

SUNOCO INC
Form 10-Q
August 03, 2006
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2006

OR

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

For the transition period from _____ to _____

Commission file number 1-6841

SUNOCO, INC.

(Exact name of registrant as specified in its charter)

PENNSYLVANIA
(State or other jurisdiction of

incorporation or organization)

1735 MARKET STREET, SUITE LL, PHILADELPHIA, PA 19103-7583

(Address of principal executive offices)

23-1743282
(I.R.S. Employer

Identification No.)

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(Zip Code)

(215) 977-3000

(Registrant's telephone number, including area code)

NOT APPLICABLE

(Former name, former address and former fiscal year, if changed since last report)

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

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

At June 30, 2006, there were 130,409,122 shares of Common Stock, \$1 par value outstanding.

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PART I

FINANCIAL INFORMATION

Item 1. Financial Statements

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

Sunoco, Inc. and Subsidiaries

(Millions of Dollars and Shares, Except Per Share Amounts)

	For the Six Months Ended June 30	
	2006	2005
	(UNAUDITED)	
REVENUES		
Sales and other operating revenue (including consumer excise taxes)	\$ 19,144	\$ 15,161
Interest income	18	6
Other income, net (Notes 2 and 3)	21	32
	19,183	15,199
COSTS AND EXPENSES		
Cost of products sold and operating expenses	16,312	12,640
Consumer excise taxes	1,291	1,225
Selling, general and administrative expenses (Note 2)	420	434
Depreciation, depletion and amortization	226	207
Payroll, property and other taxes	65	64
Interest cost and debt expense	53	46
Interest capitalized	(5)	(12)
	18,362	14,604
Income before income tax expense	821	595
Income tax expense	316	237
NET INCOME	\$ 505	\$ 358
Net income per share of common stock:		
Basic	\$ 3.82	\$ 2.60
Diluted	\$ 3.80	\$ 2.58
Weighted-average number of shares outstanding (Notes 5 and 9):		
Basic	132.2	137.7
Diluted	132.9	138.5
Cash dividends paid per share of common stock (Note 9)	\$.45	\$.35

(See Accompanying Notes)

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CONDENSED CONSOLIDATED STATEMENTS OF INCOME

Sunoco, Inc. and Subsidiaries

(Millions of Dollars and Shares, Except Per Share Amounts)

	For the Three Months Ended June 30	
	2006	2005
	(UNAUDITED)	
REVENUES		
Sales and other operating revenue (including consumer excise taxes)	\$ 10,575	\$ 7,970
Interest income	8	3
Other income, net (Notes 2 and 3)	7	17
	10,590	7,990
COSTS AND EXPENSES		
Cost of products sold and operating expenses	8,858	6,581
Consumer excise taxes	663	640
Selling, general and administrative expenses (Note 2)	210	225
Depreciation, depletion and amortization	114	102
Payroll, property and other taxes	31	28
Interest cost and debt expense	27	23
Interest capitalized	(4)	(6)
	9,899	7,593
Income before income tax expense	691	397
Income tax expense	265	155
NET INCOME	\$ 426	\$ 242
Net income per share of common stock:		
Basic	\$ 3.24	\$ 1.77
Diluted	\$ 3.22	\$ 1.75
Weighted-average number of shares outstanding (Notes 5 and 9):		
Basic	131.5	137.1
Diluted	132.2	138.0
Cash dividends paid per share of common stock (Note 9)	\$.25	\$.20

(See Accompanying Notes)

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CONDENSED CONSOLIDATED BALANCE SHEETS

Sunoco, Inc. and Subsidiaries

(Millions of Dollars)

	At June 30 2006 (UNAUDITED)	At December 31 2005
ASSETS		
Current Assets		
Cash and cash equivalents	\$ 600	\$ 919
Accounts and notes receivable, net	2,363	1,754
Inventories:		
Crude oil	531	317
Petroleum and chemical products	495	322
Materials, supplies and other	168	160
Deferred income taxes	216	215
Total Current Assets	4,373	3,687
Investments and long-term receivables	127	143
Properties, plants and equipment	10,004	9,576
Less accumulated depreciation, depletion and amortization	4,035	3,918
Properties, plants and equipment, net	5,969	5,658
Prepaid retirement costs	12	12
Deferred charges and other assets (Note 3)	449	431
Total Assets	\$ 10,930	\$ 9,931
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Accounts payable	\$ 3,711	\$ 3,014
Accrued liabilities (Note 6)	475	681
Current portion of long-term debt	195	177
Taxes payable	434	338
Total Current Liabilities	4,815	4,210
Long-term debt (Note 7)	1,243	1,234
Retirement benefit liabilities (Note 8)	537	563
Deferred income taxes	895	817
Other deferred credits and liabilities (Notes 3 and 6)	400	409
Commitments and contingent liabilities (Note 6)		
Minority interests (Note 2)	745	647
Shareholders' equity (Note 9)	2,295	2,051
Total Liabilities and Shareholders' Equity	\$ 10,930	\$ 9,931

(See Accompanying Notes)

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

Sunoco, Inc. and Subsidiaries

(Millions of Dollars)

	For the Six Months	
	Ended June 30	
	2006	2005
	(UNAUDITED)	
INCREASES (DECREASES) IN CASH AND CASH EQUIVALENTS		
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 505	\$ 358
Adjustments to reconcile net income to net cash provided by operating activities:		
Phenol supply contract dispute payment (Note 3)	(95)	
Proceeds from power contract restructuring (Note 3)		48
Depreciation, depletion and amortization	226	207
Deferred income tax expense	75	25
Payments in excess of expense for retirement plans	(26)	(5)
Changes in working capital pertaining to operating activities, net of effect of acquisitions:		
Accounts and notes receivable	(547)	(432)
Inventories	(393)	(222)
Accounts payable and accrued liabilities	501	587
Taxes payable	96	(7)
Other	23	12
Net cash provided by operating activities	365	571
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures	(429)	(470)
Acquisitions (Notes 3 and 6)	(123)	
Proceeds from divestments (Note 3)	28	21
Other	(9)	5
Net cash used in investing activities	(533)	(444)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net proceeds from issuance of long-term debt	301	
Repayments of long-term debt	(275)	(13)
Net proceeds from issuance of Sunoco Logistics		
Partners L.P. limited partnership units (Note 2)	110	99
Cash distributions to investors in cokemaking operations	(7)	(11)
Cash distributions to investors in Sunoco Logistics Partners L.P.	(22)	(12)
Cash dividend payments	(60)	(48)
Purchases of common stock for treasury	(198)	(131)
Proceeds from issuance of common stock under management incentive plans	1	6
Other	(1)	(5)
Net cash used in financing activities	(151)	(115)
Net increase (decrease) in cash and cash equivalents	(319)	12

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Cash and cash equivalents at beginning of period	919	405
Cash and cash equivalents at end of period	\$ 600	\$ 417

(See Accompanying Notes)

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. General.

The accompanying condensed consolidated financial statements are presented in accordance with the requirements of Form 10-Q and U.S. generally accepted accounting principles for interim financial reporting. They do not include all disclosures normally made in financial statements contained in Form 10-K. In management's opinion, all adjustments necessary for a fair presentation of the results of operations, financial position and cash flows for the periods shown have been made. All such adjustments are of a normal recurring nature. Results for the three and six months ended June 30, 2006 are not necessarily indicative of results for the full-year 2006.

Share and per-share data (except par value) presented for all periods reflect the effect of a two-for-one stock split, which was effected in the form of a common stock dividend distributed on August 1, 2005 (Note 9).

2. Minority Interests.

Cokemaking Operations

Since 1995, Sunoco has received, in four separate transactions, a total of \$724 million in exchange for interests in its Jewell and Indiana Harbor cokemaking operations. Sunoco did not recognize any gain at the dates of these transactions because the third-party investors were entitled to a preferential return on their investments. The preferential returns are currently equal to 98 percent of the cash flows and tax benefits from the respective cokemaking operations during the preferential return periods, which continue until the investors recover their investments and achieve a cumulative annual after-tax return that averages approximately 10 percent. Income is recognized as coke production and sales generate cash flows and tax benefits which are allocated to Sunoco and the third-party investors, while expense is recognized to reflect the investors' preferential returns.

The preferential return period for the Jewell operation is projected to end during 2011, while the preferential return period for the Indiana Harbor operation is projected to end during 2007. Due to the difficulty of forecasting operations and tax benefits into the future, the accuracy of these estimates is subject to considerable uncertainty. The estimated lengths of these preferential return periods are based upon the Company's current expectations of future cash flows and tax benefits, which are impacted by sales volumes and prices, raw material and operating costs, capital expenditure levels and potential limitations on the ability to recognize tax benefits based upon the level of crude oil prices (see below). The estimates also assume that the realization of nonconventional fuel tax credits is 61 percent in 2006 and 100 percent thereafter. Higher-than-expected cash flows and tax benefits will shorten the investors' preferential return periods, while lower-than-expected cash flows and tax benefits will lengthen the periods.

Following the expiration of these preferential return periods, the investor in the Jewell operation will be entitled to a minority interest in the related cash flows and tax benefits amounting to 18 percent, while the investors in the Indiana Harbor operation will be entitled to a minority interest in the related cash flows and tax benefits initially amounting to 34 percent and thereafter declining periodically to 10 percent by 2038.

Under existing tax law, the coke production at Jewell and Indiana Harbor is not eligible to generate nonconventional fuel tax credits after 2007. The energy policy legislation enacted in August 2005 includes additional tax credits pertaining to a portion of the coke production at Jewell, all of the coke production at Haverhill, where operations commenced in March 2005, and

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all future domestic coke plants placed into service by January 1, 2010. The new credits cover a four-year period, effective January 1, 2006 or the date any new facility is placed into service, if later. However, prior to their expiration dates, all of the tax credits would be phased out, on a ratable basis, if the average annual price of domestic crude oil at the wellhead is within a certain inflation-adjusted price range. (This range was \$53.20 to \$66.79 per barrel for 2005, the latest year for which the range is available.) The domestic wellhead price averaged \$59.19 per barrel for the five months ended May 31, 2006, \$64.32 per barrel for the month of May 2006 and \$50.26 per barrel for the year ended December 31, 2005. The corresponding prices for West Texas Intermediate (WTI) crude oil, a widely published reference price for domestic crude oil, were \$66.31 per barrel for the five months ended May 31, 2006, \$70.96 per barrel for the month of May 2006 and \$56.56 per barrel for the year ended December 31, 2005. Based upon the Company's estimate of domestic wellhead prices for the first half of 2006, Sun Coke recorded only 61 percent of the benefit of the tax credits that otherwise would have been available without regard to these phase-out provisions. The estimated impact of this phase-out reduced earnings for the first half of 2006 by \$5 million after tax. The ultimate amount of the credits to be earned during 2006 will be based upon the average annual price of domestic crude oil at the wellhead. In addition, if the tax credits were phased out, the Company could be required under tax indemnity agreements to make cash payments to the third-party investors. Payments would be required only if the expected end of the applicable preferential return period was extended by two years or more and if the respective third-party investor was expected to achieve a cumulative after-tax return of less than approximately 6.5 percent. The Company currently does not believe that any payments would be required, even if the average annual wellhead crude oil price were to exceed the threshold at which the credits are completely phased out.

The Company also indemnifies the third-party investors for certain tax benefits available to them during the preferential return period in the event the Internal Revenue Service disallows the tax deductions and benefits allocated to the third parties or if there is a change in the tax laws that reduces the amount of nonconventional fuel tax credits. These tax indemnifications are in effect until the applicable tax returns are no longer subject to Internal Revenue Service review. In certain of these cases, if performance under the indemnification is required, the Company also has the option to purchase the third-party investors' interests. Although the Company believes it is remote that it will be required to make any payments under these indemnifications, at June 30, 2006, the maximum potential payment under these tax indemnifications and the options to purchase the third-party investors' interests, if exercised, would have been approximately \$610 million. If this were to occur, the minority interest balance would be reduced by approximately \$185 million.

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The following table sets forth the minority interest balances and the changes in these balances attributable to the third-party investors' interests in cokemaking operations (in millions of dollars):

	Six Months Ended	
	June 30	
	2006	2005
Balance at beginning of year	\$ 234	\$ 287
Nonconventional fuel credit and other tax benefits*	(22)	(30)
Preferential return*	19	22
Cash distributions to third-party investors	(7)	(11)
Balance at end of period	\$ 224	\$ 268

* The nonconventional fuel credit and other tax benefits and the preferential return, which comprise the noncash change in the minority interest in cokemaking operations, are included in other income, net, in the condensed consolidated statements of income.

In the second quarter of 2005, Sunoco Logistics Partners L.P. (the Partnership), a master limited partnership in which Sunoco has an ownership interest, issued 2.8 million limited partnership units at a price of \$37.50 per unit. Proceeds from the offering, net of underwriting discounts and offering expenses, totaled approximately \$99 million. These proceeds were used to redeem an equal number of limited partnership units owned by Sunoco. In the third quarter of 2005, the Partnership issued an additional 1.6 million limited partnership units at a price of \$39.00 per unit. Proceeds from the offering, which totaled approximately \$61 million, net of underwriting discounts and offering expenses, were used by the Partnership principally to repay a portion of the borrowings under its revolving credit facility. In the second quarter of 2006, the Partnership issued \$175 million of senior notes due 2016 and 2.7 million limited partnership units at a price of \$43.00 per unit. Proceeds from the 2006 offerings, net of underwriting discounts and offering expenses, totaled approximately \$173 and \$110 million, respectively. These proceeds were used by the Partnership in part to repay the outstanding borrowings under its revolving credit facility with the balance used to fund a portion of the Partnership's 2006 growth capital program. Upon completion of the equity offerings, Sunoco's interest in the Partnership, including its 2 percent general partnership interest, decreased to 43 percent. The accounts of the Partnership continue to be included in Sunoco's condensed consolidated financial statements.

As of June 30, 2006, Sunoco owned 12.06 million limited partnership units consisting of 6.37 million common units and 5.69 million subordinated units. Distributions on Sunoco's subordinated units are payable only after the minimum quarterly distributions of \$.45 per unit for the common units held by the public and Sunoco, including any arrearages, have been made. The subordinated units convert to common units if certain financial tests related to earning and paying the minimum quarterly distribution for the preceding three consecutive one-year periods have been met. In February 2006 and 2005, when the quarterly cash distributions pertaining to the fourth quarters of 2005 and 2004 were paid, the first two three-year requirements were satisfied. As a result, a total of 5.70 million of Sunoco's subordinated units have been converted to common units, 2.85 million each in February 2006 and February 2005. If the Partnership continues to meet the financial tests through the fourth quarter of 2006, all of Sunoco's remaining 5.69 million subordinated units would be converted to common units in February 2007.

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The Partnership's issuance of common units to the public has resulted in an increase in the value of Sunoco's proportionate share of the Partnership's equity as the issuance price per unit exceeded Sunoco's carrying amount per unit at the time of issuance. The resultant gain to Sunoco on these transactions, which totaled approximately \$150 million pretax at June 30, 2006, has been deferred as a component of minority interest in the Company's condensed consolidated balance sheets as the common units issued do not represent residual interests in the Partnership due to Sunoco's ownership of the subordinated units. The deferred gain would be recognized in income when Sunoco's remaining subordinated units convert to common units at which time the common units become the residual interests.

The following table sets forth the minority interest balance and the changes to this balance attributable to the third-party investors' interests in Sunoco Logistics Partners L.P. (in millions of dollars):

	Six Months Ended June 30	
	2006	2005
Balance at beginning of year	\$ 397	\$ 232
Net proceeds from public equity offerings	110	99
Minority interest share of income*	20	13
Increase attributable to Partnership management incentive plan	1	5
Cash distributions to third-party investors**	(22)	(12)
 Balance at end of period	 \$ 506	 \$ 337

* Included in selling, general and administrative expenses in the condensed consolidated statements of income.

** During 2005 and the first half of 2006, the Partnership increased its quarterly cash distribution per unit from \$.625 to \$.775.

Epsilon Joint Venture Operations

Epsilon Products Company, LLC (Epsilon) is a joint venture that consists of polymer-grade propylene operations at Sunoco's Marcus Hook, PA refinery and an adjacent polypropylene plant. The joint venture is a variable interest entity for which the Company is the primary beneficiary. As such, the accounts of Epsilon are included in Sunoco's condensed consolidated financial statements.

The following table sets forth the minority interest balance and the changes to this balance attributable to the other joint venture partner's interest in Epsilon (in millions of dollars):

	Six Months Ended June 30	
	2006	2005
Balance at beginning of year	\$ 16	\$ 11
Minority interest share of income (loss)*	(1)	3
 Balance at end of period	 \$ 15	 \$ 14

* Included in selling, general and administrative expenses in the condensed consolidated statements of income.

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3. Changes in Business and Other Matters.

Acquisitions

Logistics Assets In July 2006, Sunoco Logistics Partners L.P. agreed to purchase from Sunoco for \$65 million a company that has a 55 percent interest in Mid-Valley Pipeline Company, a joint venture which owns a crude oil pipeline system in the Midwest. This transaction is subject to regulatory review and is expected to close in the third quarter of 2006. In March 2006, the Partnership purchased two separate crude oil pipeline systems and related storage facilities located in Texas, one from affiliates of Black Hills Energy, Inc. (Black Hills) for \$41 million and the other from affiliates of Alon USA Energy, Inc. (Alon) for \$68 million. The Black Hills acquisition also includes a lease acquisition marketing business and related inventory. The Partnership also expects to complete a \$20 million project to connect the Black Hills pipeline system to the Nederland terminal by mid-2007 and a \$17 million project to expand capacity on the Alon pipeline system and to construct new tankage at the Nederland terminal to service these new volumes more efficiently. In August 2005, the Partnership completed the acquisition of a crude oil pipeline system and related storage facilities located in Texas from ExxonMobil for \$100 million. In December 2005, the Partnership also completed the acquisition of an ownership interest in the Mesa Pipeline from Chevron for \$5 million which, coupled with the 7.2 percent interest it acquired from Sunoco, gave it a 37.0 percent ownership interest. The above acquisitions were initially funded with proceeds from borrowings under the Partnership s revolving credit facility (Note 2).

The purchase price of the Black Hills acquisition has been allocated to the assets acquired based on their estimated fair market values at the acquisition date. The Partnership engaged an independent appraisal firm to value the Black Hills assets. The appraisal was completed during the second quarter of 2006. The following is a summary of the effects of this transaction on Sunoco s consolidated financial position (in millions of dollars):

Increase in:	
Inventories	\$ 2
Properties, plants and equipment, net	39
	\$ 41

The purchase price of the Alon and Mesa Pipeline acquisitions has been included in properties, plants and equipment in the condensed consolidated balance sheets. No pro forma information has been presented since the acquisitions were not material in relation to Sunoco s consolidated results of operations.

Divestments

Retail Portfolio Management Program A Retail Portfolio Management (RPM) program is ongoing, which is selectively reducing the Company s invested capital in Company-owned or leased retail sites. During the 2003-2006 period, selected sites are being divested. Most of the sites are being converted to contract dealers and distributors thereby retaining most of the gasoline sales volume attributable to the divested sites within the Sunoco branded business. The Company expects to generate divestment proceeds of approximately \$230 million, of which \$193 million has been received through June 30, 2006 related to the sale of 352 sites. During the first six months of 2006 and 2005, net gains of \$6 and \$7 million, respectively (\$3 and \$4 million after tax, respectively), were recognized in other income, net, in

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the condensed consolidated statements of income in connection with the RPM program. The Company expects the RPM program to generate additional gains during the remainder of 2006.

Other Matters

Phenol Supply Contract Dispute During the third quarter of 2005, an arbitrator ruled that Sunoco was liable in an arbitration proceeding for breaching a supply agreement concerning the prices charged to Honeywell International Inc. (Honeywell) for phenol produced at Sunoco's Philadelphia chemical plant from June 2003 through April 2005. In January 2006, the arbitrator ruled that Sunoco should bill Honeywell based on the pricing formula established in the arbitration until a second arbitration finalizes pricing for 2005 and beyond under provisions of the supply agreement which provide for a price reopener on and after January 1, 2005. Damages of approximately \$95 million (\$56 million after tax), including prejudgment interest, were assessed, of which \$27, \$48 and \$20 million pertained to 2005, 2004 and 2003, respectively. Such damages, which were paid to Honeywell in April 2006, were recorded as a charge against earnings in the 2005 consolidated statement of income (\$78 million in the third quarter and \$17 million in the fourth quarter). In March 2006, a U.S. District Court judge upheld the first arbitrator's ruling. In July 2006, the second arbitrator ruled that the pricing through July 2009 should be based essentially on the pricing formula established in the first arbitration. As Sunoco has been billing Honeywell based on this formula, this ruling did not impact Sunoco's consolidated results of operations.

Power Contract Restructuring - In December 2004, Sunoco and a subsidiary of FPL Energy (FPL) agreed to a restructuring of an agreement under which Sunoco may purchase steam from a natural gas fired cogeneration power plant owned and operated by FPL at Sunoco's Marcus Hook refinery. Under the restructured terms, FPL surrendered its easement interest in land adjacent to the power plant on which four auxiliary boilers were constructed, thereby transferring ownership of the auxiliary boilers with an estimated fair market value of \$33 million to Sunoco. FPL operates the auxiliary boilers on Sunoco's behalf. When the cogeneration plant is in operation, Sunoco has the option to purchase steam from the facility at a rate equivalent to that set forth in the original agreement. As part of the restructuring, Sunoco has agreed to a long-term lease of the land on which the cogeneration facility was constructed to FPL and to modify certain terms in the existing agreement for an aggregate cash payment of \$48 million, most of which is attributable to prepaid rent. Sunoco received this \$48 million payment in January 2005. No gain or loss was recognized in connection with the restructuring. Upon completion of the restructured agreement in January 2005, deferred revenue of \$81 million was recorded in other deferred credits and liabilities in the condensed consolidated balance sheet, which is being amortized into income over the 30-year term of the contract.

4. Stock-Based Compensation.

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (SFAS No. 123R), utilizing the modified-prospective method. SFAS No. 123R revised the accounting for stock-based compensation required by Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (SFAS No. 123). Among other things, SFAS No. 123R requires a fair-value-based method of accounting for share-based payment transactions, which is similar to the method followed by the Company under the provisions of SFAS No. 123. SFAS No. 123R also requires the use of a non-substantive vesting period approach for new share-based payment awards that vest when an employee becomes retirement eligible as is the case under Sunoco's share-

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based awards (i.e., the vesting period cannot exceed the date an employee becomes retirement eligible). The effect will be to accelerate expense recognition compared to the vesting period approach that Sunoco previously followed under SFAS No. 123. Adoption of SFAS No. 123R did not have a material effect on the Company's results of operations for the six-month period ended June 30, 2006. However, assuming the fair value of awards to be granted in the fourth quarter of 2006 are similar to the value of those granted in December 2005, the Company currently estimates that its after-tax compensation expense under SFAS No. 123R will be approximately \$5-\$10 million higher in 2006 than it would have been under SFAS No. 123 as a result of the accelerated expense recognition. The future impact of the non-substantive vesting period will be dependent upon the value of future stock-based awards granted to employees who are eligible to retire prior to the normal vesting periods of the awards.

The stock options granted under the Company's management incentive plans have a 10-year term, are not exercisable until two years after the date of grant and permit optionees to purchase Company stock at its fair market value on the date of grant. Under SFAS No. 123, the fair value of the stock options was estimated using the Black-Scholes option pricing model. Use of this model requires the Company to make certain assumptions regarding the term that the options are expected to be outstanding (expected life), as well as regarding the risk-free interest rate, the Company's expected dividend yield and the expected volatility of the Company's stock price during the period the options are expected to be outstanding. The expected life and dividend yield are estimated based on historical experience. The risk-free interest rate is based on the U.S. Treasury yield curve at the date of grant for periods that are approximately equal to the expected life. The Company uses historical share prices, for a period equivalent to the options' expected life, to estimate the expected volatility of the Company's share price. The Company continues to use the Black-Scholes option pricing model to estimate the fair value of stock options under SFAS No. 123R.

During the six months ended June 30, 2006 and 2005, 49,070 and 625,812 stock options, respectively, were exercised with an intrinsic value of \$3 and \$19 million, respectively. Cash received from the exercise of options during the six months ended June 30, 2006 totaled \$1 million and the related tax benefit realized was \$1 million. At June 30, 2006, there were 1,478,286 stock options outstanding, of which 284,336 were exercisable. As of that date, the aggregate intrinsic value of all of the outstanding stock options was \$37 million, while the aggregate intrinsic value and the weighted-average remaining contractual term of the exercisable options was \$14 million and five years, respectively.

Common stock unit awards under the Company's management incentive plans mature upon completion of a three-year service period or upon attainment of predetermined performance targets during the three-year period. For the performance-based awards, adjustments for attainment of performance targets can range from 0-200 percent of the award grant. Awards are payable in cash or common stock. Awards to be paid in cash are classified as liabilities in the Company's condensed consolidated balance sheets and are re-measured for expense purposes at fair value each period (based on the fair value of an equivalent number of Sunoco common shares at the end of the period) with any change in fair value recognized as an increase or decrease in income. For awards to be settled in common stock, the fair value for expense purposes is based on the closing price of the Company's shares on the date of grant.

During the six months ended June 30, 2006 and 2005, 527,000 and 276,000 common stock units, respectively, were settled in cash and 75,200 and 53,200 common stock units, respectively, were settled in common stock. The intrinsic value of the common stock units that were settled in cash during

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the six months ended June 30, 2006 and 2005 totaled \$43 and \$12 million, respectively, while the intrinsic value of the common stock unit awards that were settled in common stock totaled \$6 and \$2 million, respectively. At June 30, 2006, excluding any potential adjustment for performance, there were 531,140 common stock units outstanding payable in cash and 152,415 payable in stock with an aggregate intrinsic value of \$37 and \$11 million, respectively.

For the six months ended June 30, 2006 and 2005, the Company recognized stock-based compensation expense of \$14 and \$25 million, respectively, and related tax benefits of \$6 and \$10 million, respectively. As of June 30, 2006, total compensation cost related to nonvested awards not yet recognized was \$37 million, and the weighted-average period over which this cost is expected to be recognized in income is 1.5 years. The stock-based compensation expense and the total compensation cost related to nonvested awards not yet recognized reflect the Company's estimates of performance factors pertaining to performance-based common stock unit awards.

5. Earnings Per Share Data.

The following table sets forth the reconciliation of the weighted-average number of common shares used to compute basic earnings per share (EPS) to those used to compute diluted EPS (in millions):

	Six Months Ended June 30		Three Months Ended June 30	
	2006	2005	2006	2005
Weighted-average number of common shares outstanding - basic	132.2	137.7	131.5	137.1
Add effect of dilutive stock incentive awards	.7	.8	.7	.9
Weighted-average number of shares - diluted	132.9	138.5	132.2	138.0

6. Commitments and Contingent Liabilities.

Commitments

Sunoco is contingently liable under various arrangements which guarantee debt of third parties aggregating to approximately \$6 million at June 30, 2006. At this time, management does not believe that it is likely that the Company will have to perform under any of these guarantees.

Over the years, Sunoco has sold thousands of retail gasoline outlets as well as refineries, terminals, coal mines, oil and gas properties and various other assets. In connection with these sales, the Company has indemnified certain purchasers for potential environmental and other contingent liabilities related to the period prior to the transaction dates. In most cases, the effect of these arrangements was to afford protection for the purchasers with respect to obligations for which the Company was already primarily liable. While some of these indemnities have spending thresholds which must be exceeded before they become operative, or limits on Sunoco's maximum exposure, they generally are not limited. The Company recognizes the fair value of the obligations undertaken for all guarantees entered into or modified after January 1, 2003. In addition, the Company accrues for any obligations under these agreements when a loss is probable and reasonably estimable. The Company cannot reasonably estimate the maximum potential amount of future payments under these agreements.

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Effective January 1, 2001, Sunoco completed the acquisition of Aristech Chemical Corporation (Aristech), a wholly owned subsidiary of Mitsubishi Corporation (Mitsubishi), for \$506 million in cash and the assumption of \$163 million of debt. Contingent payments (the earn out) may also be made if realized margins for polypropylene and phenol exceed certain agreed-upon thresholds through 2006. For 2005, a \$14 million payment was earned, which was paid in April 2006. Any additional contingent payment earned in 2006 is limited to \$90 million. All earn-out payments are being treated as adjustments to the purchase price. In addition, Mitsubishi is responsible for up to \$100 million of any potential environmental liabilities of the business identified through January 1, 2026 arising out of or related to the period prior to the acquisition date.

Environmental Remediation Activities

Sunoco is subject to extensive and frequently changing federal, state and local laws and regulations, including, but not limited to, those relating to the discharge of materials into the environment or that otherwise deal with the protection of the environment, waste management and the characteristics and composition of fuels. As with the industry generally, compliance with existing and anticipated laws and regulations increases the overall cost of operating Sunoco s businesses, including remediation, operating costs and capital costs to construct, maintain and upgrade equipment and facilities.

Existing laws and regulations result in liabilities and loss contingencies for remediation at Sunoco s facilities and at formerly owned or third-party sites. The accrued liability for environmental remediation is classified in the condensed consolidated balance sheets as follows (in millions of dollars):

	At June 30 2006	At December 31 2005
Accrued liabilities	\$ 41	\$ 37
Other deferred credits and liabilities	91	100
	\$ 132	\$ 137

The following table summarizes the changes in the accrued liability for environmental remediation activities by category (in millions of dollars):

	Refineries		Marketing		Chemicals		Pipelines and		Hazardous Waste		Total
	Refineries	Sites	Facilities	Terminals	Sites	Other	Sites	Other			
Balance at January 1, 2005	\$ 48	\$ 74	\$ 5	\$ 15	\$ 4	\$ 2	\$ 3	\$ 2	\$ 148		
Accruals	1	9		2					12		
Payments	(5)	(10)		(2)			(1)		(18)		
Other		(2)		1					(1)		
Balance at June 30, 2005	\$ 44	\$ 71	\$ 5	\$ 16	\$ 3	\$ 2	\$ 3	\$ 2	\$ 141		
Balance at January 1, 2006	\$ 36	\$ 78	\$ 3	\$ 15	\$ 3	\$ 2	\$ 3	\$ 2	\$ 137		
Accruals	3	10	1	1	1		1		16		
Payments	(4)	(12)		(2)			(1)	(1)	(20)		
Other				(1)					(1)		
Balance at June 30, 2006	\$ 35	\$ 76	\$ 3	\$ 14	\$ 3	\$ 1	\$ 3	\$ 1	\$ 132		

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Sunoco's accruals for environmental remediation activities reflect management's estimates of the most likely costs that will be incurred over an extended period to remediate identified conditions for which the costs

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are both probable and reasonably estimable. Engineering studies, historical experience and other factors are used to identify and evaluate remediation alternatives and their related costs in determining the estimated accruals for environmental remediation activities. Losses attributable to unasserted claims are also reflected in the accruals to the extent they are probable of occurrence and reasonably estimable.

Total future costs for the environmental remediation activities identified above will depend upon, among other things, the identification of any additional sites, the determination of the extent of the contamination at each site, the timing and nature of required remedial actions, the technology available and needed to meet the various existing legal requirements, the nature and terms of cost-sharing arrangements with other potentially responsible parties, the availability of insurance coverage, the nature and extent of future environmental laws, inflation rates and the determination of Sunoco's liability at the sites, if any, in light of the number, participation level and financial viability of the other parties. Management believes it is reasonably possible (i.e., less than probable but greater than remote) that additional environmental remediation losses will be incurred. At June 30, 2006, the aggregate of the estimated maximum additional reasonably possible losses, which relate to numerous individual sites, totaled approximately \$90 million. However, the Company believes it is very unlikely that it will realize the maximum reasonably possible loss at every site. Furthermore, the recognition of additional losses, if and when they were to occur, would likely extend over many years and, therefore, likely would not have a material impact on the Company's financial position.

Under various environmental laws, including the Resource Conservation and Recovery Act (RCRA) (which relates to solid and hazardous waste treatment, storage and disposal), Sunoco has initiated corrective remedial action at its facilities, formerly owned facilities and third-party sites. At the Company's major manufacturing facilities, Sunoco has consistently assumed continued industrial use and a containment/remediation strategy focused on eliminating unacceptable risks to human health or the environment. The remediation accruals for these sites reflect that strategy. Accruals include amounts to prevent off-site migration and to contain the impact on the facility property, as well as to address known, discrete areas requiring remediation within the plants. Activities include closure of RCRA solid waste management units, recovery of hydrocarbons, handling of impacted soil, mitigation of surface water impacts and prevention of off-site migration.

Many of Sunoco's current terminals are being addressed with the above containment/remediation strategy. At some smaller or less impacted facilities and some previously divested terminals, the focus is on remediating discrete interior areas to attain regulatory closure.

Sunoco owns or operates certain retail gasoline outlets where releases of petroleum products have occurred. Federal and state laws and regulations require that contamination caused by such releases at these sites and at formerly owned sites be assessed and remediated to meet the applicable standards. The obligation for Sunoco to remediate this type of contamination varies, depending on the extent of the release and the applicable laws and regulations. A portion of the remediation costs may be recoverable from the reimbursement fund of the applicable state, after any deductible has been met.

Future costs for environmental remediation activities at the Company's marketing sites also will be influenced by the extent of MTBE contamination of groundwater, the cleanup of which will be driven by thresholds based on drinking water protection. Though not all groundwater is used for drinking, several states have initiated or proposed more stringent MTBE cleanup

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requirements. Cost increases result directly from extended remedial operations and maintenance on sites that, under prior standards, could otherwise have been completed. Cost increases will also result from installation of additional remedial or monitoring wells and purchase of more expensive equipment because of the presence of MTBE. While actual cleanup costs for specific sites are variable and depend on many of the factors discussed above, expansion of similar MTBE remediation thresholds to additional states or adoption of even more stringent requirements for MTBE remediation would result in further cost increases.

The accrued liability for hazardous waste sites is attributable to potential obligations to remove or mitigate the environmental effects of the disposal or release of certain pollutants at third-party sites pursuant to the Comprehensive Environmental Response Compensation and Liability Act (CERCLA) (which relates to releases and remediation of hazardous substances) and similar state laws. Under CERCLA, Sunoco is potentially subject to joint and several liability for the costs of remediation at sites at which it has been identified as a potentially responsible party (PRP). As of June 30, 2006, Sunoco had been named as a PRP at 38 sites identified or potentially identifiable as Superfund sites under federal and state law. The Company is usually one of a number of companies identified as a PRP at a site. Sunoco has reviewed the nature and extent of its involvement at each site and other relevant circumstances and, based upon the other parties involved or Sunoco's negligible participation therein, believes that its potential liability associated with such sites will not be significant.

Management believes that none of the current remediation locations, which are in various stages of ongoing remediation, is individually material to Sunoco as its largest accrual for any one Superfund site, operable unit or remediation area was less than \$3 million at June 30, 2006. As a result, Sunoco's exposure to adverse developments with respect to any individual site is not expected to be material. However, if changes in environmental regulations occur, such changes could impact multiple Sunoco facilities and formerly owned and third-party sites at the same time. As a result, from time to time, significant charges against income for environmental remediation may occur.

The Company maintains insurance programs that cover certain of its existing or potential environmental liabilities, which programs vary by year, type and extent of coverage. For underground storage tank remediations, the Company can also seek reimbursement through various state funds of certain remediation costs above a deductible amount. For certain acquired properties, the Company has entered into arrangements with the sellers or others that allocate environmental liabilities and provide indemnities to the Company for remediating contamination that occurred prior to the acquisition dates. Some of these environmental indemnifications are subject to caps and limits. No accruals have been recorded for any potential contingent liabilities that will be funded by the prior owners as management does not believe, based on current information, that it is likely that any of the former owners will not perform under any of these agreements. Other than the preceding arrangements, the Company has not entered into any arrangements with third parties to mitigate its exposure to loss from environmental contamination. Claims for recovery of environmental liabilities that are probable of realization totaled \$21 million at June 30, 2006 and are included principally in deferred charges and other assets in the condensed consolidated balance sheets.

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Environmental Regulatory Matters

The U.S. Environmental Protection Agency (EPA) adopted rules under the Clean Air Act (which relates to emissions of materials into the air) that phase in limitations on the sulfur content of gasoline beginning in 2004 and the sulfur content of on-road diesel fuel beginning in mid-2006 (Tier II). The rules include banking and trading credit systems, which could provide refiners flexibility through 2006 for the low-sulfur gasoline and through May 2010 for the on-road low-sulfur diesel. These rules are expected to have a significant impact on Sunoco and its operations, primarily with respect to the capital and operating expenditures at its five refineries. The Tier II capital spending is expected to be essentially completed in 2006, while the higher operating costs are incurred as the low-sulfur fuels are produced. The Company s estimate of total capital outlays to comply with the Tier II low-sulfur gasoline and on-road diesel requirements is approximately \$750 million. Capital spending to meet these requirements totaled \$742 million through June 30, 2006. In May 2004, the EPA adopted a third rule which will phase in limitations on the allowable sulfur content in off-road diesel fuel beginning in mid-2007. The off-road diesel rule is not expected to require significant capital expenditures by Sunoco. The ultimate impact of the rules may be affected by such factors as technology selection, the effectiveness of the systems pertaining to banking and trading credits, timing uncertainties created by permitting requirements and construction schedules and any effect on prices created by changes in the level of gasoline and diesel fuel production.

In 1997, the EPA promulgated new, more stringent National Ambient Air Quality Standards (NAAQS) for ozone and fine particles, which has resulted in identification of non-attainment areas throughout the country, including Texas, Pennsylvania, Ohio, New Jersey and West Virginia, where Sunoco operates facilities. In 2004, the EPA issued final non-attainment area designations for ozone and fine particles. These standards will result in further controls of nitrogen oxide, sulfur dioxide and volatile organic compound emissions. The EPA has designated certain areas, including Philadelphia and Houston, as moderate non-attainment areas for ozone, which would require them to meet the ozone requirements by 2010, before currently mandated federal control programs would take effect. Sunoco s Bayport and LaPorte, TX chemical facilities are located within the Houston non-attainment area. If a region is not able to demonstrate attainment by 2010, there would be more stringent offset requirements, and, if a region cannot submit an approvable State Implementation Plan, there could be a moratorium on new highway projects and imposition of a Federal Implementation Plan, including potentially significant lifestyle changes to bring the region to attainment. However, EPA s designation of ozone non-attainment areas and the EPA s rule on state implementation are currently being challenged by the State of Ohio, trade associations and health and environmental groups. In 2005, EPA issued a final rule revoking a previously proposed 1-hour ozone standard and related provisions in favor of a more stringent 8-hour standard. The EPA issued a subsequent rule codifying the revocation of the 1-hour ozone standard for the areas with effective 8-hour ozone non-attainment designations. Both industry and environmental groups have filed lawsuits challenging various provisions of the final rule. In 2005, the EPA also identified 21 counties which, based on 2003-2004 data, now are in attainment of the fine particles standard. Sunoco s Toledo refinery is within one of these attainment areas. Regulatory programs, when established to implement the EPA s standards, could have an impact on Sunoco and its operations. However, the potential financial impact cannot be reasonably estimated until the EPA promulgates regulatory programs to attain the standards, and the states, as necessary, develop and implement revised State Implementation Plans to respond to the new regulations.

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Under existing law that was enacted in August 2005, a new renewable fuels mandate for ethanol use in gasoline was established (immediately in California and on May 5, 2006 for the rest of the nation). Although the act did not ban MTBE, during the second quarter of 2006, Sunoco discontinued the use of MTBE and increased its use of ethanol in gasoline. While management expects ethanol will continue to be adequately supplied, this change by Sunoco and other refiners in the industry has price and supply implications in the marketplace. Any additional Federal and state legislation could also have a significant impact on market conditions and the profitability of Sunoco and the industry in general.

MTBE Litigation

Sunoco, along with other refiners, manufacturers and sellers of gasoline, owners and operators of retail gasoline sites, and manufacturers of MTBE, are defendants in approximately 65 cases in 17 states involving the manufacture and use of MTBE in gasoline and MTBE contamination in groundwater. Plaintiffs, which include private well owners, water providers and certain governmental authorities, allege that refiners and suppliers of gasoline containing MTBE are responsible for manufacturing and distributing a defective product that contaminates groundwater. Plaintiffs are asserting primarily product liability claims but additional claims are also being asserted including, nuisance, trespass, negligence, violation of environmental laws and deceptive business practices. Plaintiffs are seeking compensatory damages, and in some cases injunctive relief, exemplary and punitive damages and attorneys' fees. All of the public water provider cases have been removed to federal court and consolidated for pretrial purposes in the U.S. District Court for the Southern District of New York (MDL 1358). Motions to remand these cases to state courts have been denied. Motions to dismiss were denied. Discovery is proceeding in four focus cases. Sunoco is a defendant in three of these cases. In addition, several of the private well owner cases are moving forward. Sunoco is a focus defendant in two of those cases. Up to this point, for the group of MTBE cases currently pending, there has been insufficient information developed about the plaintiffs' legal theories or the facts that would be relevant to an analysis of potential exposure. Based on the current law and facts available at this time, Sunoco believes that these cases will not have a material adverse effect on its consolidated financial position.

Conclusion

Many other legal and administrative proceedings are pending or possible against Sunoco from its current and past operations, including proceedings related to commercial and tax disputes, product liability, antitrust, employment claims, leaks from pipelines and underground storage tanks, natural resource damage claims, premises-liability claims, allegations of exposures of third parties to toxic substances (such as benzene or asbestos) and general environmental claims. The ultimate outcome of pending proceedings and other matters identified above cannot be ascertained at this time; however, it is reasonably possible that some of them could be resolved unfavorably to Sunoco. Management believes that these matters could have a significant impact on results of operations for any future quarter or year. However, management does not believe that any additional liabilities which may arise pertaining to such matters would be material in relation to the consolidated financial position of Sunoco at June 30, 2006. Furthermore, management does not believe that the overall costs for environmental activities will have a material impact over an extended period of time on Sunoco's cash flows or liquidity.

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7. Debt Redemption.

In the second quarter of 2006, the Company redeemed its 9-3/8 percent debentures with a book value of \$56 million. The Company recognized a loss of less than \$1 million due to the early extinguishment of the debt.

8. Retirement Benefit Plans.

The following tables set forth the components of defined benefit plans and postretirement benefit plans expense (in millions of dollars):

	Defined Benefit Plans		Postretirement Benefit Plans	
	Six Months Ended		Six Months Ended	
	June 30 2006	2005	June 30 2006	2005
Service cost (cost of benefits earned during the year)	\$ 26	\$ 24	\$ 5	\$ 4
Interest cost on benefit obligations	43	42	11	12
Expected return on plan assets	(47)	(45)		
Amortization of:				
Prior service cost (benefit)	1	1	(2)	(2)
Unrecognized losses	16	15	2	1
Total expense	\$ 39	\$ 37	\$ 16	\$ 15

	Defined Benefit Plans		Postretirement Benefit Plans	
	Three Months Ended		Three Months Ended	
	June 30 2006	2005	June 30 2006	2005
Service cost (cost of benefits earned during the year)	\$ 13	\$ 12	\$ 2	\$ 2
Interest cost on benefit obligations	22	21	6	6
Expected return on plan assets	(24)	(23)		
Amortization of:				
Prior service cost (benefit)			(1)	(1)
Unrecognized losses	6	8	1	
Total expense	\$ 17	\$ 18	\$ 8	\$ 7

9. Shareholders Equity.

	At	At
	June 30	December 31
	2006	2005
Common stock, par value \$1 per share	\$ 280	\$ 280

(Millions of Dollars)

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Capital in excess of par value	1,595	1,587
Earnings employed in the business	4,211	3,766
Accumulated other comprehensive loss	(201)	(192)
Common stock held in treasury, at cost	(3,590)	(3,390)
Total	\$ 2,295	\$ 2,051

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On July 7, 2005, the Company's Board of Directors (Board) approved a two-for-one split of Sunoco's common stock to be effected in the form of a stock dividend. The shares were distributed on August 1, 2005 to shareholders of record as of July 18, 2005. In connection with the common stock split, the number of authorized shares of common stock was increased from 200 million to 400 million, and the shares of common stock reserved for issuance pertaining to Sunoco's 6-3/4 percent convertible debentures and various employee benefit plans were proportionally increased in accordance with the terms of those respective agreements and plans.

During the first six months of 2006, the Company repurchased 2,843,000 shares of common stock for \$198 million under an existing repurchase authorization. At June 30, 2006, the Company had a remaining authorization from its Board to purchase up to \$109 million of Company common stock in the open market from time to time depending on prevailing market conditions and available cash. In July 2006, an additional \$500 million authorization was approved.

The Company increased the quarterly cash dividend paid on common stock from \$.15 per share (\$.60 per year) to \$.20 per share (\$.80 per year) beginning with the second quarter of 2005 and then to \$.25 per share (\$1.00 per year) beginning with the second quarter of 2006.

10. Comprehensive Income.

The following table sets forth Sunoco's comprehensive income (in millions of dollars):

	Six Months Ended June 30		Three Months Ended June 30	
	2006	2005	2006	2005
Net income	\$ 505	\$ 358	\$ 426	\$ 242
Other comprehensive income, net of related income taxes:				
Net hedging gains (losses)	(13)	6	(12)	3
Reclassifications of net hedging (gains) losses to earnings	4	(3)	2	(1)
Comprehensive income	\$ 496	\$ 361	\$ 416	\$ 244

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11. Business Segment Information.

The following table sets forth certain income statement information concerning Sunoco's business segments (in millions of dollars):

Six Months Ended	Sales and Other Operating Revenue		Segment Income (Loss) (after tax)
	Unaffiliated Customers	Inter- segment	
June 30, 2006			
Refining and Supply	\$ 9,194	\$ 5,548	\$ 482
Retail Marketing	6,707		10
Chemicals	1,250		22
Logistics	1,756	993	18
Coke	237	5	24
Corporate and Other			(51)*
Consolidated	\$ 19,144		\$ 505
June 30, 2005			
Refining and Supply	\$ 7,273	\$ 4,215	\$ 320
Retail Marketing	5,324		(1)
Chemicals	1,248		63
Logistics	1,121	971	12
Coke	195		23
Corporate and Other			(59)**
Consolidated	\$ 15,161		\$ 358

* Consists of \$27 million of after-tax corporate expenses and \$24 million of after-tax net financing expenses and other.

** Consists of \$32 million of after-tax corporate expenses and \$27 million of after-tax net financing expenses and other.

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Three Months Ended	Sales and Other Operating Revenue		Segment Income (Loss) (after tax)
	Unaffiliated Customers	Inter- segment	
June 30, 2006			
Refining and Supply	\$ 5,074	\$ 3,179	\$ 409
Retail Marketing	3,758		10
Chemicals	651		8
Logistics	973	516	12
Coke	119	3	10
Corporate and Other			(23)*
Consolidated	\$ 10,575		\$ 426

Three Months Ended

Three Months Ended	Sales and Other Operating Revenue		Segment Income (Loss) (after tax)
	Unaffiliated Customers	Inter- segment	
June 30, 2005			
Refining and Supply	\$ 3,836	\$ 2,235	\$ 212
Retail Marketing	2,854		7
Chemicals	589		30
Logistics	586	495	9
Coke	105		13
Corporate and Other			(29)**
Consolidated	\$ 7,970		\$ 242

* Consists of \$11 million of after-tax corporate expenses and \$12 million of after-tax net financing expenses and other.

** Consists of \$16 million of after-tax corporate expenses and \$13 million of after-tax net financing expenses and other.

12. New Accounting Pronouncement.

In July 2006, FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FASB Interpretation No. 48), was issued. It clarifies the accounting for uncertainty in income taxes recognized in an entity s financial statements in accordance with Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes, by prescribing the minimum recognition threshold and measurement attribute a tax position taken or expected to be taken on a tax return is required to meet before being recognized in the financial statements. FASB Interpretation No. 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. Sunoco is currently evaluating the impact of FASB Interpretation No. 48, which must be implemented effective January 1, 2007.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

RESULTS OF OPERATIONS - SIX MONTHS

Earnings Profile of Sunoco Businesses (after tax)

	Six Months Ended June 30		
	2006	2005	Variance
	(Millions of Dollars)		
Refining and Supply	\$ 482	\$ 320	\$ 162
Retail Marketing	10	(1)	11
Chemicals	22	63	(41)
Logistics	18	12	6
Coke	24	23	1
Corporate and Other:			
Corporate expenses	(27)	(32)	5
Net financing expenses and other	(24)	(27)	3
Consolidated net income	\$ 505	\$ 358	\$ 147

Analysis of Earnings Profile of Sunoco Businesses

In the six-month period ended June 30, 2006, Sunoco earned \$505 million, or \$3.80 per share of common stock on a diluted basis, compared to \$358 million, or \$2.58 per share, for the first half of 2005.

The \$147 million increase in net income in the first half of 2006 was primarily due to higher wholesale fuels margins (\$241 million). Also contributing to the improvement in earnings were higher retail gasoline margins (\$12 million), a lower effective income tax rate (\$11 million) and higher earnings from Sunoco's Logistics business (\$6 million). Partially offsetting these positive factors were higher expenses (\$61 million), including fuel charges; lower chemical margins (\$43 million); and lower production of refined products (\$17 million).

Table of Contents*Refining and Supply*

	For the Six Months	
	Ended June 30	
	2006	2005
Income (millions of dollars)	\$ 482	\$ 320
Wholesale margin* (per barrel):		
Total Refining and Supply	\$ 9.35	\$ 6.92
Northeast Refining	\$ 8.55	\$ 6.84
MidContinent Refining	\$ 11.69	\$ 7.14
Crude inputs as percent of crude unit rated capacity	94	98
Throughputs (thousands of barrels daily):		
Crude oil	849.7	882.9
Other feedstocks	72.7	58.0
 Total throughputs	 922.4	 940.9
Products manufactured (thousands of barrels daily):		
Gasoline	440.9	440.4
Middle distillates	309.1	315.9
Residual fuel	73.5	77.6
Petrochemicals	35.0	38.5
Lubricants	13.9	13.1
Other	84.7	92.2
 Total production	 957.1	 977.7
Less: Production used as fuel in refinery operations	44.6	47.8
 Total production available for sale	 912.5	 929.9

* Wholesale sales revenue less related cost of crude oil, other feedstocks, product purchases and terminalling and transportation divided by production available for sale.

Refining and Supply earned \$482 million in the first half of 2006 versus \$320 million in the first half of 2005. The \$162 million increase in earnings was due to higher realized margins (\$241 million), partially offset by lower production volumes (\$17 million) and higher expenses (\$65 million). The lower volumes were mainly a result of scheduled maintenance turnarounds at the Philadelphia and Toledo refineries, while the higher expenses were mainly the result of higher purchased fuel costs and expenses associated with the maintenance activities. Also contributing to the increase in expenses were operating costs to produce low-sulfur fuels.

Table of Contents*Retail Marketing*

	For the Six Months	
	Ended June 30	
	2006	2005
Income (loss) (millions of dollars)	\$ 10	\$ (1)
Retail margin* (per barrel):		
Gasoline	\$ 3.21	\$ 2.86
Middle distillates	\$ 4.37	\$ 4.27
Sales (thousands of barrels daily):		
Gasoline	298.3	297.6
Middle distillates	43.9	45.8
	342.2	343.4
Retail gasoline outlets	4,723	4,804

* Retail sales price less related wholesale price and terminalling and transportation costs per barrel. The retail sales price is the weighted-average price received through the various branded marketing distribution channels.

Retail Marketing earned \$10 million in the first half of 2006 versus a loss of \$1 million in the first six months of 2005. The \$11 million increase in results was primarily due to higher average retail gasoline margins (\$12 million). Lower expenses (\$3 million) were offset by lower non-gasoline income.

A Retail Portfolio Management (RPM) program is ongoing, which is selectively reducing the Company's invested capital in Company-owned or leased sites. During the 2003-2006 period, selected sites are being divested. Most of the sites are being converted to contract dealers or distributors thereby retaining most of the gasoline sales attributable to the divested sites within the Sunoco branded business. The Company expects to generate divestment proceeds of approximately \$230 million, of which \$193 million has been received through June 30, 2006 related to the sale of 352 sites. During the first six months of 2006 and 2005, net after-tax gains of \$3 and \$4 million, respectively, were recognized in connection with the RPM program. The Company expects the RPM program will generate additional gains in 2006.

Table of Contents*Chemicals*

	For the Six Months	
	Ended June 30	
	2006*	2005
Income (millions of dollars)	\$ 22	\$ 63
Margin** (cents per pound):		
All products***	9.8	12.7
Phenol and related products	8.1	11.9
Polypropylene***	12.2	14.3
Sales (millions of pounds):		
Phenol and related products	1,296	1,298
Polypropylene	1,131	1,116
Other	42	49
	2,469	2,463

* The income and margin data reflect a new pricing formula for 2006 sales of phenol to Honeywell International Inc. based upon the outcome of arbitration decisions in the third quarter of 2005 and first quarter of 2006 (see below).

** Wholesale sales revenue less the cost of feedstocks, product purchases and related terminalling and transportation divided by sales volumes.

*** The polypropylene and all products margins include the impact of a long-term supply contract with Equistar Chemicals, L.P. which is priced on a cost-based formula that includes a fixed discount.

Chemicals earned \$22 million in the first half of 2006 versus \$63 million in the prior-year period. The \$41 million decrease in earnings was due primarily to lower margins for both phenol and polypropylene (\$43 million). Higher expenses, due in part to higher fuel and utility costs, were offset by a \$4 million deferred tax benefit recognized in the second quarter of 2006 as a result of a state law change.

During the third quarter of 2005, an arbitrator ruled that Sunoco was liable in an arbitration proceeding for breaching a supply agreement concerning the prices charged to Honeywell International Inc. (Honeywell) for phenol produced at Sunoco's Philadelphia chemical plant from June 2003 through April 2005. In January 2006, the arbitrator ruled that Sunoco should bill Honeywell based on the pricing formula established in the arbitration until a second arbitration finalizes pricing for 2005 and beyond under provisions of the supply agreement which provide for a price reopener on and after January 1, 2005. Damages of approximately \$95 million, including prejudgment interest, were assessed, of which \$27, \$48 and \$20 million pertained to 2005, 2004 and 2003, respectively. Such damages, which were paid to Honeywell in April 2006, have been reported as a charge against 2005 earnings and were shown separately as Phenol Supply Contract Dispute under Corporate and Other in the Earnings Profile of Sunoco Businesses (\$46 million after tax in the third quarter and \$10 million after tax in the fourth quarter). In March 2006, a U.S. District Court judge upheld the first arbitrator's ruling. In July 2006, the second arbitrator ruled that the pricing through July 2009 should be based essentially on the pricing formula established in the first arbitration. As Sunoco has been billing Honeywell based on this formula, this ruling did not impact Sunoco's consolidated results of operations. (See Note 3 to the condensed consolidated financial statements.)

Logistics

Sunoco's Logistics business earned \$18 million in the first half of 2006 versus \$12 million in the first half of 2005. The \$6 million increase in earnings was due largely to the absence of a \$4 million after-tax accrual attributable to a

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pipeline spill in January 2005 and a \$2 million unfavorable tax adjustment. Also contributing to the increase were higher earnings attributable to Eastern pipeline operations and crude oil acquisition and marketing activities as well as operating results from the Partnership's acquisitions completed in 2006 and 2005. Partially offsetting these positive factors was Sunoco's reduced ownership in the Partnership subsequent to the public equity offerings in 2006 and 2005 (see Financial Condition Other Cash Flow Information below).

In July 2006, the Partnership agreed to purchase from Sunoco for \$65 million a company that has a 55 percent interest in Mid-Valley Pipeline Company, a joint venture which owns a crude oil pipeline in the Midwest. This transaction is subject to regulatory review and is expected to close in the third quarter of 2006. In March 2006, the Partnership purchased two separate crude oil pipeline systems and related storage facilities located in Texas, one from affiliates of Black Hills Energy, Inc. (Black Hills) for \$41 million and the other from affiliates of Alon USA Energy, Inc. (Alon) for \$68 million. The Black Hills acquisition also includes a lease acquisition marketing business and related inventory. The Partnership also expects to complete a \$20 million project to connect the Black Hills pipeline system to the Nederland terminal by mid-2007 and a \$17 million project to expand capacity on the Alon pipeline system and to construct new tankage at the Nederland terminal to service these new volumes more efficiently. In August 2005, the Partnership completed the acquisition of another crude oil pipeline system and related storage facilities located in Texas from ExxonMobil for \$100 million. In December 2005, the Partnership also completed the acquisition of an ownership interest in the Mesa Pipeline from Chevron for \$5 million which, coupled with the 7.2 percent interest it acquired from Sunoco, gave it a 37.0 percent ownership interest. The above acquisitions were initially funded with proceeds from borrowings under the Partnership's revolving credit facility (see Financial Condition Financial Capacity below).

Coke

Coke earned \$24 million in the first six months of 2006 versus \$23 million in the first six months of 2005. The \$1 million increase in earnings was due primarily to higher income from the cokemaking facility in Haverhill, OH, which commenced operations in March 2005, and lower selling, general and administrative expenses. Partially offsetting these positive factors were lower coal sales volumes and lower tax benefits from cokemaking operations, which reflects a partial phase-out of the benefits as a result of the high level of crude oil prices during the first half of 2006 (see below).