billion of that cash to operate the company. We don't have any issues with trapped cash that prevent us from accessing our cash balances. We have ready access to the credit markets and our debt continues to trade at levels between those of A and AA rated companies. The chart on the right shows indicative borrowing rates for any new issuances in today's markets.

For short-term funding, we have a $6 billion revolving credit facility capacity that we -- that can serve as a back stop for the issuance of very low cost commercial paper. We don't have any debt maturities in 2015. As we assess commodity price environments both in 2015 and for the next few years, we think it's unlikely that we'll need to increase our debt to a level that would cause our credit ratings to slip out of the single-A credit rating range, although it could move lower within the A range if we stay at current commodity price environments for a prolonged period. Our current debt-to-capital ratio is about 30%. We're willing to let that rise, if necessary, as we move the company to a balance of cash flows, capital expenditures and dividends in 2017.

So to summarize, we intend to maintain our strong dividend and continue exercising our increasing capital flexibility to move the company to cash flow neutrality in 2017. Our level of capital spending, rate of growth, and the level of debt that we maintain will be the variables that will be influenced by commodity prices. Now, I'll turn the call over to Matt for his operational comments.

Matt Fox - *ConocoPhillips - EVP of E&P*

Thanks, Jeff. I want to begin my comments with a brief recap of 2014, beginning with the review of our reserves performance. These are preliminary numbers, but we don't expect any material changes when the final reserves are published in our 10-K. We started the year with 8.9 billion BOE of reserves. We produced 598 million and added 742 million organically. These additions came primarily from our Lower 48, APME and Canada assets. This resulted in an organic reserves replacement ratio of 124%.

We also sold 159 million BOE, mostly from Nigeria, and ended the year then with 8.9 billion barrels of reserves. That represents a total reserve replacement ratio of 97%. Over the past three years, our total reserves replacement has averaged 129%, and that's after selling assets which generated about $14 billion of proceeds. So, let me put this all in perspective.

We launched as an E&P three years ago with 8.4 billion barrels of reserves on the books. Over that time, we've produced more than 1.5 billion barrels and sold over 400 million barrels, and yet we'll exit 2014 with 8.9 billion barrels of high-quality reserves on the books. That's pretty impressive for a company of our size.

Now, I want to recap the 2014 operational highlights that contributed to our reserve performance and our 4% production growth. As Ryan and Jeff mentioned, we achieved our production growth target both for the fourth quarter and for the year. Our base assets continue to perform well . We had strong safety performance and successfully completed several major turnarounds across the portfolio. We achieved another strong year in the unconventionals with 35% annual growth in the Eagle Ford and Bakken. We also conducted multiple pilot tests and progressed exploration and appraisal activity across our whole unconventional portfolio. And, as a result of this work, we're confident that we have an extensive profitable inventory in these plays for many years to come.

We achieved startups at five major projects across the business, Britannia Long-Term Compression in the UK, Foster Creek Phase F in the Oil Sands, and Gumusut, Kebabangan and SNP in Malaysia, and we made significant progress on our largest major projects at APLNG and Surmont 2 in preparation for startup this year. We saw progress in our deepwater program, in particular with two discoveries in a new working petroleum system offshore Senegal, and we continued appraisal of our three major discoveries in the Gulf of Mexico.

Yesterday, it was announced that we signed an agreement with Chevron and BP to jointly explore and appraise a 24-block area in Keathley Canyon that includes the Tiber and Gila discoveries. This agreement allows our companies to combine our technical strengths and financial resources to achieve efficiency through scale, reduce subsurface risk, and improve the likelihood of commerciality, so this is a great deal for all three parties.

Next, I'll review the capital reductions we just announced and the implications for our 2015 activities. We'll start from the $13.5 billion capital guidance we issued in December. We're not reducing our base maintenance capital because we don't want to jeopardize the strength of our base production or the integrity of our assets. Our development program spending will be lower by about $1.4 billion. Most of this is coming out of Lower 48 unconventionals where we have a lot of flexibility and where there's a sound economic rationale for slowing the pace of development. In 2015, we'll reduce rigs in the Lower 48 by over 60% versus 2014.

We plan to run six rigs in the Eagle Ford, three in the Bakken, and two each in the Permian conventional and unconventional. At these levels, we maintain our land possession, meet our longer-term rig commitments, and can continue to progress key pilot tests. We retain the flexibility to increase activity in these plays if we choose to. We're also reducing capital for our major projects by deferring final investment decisions in several conventional assets.

Just as a reminder, our initial budget of $13.5 billion already reflected a significant reduction in this category compared to 2014 as projects were completed and as we near startup at APLNG and Surmont. We also exercised $300 million of flexibility in our exploration and appraisal spend, primarily in the emerging Lower 48 unconventionals. As Ryan mentioned, our $11.5 billion capital guidance assumes about $500 million of cost deflation. This is what we have a clear line of sight to capture in 2015, but it's early in the year and you can be assured that we have a significant focus on this effort across the whole value chain. In 2016 and 2017, the flexibility of our capital portfolio continues to improve as more major projects are completed, and we believe this flexibility combined with a strong base portfolio positions us well for a potentially volatile few years ahead.

Next, I'll quickly cover our operational priorities for 2015. We expect to grow production by 2% to 3% from 2014 to 2015, and this includes an expected first-quarter production rate of between 1.57 and 1.61 million barrels per day. Walking through the segments, in Alaska we're focused on progressing our development drilling programs and major projects of CD-5 and Drill Site 2S. Both projects are expected to start up in the fourth quarter of this year. We intend to sanction the first phase of the North East West Sak development, the 1H NEWS project, and we'll continue to progress a new rotary rig and new coil tubing drilling rig to optimize our long-term development drilling inventory in Alaska, but we have decided to defer the final investment decision on the GMT1 project.

In the onshore Lower 48 unconventional activity will slow across the portfolio relative to 2014. We'll continue to evaluate pilot tests, including the Upper Eagle Ford with our triple-stack development concept. In the deepwater Gulf of Mexico, we'll continue to appraise existing discoveries. We have wells drilling at Gila and Tiber right now and anticipate additional appraisal well drilling in Shenandoah later this year.

In Canada, we're reducing our conventional and unconventional development drilling activity. Oil sands production from Foster Creek F will continue to ramp up, Surmont 2 is on track for first steam in mid-2015, and we'll commence exploration drilling offshore Nova Scotia later this year. In Europe, Ekofisk South and Eldfisk II continue to ramp up, and we'll continue progress on the Enochdhu and Alder projects.

In the Asia Pacific and Middle East segment, APLNG is on track for startup in the middle of the year. We're ramping up Gumusut in Malaysia and we're awaiting third-party pipeline repairs to allow production to ramp up at KBB, which we expect to start in the middle of the year. We'll also complete appraisal at the Barossa Field offshore Australia. In our Other International segment, we'll continue to monitor circumstances in Libya, evaluate results of our recent testing in Poland, begin appraisal work offshore Senegal, and continue to execute our exploratory drilling programs in Angola and Colombia.

So, we've got another busy year ahead of us, and in any price environment we're committed to safely executing our programs and delivering flexible growth while retaining high value future options and inventory. Now, I'll turn the call back to Ryan for his closing remarks.

Ryan Lance - *ConocoPhillips - Chairman and CEO*

Thank you, Matt. So, let me recap what you've heard today. I think we delivered again in 2014, but certainly that was then. Now it's all about 2015, and it's all about flexibility and resilience, which we believe we have both. Our priorities are clear. Dividend and cash flow neutrality, and we're taking immediate actions to defend them. We're cutting capex, capturing cost improvements, and exercising our balance sheet, if needed. And we're also thinking about the timeframe beyond 2015.

We're asking ourselves what's changed in our industry, if anything, for the longer term. We're testing our portfolio under different scenarios, and again we'll see that we have a resilient portfolio with flexibility to adapt if circumstances warrant. Now, some things might change, but here's what's not going to change. We're going to allocate capital prudently, we'll continue to migrate our portfolio to a lower cost of supply, we'll maintain capital and financial flexibility, and we'll pay our shareholders first. That's our formula for creating long-term shareholder value. And I'll look forward to seeing you and describing that in more detail in April in New York. So, with that, now let me turn the call back over to the operator and we'll take some Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question is from Doug Leggate of Bank of America Merrill Lynch.

Please go ahead.

Doug Leggate - *BofA Merrill Lynch - Analyst*

Good morning, everybody. Thanks for taking my questions.

Folks, I wonder if I could dig into the cash flow neutrality question a little bit because obviously the dividend is still a big commitment for you guys. When you separated Phillips, I think Jim at the time had talked about a maintenance capital level of around $10 billion to hold production flat.

I guess what I'm trying to understand is to Matt's comments, obviously, that was $100 oil. One assumes that costs are going to drop at some point, but also had a slightly different portfolio. And you've had a bunch of new projects come online that are longer life or will come online rather. So what is that number today, as it stands today, and maybe assuming some cost reductions over time?

And I've got a follow up, please.

Matt Fox - *ConocoPhillips - EVP of E&P*

I think, Doug, a number of $9 billion to $10 billion, to keep production flat is a good go-by for now. It clearly is going to be a function of how much deflation we see, sustained deflation across the industry. But a number of that sort of magnitude is a good go-by for the time being.

Doug Leggate - *BofA Merrill Lynch - Analyst*

When you talk about cash flow neutrality, I don't know if this is either Jeff or Matt, but what commodity deck are you assuming when you think about that for 2017?

Jeff Sheets - *ConocoPhillips - EVP of Finance and CFO*

That's like the comment that Matt made about capital; that also depends on what kind of cost deflation we see in both capital costs and operating costs. We don't expect that prices are going to maintain at current levels for that period of time. So we would be at cash flow neutrality at some improvement over current price levels, but not at a level as high as what we've experienced recently.

Ryan Lance - *ConocoPhillips - Chairman and CEO*

Doug, what I would say is that we see a modestly rising price deck over the course of the next few years, but certainly not back to a level that we've seen the last two or three years.

Doug Leggate - *BofA Merrill Lynch - Analyst*

Got it.

My follow-up, if I may, Ryan, is probably one for you. It's really more of a high-level strategy question because we could debate over the years what the market looks for out of Conoco. Your unique offering obviously is the dividend, but top line growth for a company of your size is always going to be relatively modest at best.

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So when you think about the trade-off between portfolio high grading, bringing new projects on and perhaps monetizing or exiting other areas, with the potential to buy back shares when you do get a windfall of oil prices as we may have just had the last several years, how do you see the strategic rationale of continuing to pursue top line growth in a volatile oil price environment, as opposed to continuous high grading with a very strong yield and the option to buy back stock? I'm just kind of curious as to how this whole oil price environment changes your thinking.

Ryan Lance - *ConocoPhillips - Chairman and CEO*

Yes, I think as I look out, we probably should expect with some of the modest growth that we're seeing in demand and really the resiliency that we see in the unconventionals having an impact on supply, we're going to be in a more volatile world as we go ahead. So as I think about that strategically for the company, we're trying to build a company that has a solid base of legacy assets, low production decline, the things that you can underpin the dividend with over time.

So as we bring on the oil sands, our legacy assets in Alaska, what we're doing in Europe and the North Sea, what we're building in Asia Pacific, and then on top of that we're moving to a lower cost of supply in the portfolio through the addition of the unconventional portfolio that we're developing here in North America. And that provides us a lot of resilience and flexibility to the capital.

So we'll see what the commodity price gives us. We'll protect the dividend first. And then, with what's left over in the cash flow, we'll fund a capital program that will set the growth that we see coming out of that because we know the growth is directly related to that capital program.

When it comes to share buyback, we'll just assess what we have in terms of capital opportunities in the portfolio. If they are good, strong returns, which we think they're going to be with the unconventional inventory that we have, we'll judge that against the opportunity for share buyback down the road.

Operator

Thank you.

Our next question is from Doug Terreson of Evercore ISI.

Please go ahead.

Doug Terreson - *Evercore ISI - Analyst*

Good morning, everybody.

Ryan Lance - *ConocoPhillips - Chairman and CEO*

Good morning, Doug.

Doug Terreson - *Evercore ISI - Analyst*

Ryan, one of your competitors indicated today that service costs have not declined as much as might be expected, given the decline in oil and gas prices. And while there's always going to be lag effects and different contract durations and other things, I wanted to see if you would elaborate further on what ConocoPhillips is seeing in the market and whether service cost lag effects were an important factor in today's reduction in spending or whether it was really lower prices.

And then also some of the specific initiatives that you are undertaking that led to the $500 million benefit that you talked about a few minutes ago.

Ryan Lance - *ConocoPhillips - Chairman and CEO*

Sure, Doug, I can chime in. And Matt's even closer to it than I am, so I can let him add some color to it if he would like.

But as we've said, we are seeing reductions. As rigs start rolling off, onshore rig rates will be coming down. We're seeing pumping services in some of the commodities and we're tracking each one of those. We have 20 different categories that we track on the supply chain side, and we're looking at them pretty closely. Now, a lot of those are coming to the capital side; some go to the opex side.

What we said is we've got a pretty clear line of sight to the $500 million of reductions that we factored in. But those are going to continue as this commodity price environment continues into 2015 and depending on the recovery that we see coming into 2016. We're all over it. We're looking to try to capture as much of that as we can.

The interesting sort of piece that you get all the reductions and the flexibility that we're exercising is in North America. And that's where we expect to see a lot of the first reductions from capturing the deflation.

I don't know, Matt?

I think that's where we're all over it, Doug. We're going to get as much as we can out of it and as quickly as we can.

Doug Terreson - *Evercore ISI - Analyst*

Okay. Thanks a lot.

Operator

Thank you.

Our next question is from Scott Hanold of RBC Capital Markets.

Please go ahead.

Scott Hanold - *RBC Capital Markets - Analyst*

Thanks.

I would like to dig into the capex and flexibility just a little bit more. And you did cite your maintenance capexis around $9 billion to $10 billion. But when you step back and look at kind of major project spend, as I think you've cited, you're seeing a reduction in 2016-2017.

Can you give us a sense of what the size of that might be and how much do you think you need to spend annually on those longer-dated projects, whether you have them today or need to build them for kind of long-term growth opportunities?

Matt Fox - *ConocoPhillips - EVP of E&P*

Well, as we move from 2015 into 2016, we'll see about $2 billion coming out of our major capital projects, capex requirements, just from Surmont and APLNG. So that's why we're referring to a significant increase in flexibility from 2015 to 2016, and that trend continues. There are several hundred million -- it's not billions of dollars as we go from 2016 to 2017.

That trend of reducing capital going to major projects and increasing capital going to the flexible low cost of supply development programs, that's an underlying part of the strategy that we've been executing for the past three years. And we're in the middle of that adjustment to our overall investment and portfolio right now and for the next couple of years.

Scott Hanold - *RBC Capital Markets - Analyst*

Okay. So if I can kind of clarify, if I look at that $11.5 billion 2015 budget call it, you'd take out $2.5 billion for some of these major projects. And that gets you to somewhat that maintenance capital level?

Matt Fox - *ConocoPhillips - EVP of E&P*

That's a good way of thinking about that. That's close enough.

Scott Hanold - *RBC Capital Markets - Analyst*

Okay. I appreciate that.

And one follow-up question then. On your rig count reductions, obviously they're pretty meaningful in the US onshore. When you look at plays like the Bakken, Eagle Ford and Permian, can you give a sense, when you're drilling your projects today, and you sit there and look at three, four and six rig counts, do you assume these will be economic at current spot prices, strip prices or a better price?

And just to give you some context, I know there's a lot of debate whether or not the Bakken is economic today. So why should there be any rigs drilling there today?

Matt Fox - *ConocoPhillips - EVP of E&P*

We are in the sweet spot of the Bakken. With the rig rates and the rates that we are getting, it's economic at current conditions, but we're actually taking it all the way down to three rigs this year. We do have some commitments within some of the units in the Bakken where we have to run some rigs in the Bakken.

The Eagle Ford is still very economic, even at current prices. But having said that, it makes more economic sense to defer. So what we're dealing with in the Eagle Ford is a balance of -- we have some commitments. We need to run probably three rigs to meet commitments on our leasehold. And we're also keen to continue to learn on the Eagle Ford because we have a huge inventory there that we could develop over the next couple of decades. And we want to make sure that we're capturing all the learnings.

So we're choosing to continue with some of our pilot tests as we go through 2015. And our expectation is as some of the capital flexibility appears more into next year, then we're likely to increase our rig counts and take advantage of what may be higher prices but certainly will be deflated costs.

Operator

Thank you.

Our next question is from John Herrlin of Societe Generale.

Please go ahead.

John Herrlin - *Societe Generale - Analyst*

Yes, hello. Addressing the services costs another way, are you getting discounts from book rates? Or are you going to be able to get longer-term rates at discount? Or is it too early regarding fracking rigs, etc?

Matt Fox - *ConocoPhillips - EVP of E&P*

There's a mixture of both going on, John. This isn't a great time to enter into long-term commitments. We'll wait until we see how the deflation works its way through the system.

But we are working with the suppliers. We've got a great relationship with the suppliers. And we're looking at it across the spectrum of things that influence our capital and operating costs, and making judgments every day on what the most prudent thing to do is in terms of contract duration and commitments against the reducing costs that we're seeing.

John Herrlin - *Societe Generale - Analyst*

Okay. Thanks, Matt.

One other question. Ryan, you say it's a more volatile world. Given the short-cycle nature of shale-based activity, would you ever institute a hedging program for the shales? Or just given your size, it's not realistic?

Ryan Lance - *ConocoPhillips - Chairman and CEO*

Yes, I think the latter is the case, John. At our size we're naturally hedged across a lot of commodities and the markers. So given our size and where we're at, we don't see that as a useful strategy right now.

John Herrlin - *Societe Generale - Analyst*

Great. Thank you.

Ryan Lance - *ConocoPhillips - Chairman and CEO*

Thanks, John.

Operator

Thank you.

Our next question is from Guy Baber of Simmons & Company.

Please go ahead.

Guy Baber - *Simmons & Company International - Analyst*

Good afternoon, everybody.

I had a question on your 2015 production. And I was trying to get a better sense of the general trend as we progress through the year, especially for the US unconventional portfolio. So could you help frame for us perhaps what kind of a 2015 exit rate production expectations might be for the Lower 48 on the current capital spending plans?

And then any early expectations on 2016 with current rig count levels would be much appreciated. And then I have a follow-up.

Matt Fox - *ConocoPhillips - EVP of E&P*

Well, Guy, I think you are really trying to focus in on the unconventionals in our portfolio. So to give you a sense of that, we expect our production from the Eagle Ford and Bakken will grow from about 200,000 barrels a day in 2014 to about 225,000 barrels a day in 2015. So somewhere between a 10% and a 15% increase.

Now, that production growth is all going to come through the first half of the year. And then if we stay at the rig counts that we said just now, we're going into a slow decline in both the Bakken and the Eagle Ford, not a rapid decline but a slow decline. And that's going to continue into early 2016.

So early 2016 average rate is going to be a function of the number of rigs we decide to run. And, as I said earlier, we do expect to increase our rigs in the Eagle Ford and Bakken in 2016. So production may be flat from 2015 to 2016, but time will tell.

So growing production on average year on year from 2014 to 2015, all of that growth is seen in the early part, in the first half of the year, and then a slow decline through the third and fourth quarter.

Guy Baber - *Simmons & Company International - Analyst*

That's very helpful, Matt.

And then my follow-up. I wanted to kind of walk through some of the implications of the lower rig count. And you partially addressed this in your prepared comments, Matt. But how do you think about reduced investment levels materially, but still retaining the practical ability to quickly flex those activity levels higher if the commodity price improves?

And then, secondly, can you just address, just with a focus on minimizing spending and maximizing efficiencies, your ability to still continue with some of your experimentation to drive the long-term rates? Are those plans still going to be in place in the Eagle Ford and the Bakken as well with the lower rig count? Any comments you can provide there would be great.

Matt Fox - *ConocoPhillips - EVP of E&P*

Yes, so the organization that we have in the Lower 48 is flexible enough to bring the rigs down and bring the rigs back up, if we want to do that. So that flexibility exists; and we're exercising that flexibility now on the way down, and we'll be ready to do it on the way back up again. So the organizational flexibility and the relationships with the suppliers and so on, that's all in hand to go both ways.

In terms of the continued experimentation, yes, we have to choke back somewhat on the pace of learning. We can't do all of the pilot tests that we'd like to do because you need to be drilling a lot of wells to do some of those. But the critical pilot tests that really have the biggest implications for a long-term resource, understanding we're going to continue with those sort of pilot tests through this downturn because of the implications of the value of that information for the long-term that we think is worth continuing to collect.

Operator

Thank you.

Our next question is from Blake Fernandez of Scotia Howard Weil.

Please go ahead.

Blake Fernandez - *Scotia Howard Weil - Analyst*

Hello, good morning.

I have a question on slide 7. It looks like you provide the regional breakout of your adjusted earnings. And I hate to put too much emphasis on just one quarter, but it looks like the Lower 48 actually saw a loss compared to the other regions. And obviously you're cutting capex in the Lower 48 as well. I guess my view is that that was one of the main drivers of margin expansion going forward.

And so could you maybe elaborate a little bit on the economics that you're seeing there compared to the other investment opportunities that you have?

Jeff Sheets - *ConocoPhillips - EVP of Finance and CFO*

Blake, in the Lower 48 in the fourth quarter, there were around $100 million or so of impairments that happened. And then also some dry hole costs related to the Shenandoah appraisal well that we wrote off as well, which impacted that loss somewhat. But having said that, it will be a challenging year coming forward for Lower 48 based on the fact that there's still a fairly heavy natural gas weighting in the Lower 48 production.

As Matt mentioned, the economics are still there for continued investments that we're making; and those are good cash margin investments. But it is going to be a challenging 2015 at current commodity price levels in the Lower 48.

Blake Fernandez - *Scotia Howard Weil - Analyst*

Sure. Understood. Okay.

And then the second question is on the commitment to the dividend. I fully appreciate the differentiated strategy and having that as the top priority. But you kind of mentioned debt to cap would increase, and potentially investment grade could go below double-A or single-A. Is there a level that we should think about where you begin to have to rethink that strategy and emphasis on the dividend, whether it be investment grade rating or a certain debt to cap level?

Jeff Sheets - *ConocoPhillips - EVP of Finance and CFO*

As we mentioned in our remarks on the call, as we look at a lot of different scenarios that might happen over the next couple of years, we think between the capital flexibility that we have, the potential that we could have some level of asset sales in the mix, and the cash balance that we're starting with, we don't think we're going to be having to face the question of having more borrowings than will take us out of that single-A credit rating range.

Again, that's part of the overall message here, is that's baking in the dividend as the first priority for how we're using our cash flow.

Operator

Thank you.

Our next question is from Paul Cheng of Barclays.

Please go ahead.

Paul Cheng - *Barclays Capital - Analyst*

Hello. Couple quick questions, if I could. Maybe this is for Matt and Jeff.

If you're looking at your supply costs, do you have a rough percentage how much of that supply cost is currently under contract longer than two years?

Matt Fox - *ConocoPhillips - EVP of E&P*

Supply costs -- do you mean like our rigs and so on?

Paul Cheng - *Barclays Capital - Analyst*

Yes, a rig or anything related to your upstream operation.

Matt Fox - *ConocoPhillips - EVP of E&P*

Well, in our North America business and certainly in Canada and the Lower 48, there's very, very little that extends beyond one year in terms of rig contracts. Most of them are 30 days.

If we move out to the international business, there's some in the UK and Alaska and Norway that are on longer-term contracts than that. But typically, it is not common for us to have a significant amount of our drilling development-led portfolio constrained by long-term contracts.

Paul Cheng - *Barclays Capital - Analyst*

Matt, should we assume that more than 50% of your supply cost base, that you could potentially start seeing cost reduction in a relatively quick timeline?

Matt Fox - *ConocoPhillips - EVP of E&P*

I see what you're getting at - you're looking at the opportunities to get deflation into--

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Paul Cheng - *Barclays Capital - Analyst*

That's correct. How quickly? Because if you have a lot of your services under long-term contract, and maybe that you can negotiate even though you are still under contract. But normally, people don't allow that. But that's what I'm trying to understand. How quickly is that saving will be able to pass through?

Matt Fox - *ConocoPhillips - EVP of E&P*

So we're going to see it most quickly in the onshore North American business, particularly in Canada and the Lower 48. We're not going to see it, for example, in the APLNG project. We're now almost 100% labor costs. We're not likely to see labor costs in Australia decrease over the next year.

The same applies really to the Surmont 2 project in Canada. That's all labor just now. And we don't anticipate any significant labor cost reductions over the next few months as we complete the project.

So the short answer is that the major projects are going to see limited and slower deflationary forces act on them. And the development programs everywhere, but in particular in Canada and Lower 48, you're going to see it more quickly.

Paul Cheng - *Barclays Capital - Analyst*

Okay.

Second question. This is for Ryan.

Ryan, I understand your priority in protecting dividend. What if as the industry is under stress and great opportunity arises and you have to make a choice between making an acquisition, but that has to dramatically cut your dividends subsequently to ensure that you have sufficient cash flow going forward, how that choice would be made from your standpoint? How do you balance that?

Ryan Lance - *ConocoPhillips - Chairman and CEO*

Well, Paul, it's an interesting scenario to try to think about. But it's a tough one to pontificate a little bit over because we're focused on executing the plan that we have.

We watch the M&A market. We see the assets that are out there. The issue with M&A in our portfolios, it's got to compete against the investments that we have in the portfolio already today. And it's a pretty big hurdle for us to climb over. So I wouldn't speculate on where that might go.

Operator

Thank you.

Our next question is from Ryan Todd of Deutsche Bank.

Please go ahead.

Ryan Todd - *Deutsche Bank - Analyst*

Thanks.

THOMSON REUTERS

Good afternoon, gentlemen.

Maybe one follow up on activity levels and balance sheet. I guess as we look forward into 2016, implied on reaching that 2017 cash flow neutrality target, even though the current capex balance and dividend rate would imply a relatively significant ramp in cash flow, potentially from commodity prices into 2017 as is. So what would you need to see I guess in the market, either from a cost or from a commodity point of view, to actually start adding capital back to the budget as opposed to just letting things play out through 2017?

Matt Fox - *ConocoPhillips - EVP of E&P*

What we've said is that we're going to allow our capital to be flexible, and to manage within our cash flow and maintain the dividend. So the capital is going to flex, and we have the portfolio to allow that to happen. So when we say that we're going to get to cash flow neutrality in 2017, there are a bunch of different ways that that could transpire.

It could transpire through higher prices with more capital and more production, or lower prices with less capital and less production growth. So we model all of these scenarios. We plan to talk more about this, Ryan, when we have our Analyst Day in April.

Ryan Lance - *ConocoPhillips - Chairman and CEO*

But capital, Ryan, is the flywheel.

So again, we start with dividends being the number one priority. We'll fund that out of the cash flow. The growth will come from whatever capital level that we set in the commodity price. And the cash flow informs that. And then we're setting that level to make sure that we reach cash flow neutrality by 2017.

And as Matt said, across various scenarios of combination of capital and oil price projections, we're focused on getting there in 2017.

Ryan Todd - *Deutsche Bank - Analyst*

Great. I appreciate the lots of moving pieces in the equation. Just trying to get an idea if there is a level that you would think about that you would have to see at least to actually start putting some money back into the business incrementally from what you have now.

Ryan Lance - *ConocoPhillips - Chairman and CEO*

Well, we won't let cash flow neutrality move out beyond 2017. So I think that's the stake you can put in the ground, Ryan.

Ryan Todd - *Deutsche Bank - Analyst*

Okay. That's helpful.

Ryan Lance - *ConocoPhillips - Chairman and CEO*

And it could move closer, depending on the commodity price levels and then what the markets doing.

Ryan Todd - *Deutsche Bank - Analyst*

That's helpful.

Then if I could ask on what you're seeing on the cost environment; I know you talked a little bit. Am I correct in understanding that the vast majority of the $500 million capex cuts that you've implied in the budget to date have come in the US? And either way, can you talk a little bit -- we have a little bit more visibility I think generally in what we see in the US -- but can you talk a little bit about what you're seeing globally on costs across deepwater, major capital projects -- those type of things in the current environment?

Ryan Lance - *ConocoPhillips - Chairman and CEO*

Well, I think Matt's tried to address that. We see it will be slower in the major projects. And those like APLNG and Surmont that have a large labor component, that's going to take a long time to work through the system, depending how long the down cycle is.

We do see deepwater floater rigs coming off quite a bit. So the market today is quite a bit less than it was just a year ago, maybe this time a year ago. So we do see pieces of that.

Tubular goods, old country tubular goods, we see that coming down. That's a commodity that we use across the world. So where we have development drilling programs and we use workovers and stuff, we see some of that flowing through as well.

So by category, it's different by each category; and it's different around the world. And the $500 million that we're talking about is something that we've got pretty clear line of sight on to capture this year. And that will continue into 2016.

Operator

Thank you.

Our next question is from Edward Westlake of Credit Suisse.

Please go ahead.

Edward Westlake - *Credit Suisse - Analyst*

Yes, good morning. Good discussion so far. I'm going to have to stick with capex, then ask some smaller questions.

Just on the $4.5 billion of major project spend, given that you do have APLNG, heavy oil, and some large projects in Malaysia that are going to finish hopefully at some point in 2015, it might be a help to us to maybe give us some color as to just on the existing projects, how might that look in 2016? Forget cost deflation, but just the timing of the capex cycle.

Matt Fox - *ConocoPhillips - EVP of E&P*

So roughly speaking, we're going to see -- well, let me give you specifics. APLNG will go from something like $1.6 billion this year to zero next year. Surmont will go from about $800 million this year to about $250 million next year. So there are a few bends or high level views of those biggest projects.

There are a few projects that are increasing in capital year on year. As the Clair Ridge project moves toward closure, we'll see a slight increase in capital there next year; and same with the Malikai project in Malaysia. But overall, we're going to see something greater than $2 billion coming out in the mix between those larger -- the biggest projects we're executing coming to an end -- and some smaller projects that are already in execution ramping up a bit.

Edward Westlake - *Credit Suisse - Analyst*

With the cash flow from those and then that provides more confidence to add back rigs into shale. So I can see how that works.

Matt Fox - *ConocoPhillips - EVP of E&P*

Actually, you make a good point there, Ed, because one of the things about the projects like APLNG and Surmont, for example, is they'll start producing this year; but they won't actually get to peak rates for a full year, until 2017. So they're going to be continuing to contribute to growth long after the capital is spent. As the Surmont project takes three years to ramp up, APLNG won't actually get to peak production until sometime early in 2016.

The KBB project in Malaysia, we might only get half a year. Despite the fact that the project is complete, we're waiting on this pipeline being repaired. We might only get half a year of production from KBB this year, but we'll get full year of production in 2015 and so on.

So we're happy that these major projects are now getting to completion. Not just because we don't have to spend the capex, but because now we're going to reap the reward over the next several years of contributing, growing our base production through these long-life -- many of them long-life -- flat production projects.

Jeff Sheets - *ConocoPhillips - EVP of Finance and CFO*

To put a little bit more point on what Matt said as well, if you go back to our analyst presentation last April, we talked some numbers about how much cash we can expect to see coming out of APLNG and out of FCCL, once those things are up and running, kind of full rates by 2017. And those are lower numbers at lower commodity prices, but that's still a pretty significant source of cash for us. And that is an important part of the equation of getting to cash flow neutrality in 2017.

Edward Westlake - *Credit Suisse - Analyst*

And just on APLNG though, just as a follow up, how will you be treating the CBM drilling costs? Would that be in capex, or you'd put that in opex? Just more of a modeling question, the maintenance capex on that project -- which can be quite significant, I think.

Jeff Sheets - *ConocoPhillips - EVP of Finance and CFO*

Because of the fact that APLNG is done with equity accounting for us, you don't end up seeing the capital expenditures for APLNG or the operating costs for it. You just see contributions in the current state. The contributions then are going in as capital, and we'll just see distributions coming back out in the future.

Operator

Thank you.

Our next question is from Alastair Syme of Citi. Please go ahead.

Alastair Syme - *Citigroup - Analyst*

Hello. I wonder if I could ask to what extent in this environment the opex and overhead might be the flywheel in terms of cash neutrality. If you could put some granularity around the comments you made about G&A costs, it would be useful.

Matt Fox - *ConocoPhillips - EVP of E&P*

Yes, Alastair, we're thoughtful of the capital; but we're equally focused on the operating costs here, as you'd expect. And just like we're focused across the whole value chain for capital deflation opportunities in capital, the same thing is happening in operating costs.

First of all, in costs that are externally driven, like contract labor, materials, and chemicals. And there's some of that price sensitivity to transportation costs in some of our transportation contracts. But we've got to look inside too for self-help reductions looking at our internal operating costs and G&A. So we're already taking action there.

We're going to have no salary increases in 2014. We've got a hiring freeze in place across most of the company. We've already announced plans to reduce head count in Europe that's quite significant. And we're likely to see more headcount reductions in other parts of the business as we reassess the implications of lower prices on our future plans.

So we have the whole company focused on minimizing our operating costs, and we're not going to leave any stone unturned. But we're not going to take any measures that reduce the safety or integrity of our assets.

And this is one of the things, Alastair, that we intend to talk about in more detail at the Analyst Day in April, our approach to the operating cost side of the equation.

Alastair Syme - *Citigroup - Analyst*

Could you say how much of your operating costs are supply-driven versus internal, what percentage roughly? Roughly.

Matt Fox - *ConocoPhillips - EVP of E&P*

It's about roughly 30% is internal company labor. And then the rest is a mixture of transportation costs, contract labor, materials, parts. But about 30% is ConocoPhillips' internal employee labor.

Alastair Syme - *Citigroup - Analyst*

Thank you very much.

Ellen DeSanctis - *ConocoPhillips - VP of IR and Communications*

Thanks, Alastair.

Operator

Thank you.

Our next question is from Roger Read of Wells Fargo.

Please go ahead.

Roger Read - *Wells Fargo Securities, LLC - Analyst*

Good morning.

Ryan Lance - *ConocoPhillips - Chairman and CEO*

Hello, Roger.

Roger Read - *Wells Fargo Securities, LLC - Analyst*

I guess coming at the opex question a slightly different way, we've talked a lot about capex flexibility. As you think about the cash margin potential here, and I think about the shale play certainly where they were probably a little more on the higher cash cost side, certainly looking across the industry. So as you pull back a little bit on your drilling there as we look at some of the projects, probably more of a 2016 than a 2015 impact from APLNG and Surmont. But what do you think about cash margins as you look into the latter part of 2015 and 2016?

Ryan Lance - *ConocoPhillips - Chairman and CEO*

Well, we expect the absolute level of the cash margin will come down with the commodity prices, obviously. But as we look across the portfolio, the most important portfolio is quite resilient -- on a cash breakeven basis -- is pretty resilient to these prices.

So as Matt said, we're going to continue to drive operating cost reductions, as well as the capital reductions. And while the absolute level of the margin will probably come down, we're still going to try to drive to see those margin improvements over the course of the next couple of years.

Roger Read - *Wells Fargo Securities, LLC - Analyst*

Okay, thanks.

And then it may be a better question in April, but as you think about the exploration program here as part of the overall capex discipline and keeping the dividend in mind, flexibility obviously on the growth projects. What is the flexibility on exploration? And what is the maybe incentive here, as you mention with lower rig rates, to shift things out another 6 or 12 months where you can?

Matt Fox - *ConocoPhillips - EVP of E&P*

On the short-term aspect of that question, in terms of the flexibility in our exploration spend, there's relatively limited flexibility in the short-term on our conventional exploration activity. We have rigs under contracts. We have agreements in place with governments and partners.

So over the next year through 2015 -- that's why we haven't taken as much as you might expect out of exploration. We really have to go through the parts of the exploration portfolio that are flexible. So we think that 2015 is quite a big year for exploration in Angola, Senegal, Gulf of Mexico, Nova Scotia, for example, and Australia.

And then there is the longer-term question about the role of exploration in the growth of the company. And that's one of the things we are going to talk about more in the Analyst Day in a couple of months.

Operator

Thank you.

Our next--

Ellen DeSanctis - *ConocoPhillips - VP of IR and Communications*

Christine?

Operator

Yes?

Ellen DeSanctis - *ConocoPhillips - VP of IR and Communications*

I'm sorry, Christine. I'm seeing it's the top of the hour. We'll take one more question, if you don't mind, okay?

Operator

Okay. Our last question is from Phil Gresh of JPMorgan.

Please go ahead.

Phil Gresh - *JPMorgan - Analyst*

Hello, thanks for sneaking me in.

Two quick ones. One is just the budget for this year. Is it fair to say that the $11.5 billion is kind of set in stone at this point, absent further deflation, given that you have $2 billion rolling off into next year and that $9.5 billion is kind of the core required spend? So if you cut any more this year, you would be kind of cutting into the meat of it, so to speak?

Ryan Lance - *ConocoPhillips - Chairman and CEO*

I think we've got to set the scope that we want to execute with the $11.5 billion. There's some uncertainty as to how much deflation we'll capture this year. We've added some in, could be more than that. We're certainly trying to drive to more than that.

But, yes, we've set the scope associated with what we want to execute on the $11.5 billion.

Phil Gresh - *JPMorgan - Analyst*

Got it.

And then just a follow up just on the asset sales topic. Maybe any additional color you could provide around how you might approach a process like that -- kind of what parts of the portfolio might be something you would want to monetize in this type of environment?

Ryan Lance - *ConocoPhillips - Chairman and CEO*

Well, we continue to look. I've said we won't have another large announced asset disposition program. But you should expect us every year to be pruning the bottom part of the portfolio.

It obviously it gets tougher in this type of commodity price environment, but we set our new base case. We know what the assets are worth to us internally. And if there's interest out there in certain assets, we'll entertain those and look at them. So I think you should expect some modest amount. It will be tougher over the next couple of years. But there will still be some pieces of our portfolio that we'll be taking a hard look at.

Phil Gresh - *JPMorgan - Analyst*

So you think you could get $500 million to $1 billion in cash a year out of asset sales? Any kind of target you're thinking about?

Ryan Lance - *ConocoPhillips - Chairman and CEO*

No, I don't really have a target in mind. We'll do what makes sense.

Phil Gresh - *JPMorgan - Analyst*

Okay, okay. Fair enough. Thanks.

Ellen DeSanctis - *ConocoPhillips - VP of IR and Communications*

Thanks, Phil.

Okay, Christina, why don't you wrap it up here?

Thanks, everybody, for your time. And by all means, call IR if you have any other additional questions.

Operator

Thank you. And thank you, ladies and gentlemen. This concludes today's conference. Thank you for participating. You may now disconnect.

Editor

CAUTIONARY STATEMENT FOR THE PURPOSES OF THE "SAFE HARBOR" PROVISIONS OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

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