

NEWFIELD EXPLORATION CO /DE/  
Form 10-Q  
October 31, 2006

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**SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 10-Q**

**(Mark One)**

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

**For the Quarterly Period Ended September 30, 2006**

OR

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

For the Transition Period from \_\_\_\_\_ to \_\_\_\_\_.

**Commission File Number: 1-12534**

**NEWFIELD EXPLORATION COMPANY**

(Exact name of Registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**72-1133047**

(I.R.S. Employer  
Identification Number)

**363 North Sam Houston Parkway East**

**Suite 2020**

**Houston, Texas 77060**

(Address and Zip Code of principal executive offices)

**(281) 847-6000**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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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 Act).

Yes  No

As of October 30, 2006, there were 128,976,619 shares of the Registrant's Common Stock, par value \$0.01 per share, outstanding.

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CONSOLIDATED BALANCE SHEET****(In millions, except share data)  
(Unaudited)**

	September 30, 2006	December 31, 2005
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 265	\$ 39
Short-term investments	30	—
Accounts receivable	318	370
Inventories	42	22
Derivative assets	275	10
Deferred taxes	—	46
Other current assets	74	53
Total current assets	1,004	540
Oil and gas properties (full cost method, of which \$999 at September 30, 2006 and \$901 at December 31, 2005 were excluded from amortization)	8,326	7,042
Less—accumulated depreciation, depletion and amortization	(3,054)	(2,632)
	5,272	4,410
Furniture, fixtures and equipment, net	21	20
Derivative assets	17	17
Other assets	20	23
Deferred taxes	11	9
Goodwill	62	62
Total assets	\$ 6,407	\$ 5,081
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 74	\$ 41
Accrued liabilities	587	454
Advances from joint owners	70	29
Asset retirement obligation	49	47
Deferred taxes	53	—
Derivative liabilities	104	99
Total current liabilities	937	670
Other liabilities	23	21
Derivative liabilities	192	209
Long-term debt	1,171	870
Asset retirement obligation	223	213
Deferred taxes	915	720
Total long-term liabilities	2,524	2,033

Commitments and contingencies (Note 5)	—	—
Stockholders' equity:		
Preferred stock (\$0.01 par value; 5,000,000 shares authorized; no shares issued)	—	—
Common stock (\$0.01 par value; 200,000,000 shares authorized at September 30, 2006 and December 31, 2005; 130,828,550 and 129,356,162 shares issued and outstanding at September 30, 2006 and December 31, 2005, respectively)	1	1
Additional paid-in capital	1,182	1,186
Treasury stock (at cost; 1,879,081 and 1,815,594 shares at September 30, 2006 and December 31, 2005, respectively)	(31)	(27)
Unearned compensation	—	(34)
Accumulated other comprehensive income (loss):		
Foreign currency translation adjustment	5	(4)
Commodity derivatives	(16)	(40)
Retained earnings	1,805	1,296
Total stockholders' equity	2,946	2,378
Total liabilities and stockholders' equity	\$ 6,407	\$ 5,081

The accompanying notes to consolidated financial statements are an integral part of this statement.

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**NEWFIELD EXPLORATION COMPANY**  
**CONSOLIDATED STATEMENT OF INCOME**  
(In millions, except per share data)  
(Unaudited)

	Three Months Ended September 30, 2006		Nine Months Ended September 30, 2006	
	2006	2005	2006	2005
Oil and gas revenues	\$ 425	\$ 460	\$ 1,246	\$ 1,319
Operating expenses:				
Lease operating	36	55	155	150
Production and other taxes	12	18	43	41
Depreciation, depletion and amortization	159	127	434	403
Ceiling test writedown	6	—	6	—
General and administrative	34	25	92	76
Other	(6)	(7)	(11)	(7)
Total operating expenses	241	218	719	663
Income from operations	184	242	527	656
Other income (expenses):				
Interest expense	(23)	(17)	(65)	(54)
Capitalized interest	11	11	33	34
Commodity derivative income (expense)	247	(238)	299	(393)
Other	2	2	7	3
	237	(242)	274	(410)
Income before income taxes	421	—	801	246
Income tax provision (benefit):				
Current	18	29	30	68
Deferred	137	(29)	262	14
	155	—	292	82
Net income	\$ 266	\$ —	\$ 509	\$ 164
Earnings per share:				
Basic	\$ 2.10	\$ —	\$ 4.02	\$ 1.31
Diluted	\$ 2.06	\$ —	\$ 3.95	\$ 1.29
Weighted average number of shares outstanding for basic earnings per share	126	126	127	125
Weighted average number of shares outstanding for diluted earnings per share	129	126	129	128

The accompanying notes to consolidated financial statements are an integral part of this statement.

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**NEWFIELD EXPLORATION COMPANY**  
**CONSOLIDATED STATEMENT OF CASH FLOWS**

(In millions)  
(Unaudited)

	<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 509	\$ 164
<b>Adjustments to reconcile net income to net cash provided by operating activities:</b>		
Depreciation, depletion and amortization	434	403
Deferred taxes	262	14
Stock-based compensation	23	5
Early redemption cost on senior subordinated notes	8	—
Ceiling test writedown	6	—
Gain on sale of floating production system	—	(7)
Unrealized commodity derivative (income) expense	(226)	357
<b>Changes in operating assets and liabilities:</b>		
(Increase) decrease in accounts receivable	82	(12)
Increase in inventories	(18)	(11)
Increase in other current assets	(20)	(11)
Decrease in other assets	12	4
Increase (decrease) in accounts payable and accrued liabilities	41	(17)
Decrease in commodity derivative liabilities	(13)	(14)
Increase in advances from joint owners	40	5
Increase in other liabilities	5	7
<b>Net cash provided by operating activities</b>	<b>1,145</b>	<b>887</b>
<b>Cash flows from investing activities:</b>		
Additions to oil and gas properties	(1,244)	(762)
Insurance recoveries	45	—
Proceeds from sale of oil and gas properties	—	11
Proceeds from sale of floating production system	—	7
Additions to furniture, fixtures and equipment	(4)	(4)
Purchases of short-term investments	(541)	—
Redemption of short-term investments	511	—
<b>Net cash used in investing activities</b>	<b>(1,233)</b>	<b>(748)</b>
<b>Cash flows from financing activities:</b>		
Proceeds from borrowings under credit arrangements	491	604
Repayments of borrowings under credit arrangements	(491)	(724)
Proceeds from issuance of senior subordinated notes	550	—
Repayment of senior subordinated notes	(250)	—
Proceeds from issuances of common stock	9	28



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Stock-based compensation excess tax benefit	3	
Purchases of treasury stock	(3)	—
Net cash provided by (used in) financing activities	309	(92)
Effect of exchange rate changes on cash and cash equivalents	5	(3)
Increase in cash and cash equivalents	226	44
Cash and cash equivalents, beginning of period	39	58
Cash and cash equivalents, end of period	\$ 265	\$ 102

The accompanying notes to consolidated financial statements are an integral part of this statement.

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**NEWFIELD EXPLORATION COMPANY**  
**CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY**

(In millions)

(Unaudited)

	Common Stock		Treasury Stock		Additional Paid-in Capital		Unearned Compensation	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
	Shares	Amount	Shares	Amount	Capital	Compensation	Earnings	(Loss)	Equity	
<b>Balance, December 31, 2005</b>	129.4	\$ 1	(1.8)	\$ (27)	\$ 1,186	\$ (34)	\$ 1,296	\$ (44)	\$ 2,378	
Issuance of common and restricted stock	1.4				9				9	
Stock-based compensation					18				18	
Treasury stock, at cost			(0.1)	(4)					(4)	
Excess tax benefit from stock-based compensation					3				3	
Adoption of SFAS No. 123(R)					(34)	34				
Comprehensive income:										
Net income							509		509	
Foreign currency translation adjustment, net of tax of (\$5)								9	9	
Reclassification adjustments for settled hedging positions, net of tax of \$15								(28)	(28)	
Changes in fair value of outstanding hedging positions, net of tax of (\$28)								52	52	
Total comprehensive income									542	
<b>Balance, September 30, 2006</b>	130.8	\$ 1	(1.9)	\$ (31)	\$ 1,182	\$	\$ 1,805	\$ (11)	\$ 2,946	

The accompanying notes to consolidated financial statements are an integral part of this statement.

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**NEWFIELD EXPLORATION COMPANY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. Organization and Summary of Significant Accounting Policies:**

***Organization and Principles of Consolidation***

We are an independent oil and gas company engaged in the exploration, development and acquisition of crude oil and natural gas properties. Our company was founded in 1989 and initially focused on the shallow waters of the Gulf of Mexico. Today, we have a diversified asset base. Our domestic areas of operation include the onshore Gulf Coast, the Anadarko and Arkoma Basins of the Mid-Continent, the Uinta Basin of the Rocky Mountains and the Gulf of Mexico. Internationally, we are active offshore Malaysia and China and in the U.K. North Sea.

Our financial statements include the accounts of Newfield Exploration Company, a Delaware corporation, and its subsidiaries. We proportionately consolidate our interests in oil and gas exploration and production ventures and partnerships in accordance with industry practice. All significant intercompany balances and transactions have been eliminated. Unless otherwise specified or the context otherwise requires, all references in these notes to “we,” “us” or “our” are to Newfield Exploration Company and its subsidiaries.

These unaudited consolidated financial statements reflect, in the opinion of our management, all adjustments, consisting only of normal and recurring adjustments, necessary to state fairly our financial position as of, and results of operations for, the periods presented. These financial statements have been prepared in accordance with the instructions to Form 10-Q and, therefore, do not include all disclosures required for financial statements prepared in conformity with accounting principles generally accepted in the United States of America. Interim period results are not necessarily indicative of results of operations or cash flows for a full year.

These financial statements and notes should be read in conjunction with our audited consolidated financial statements and the notes thereto included in our annual report on Form 10-K for the year ended December 31, 2005.

***Dependence on Oil and Gas Prices***

As an independent oil and gas producer, our revenue, profitability and future rate of growth are substantially dependent on prevailing prices for natural gas and oil. Historically, the energy markets have been very volatile and it is likely that oil and gas prices will continue to be subject to wide fluctuations in the future. A substantial or extended decline in oil or gas prices could have a material adverse effect on our financial position, results of operations, cash flows and access to capital and on the quantities of oil and gas reserves that we can economically produce.

***Use of Estimates***

The preparation of our consolidated financial statements in accordance with accounting principles generally accepted in the United States of America requires our management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, the reported amounts of revenues and expenses during the reporting period and the reported amounts of proved oil and gas reserves. Actual results could differ from these estimates. Our most significant financial estimates are related to our proved oil and gas reserves.

***Investments***

Investments consist of highly liquid investment grade commercial paper with a maturity of less than six months. These investments are classified as “available-for-sale.” Accordingly, unrealized gains and losses and the related deferred income tax effects are excluded from earnings and reported as a separate component of stockholders’ equity. Realized gains or losses are computed based on specific identification of the securities sold.

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**NEWFIELD EXPLORATION COMPANY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

(Unaudited)

***Insurance Recoveries***

On August 11, 2006, we reached an agreement with our underwriters to settle all claims related to Hurricanes Katrina and Rita (business interruption, property damage and control of well/operator's extra expense) for \$235 million. After adjustments for applicable deductibles and amounts already collected for previously submitted claims, we received net proceeds of \$190 million during the third quarter of 2006. Based on the nature of the coverage provided under the policies, we have recorded a cumulative inception to date credit of \$58 million to other operating expense (of which, credits of \$6 million and \$36 million were recorded during the three and nine months ended September 30, 2006, respectively) for amounts attributable to business interruption coverage; a credit of \$48 million to our domestic full cost pool (all of which was recorded during the three months ended September 30, 2006) for amounts attributable to property damage coverage; and a cumulative \$129 million credit to lease operating expense (of which, credits of \$79 million and \$121 million were recorded during the three and nine months ended September 30, 2006, respectively) for amounts attributable to all other hurricane repair and cleanup related coverage. For the three and nine months ended September 30, 2006, our credit to lease operating expense exceeded our costs incurred to date for hurricane related repair and cleanup costs by approximately \$34 million. We have reflected the cash flows related to the settlement of the property damage portion of our policies as a source of investing cash flows while the cash related to the settlement of our business interruption policy and other control of well/operator's extra expense policies has been reflected as a source of operating cash flows in our consolidated statement of cash flows. All remaining costs expected to be incurred in future periods related to the hurricanes will be accounted for based on the nature of the cost (i.e. capitalized to the extent related to field redevelopment, expensed to the extent related to repair or debris removal).

***Inventories***

Inventories consist primarily of tubular goods and well equipment held for use in our oil and gas operations and oil produced in offshore Malaysia and China but not sold. Inventories are carried at the lower of cost or market. Crude oil from our operations offshore Malaysia and China is produced into floating production, storage and off-loading vessels and sold periodically as barge quantities are accumulated. The product inventory at September 30, 2006 consisted of approximately 220,000 barrels of crude oil valued at cost of \$6 million. Cost for purposes of the carrying value of oil inventory is the sum of production costs and depreciation, depletion and amortization expense.

***Foreign Currency***

The British pound is the functional currency for our operations in the United Kingdom. Translation adjustments resulting from translating our United Kingdom subsidiaries' British pound financial statements into U.S. dollars are included as accumulated other comprehensive income on our consolidated balance sheet and statement of stockholders' equity. The functional currency for all other foreign operations is the U.S. dollar. Gains and losses incurred on currency transactions in other than a country's functional currency are recorded under the caption "Other income (expenses) - Other" on our consolidated statement of income.

***Accounting for Asset Retirement Obligations***

If a reasonable estimate of the fair value of an obligation to perform site reclamation, dismantle facilities or plug and abandon wells can be made, we record a liability (an "asset retirement obligation" or "ARO") on our consolidated balance sheet and capitalize the asset retirement cost in oil and gas properties in the period in which the retirement obligation

is incurred. In general, the amount of an ARO and the costs capitalized will be equal to the estimated future cost to satisfy the abandonment obligation assuming the normal operation of the asset, using current prices that are escalated by an assumed inflation factor up to the estimated settlement date, which is then discounted back to the date that the abandonment obligation was incurred using an assumed cost of funds for our company. After recording these amounts, the ARO is accreted to its future estimated value using the same assumed cost of funds and the additional capitalized costs are depreciated on a unit-of-production basis within the related full cost pool. Both the accretion and the depreciation are included in depreciation, depletion and amortization on our consolidated statement of income.

The change in our ARO for the nine months ended September 30, 2006 is set forth below (in millions):

Balance as of January 1, 2006	\$ 260
Accretion expense	11
Additions	23
Settlements	(22)
Balance as of September 30, 2006	272
Less: Current portion	49
Long-term ARO	\$ 223

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**NEWFIELD EXPLORATION COMPANY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

(Unaudited)

***Stock-Based Compensation***

On January 1, 2006, we adopted SFAS No. 123 (revised 2004), “*Share-Based Payment*,” (SFAS No. 123 (R)) to account for stock-based compensation. Among other items, SFAS No. 123(R) eliminates the use of APB 25 and the intrinsic value method of accounting and requires companies to recognize in their financial statements the cost of services received in exchange for awards of equity instruments based on the grant date fair value of those awards. We elected to use the modified prospective method for adoption, which requires compensation expense to be recorded for all unvested stock options and other equity-based compensation beginning in the first quarter of adoption. For all unvested options outstanding as of January 1, 2006, the previously measured but unrecognized compensation expense, based on the fair value at the original grant date, will be recognized in our financial statements over the remaining vesting period. For equity-based compensation awards granted or modified subsequent to January 1, 2006, compensation expense, based on the fair value on the date of grant or modification, will be recognized in our financial statements over the vesting period. We utilize the Black-Scholes option pricing model to measure the fair value of stock options and a lattice-based model for our performance and market-based restricted shares. Prior to the adoption of SFAS No. 123(R), we followed the intrinsic value method in accordance with APB 25 to account for stock-based compensation. Prior period financial statements have not been restated.

Historically, we have used and we anticipate continuing to use unissued shares of stock when stock options are exercised. At September 30, 2006, we had approximately 2.6 million additional shares available for issuance pursuant to our existing plans. Of the shares available at September 30, 2006, only 1.1 million could be granted as restricted shares. Grants of restricted shares under our 2004 Omnibus Stock Plan reduce the total number of shares available under that plan by two times the number of shares issued.

The modified prospective method requires us to estimate forfeitures in calculating the expense related to stock-based compensation as opposed to our prior policy of recognizing the forfeitures as they occurred. We recorded a cumulative effect gain on a change in accounting principle of \$1 million as a result of the adoption of this standard. Because the amount was immaterial, we included it in general and administrative expense on our consolidated statement of income.

The modified prospective method precludes changes to the grant date fair value of equity awards granted before the required effective date of adoption of SFAS No. 123(R). Any unearned compensation recorded under APB 25 related to these awards is eliminated against the appropriate equity accounts. As a result, upon adoption we eliminated \$34 million of unearned compensation cost and reduced by a like amount additional paid-in capital on our consolidated balance sheet.

For the three and nine months ended September 30, 2006, we recorded stock-based compensation expense of \$7 million (pre-tax) and \$23 million (pre-tax), respectively, for all plans. Of these amounts, \$3 million and \$10 million were capitalized in oil and gas properties for the three and nine months ended September 30, 2006, respectively. The impact to net income of adopting SFAS No. 123(R) for the three and nine months ended September 30, 2006 was \$1 million, or \$0.01 per basic and diluted share and \$4 million, or \$0.03 per basic and diluted share, respectively. SFAS No. 123(R) also requires tax benefits relating to excess stock-based compensation deductions to be prospectively presented in our statement of cash flows as financing cash inflows. Accordingly, for the nine months ended September 30, 2006, we reported \$3 million of excess tax benefits from stock-based compensation as cash provided by financing

activities on our statement of cash flows.

As of September 30, 2006, there was approximately \$64 million of total unrecognized compensation expense related to unvested stock-based compensation. This compensation expense is expected to be recognized on a straight-line basis over the remaining vesting period of approximately five years.

**Stock Options.** We have granted stock options under several plans. Options generally expire ten years from the date of grant and become exercisable at the rate of 20% per year. The exercise price of options cannot be less than the fair market value per share of our common stock on the date of grant.

The fair value of the stock options granted prior to and remaining outstanding at January 1, 2006 was determined using the Black-Scholes option valuation method assuming: no dividends, a weighted average risk-free interest rate of 4.09%, expected life of 6.5 years and a weighted average volatility of 37.52%.

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(Unaudited)

Information about stock option activity for the nine months ended September 30, 2006 is presented below:

	<b>Number of Shares Underlying Options (In millions)</b>	<b>Weighted Average Exercise Price Per Share</b>	<b>Weighted Average Grant Date Fair Value Per Share</b>	<b>Weighted Average Contractual Life in Years</b>	<b>Aggregate Intrinsic Value (In millions) (1)</b>
Outstanding at December 31, 2005	6.5	\$23.60	\$10.64	7.4	\$171
Granted		—			
Exercised	(0.4)	20.87	9.30		(9)
Forfeited	(0.2)	27.98	12.76		(3)
Outstanding at September 30, 2006	5.9	\$23.60	\$10.67	6.6	\$ 88
Exercisable at September 30, 2006	2.8	\$19.67	\$ 8.87	5.4	\$ 52

(1) The intrinsic value of a stock option is the amount by which the current market value of the underlying stock at the indicated date, grant date, exercise date or forfeiture date, as applicable, exceeds the exercise price of the option.

The aggregate intrinsic value of stock options exercised during the three and nine months ended September 30, 2005 was approximately \$13 million and \$41 million, respectively.

Information about stock options outstanding and exercisable at September 30, 2006 is summarized below:

<b>Range of Exercise Prices</b>	<b>Options Outstanding</b>			<b>Options Exercisable</b>	
	<b>Number of Shares Underlying Options</b>	<b>Weighted Average Remaining Contractual Life</b>	<b>Weighted Average Exercise Price</b>	<b>Number of Shares Underlying Options</b>	<b>Weighted Average Exercise Price</b>
\$7.97 to \$10.00	44,000	1.9 years	\$ 8.14	44,000	\$ 8.14
10.01 to 12.50	130,442	1.5 years	11.79	130,442	11.79
12.51 to 15.00	484,075	3.4 years	14.71	469,475	14.72
15.01 to 17.50	1,212,020	5.8 years	16.63	768,720	16.63
17.51 to 22.50	956,660	5.5 years	18.94	625,380	18.99
22.51 to 27.50	921,780	7.4 years	24.75	300,900	24.72
27.51 to 35.00	1,704,600	8.2 years	31.11	353,800	30.78

35.01 to 41.72	388,800	8.6 years	37.92	64,000	38.31
	5,842,377	6.6 years	\$23.60	2,756,717	\$19.67

**Restricted Shares.** At September 30, 2006, our employees held 0.6 million restricted shares that primarily vest equally over the service period of five years. The vesting of these shares is dependant upon the employees continued service with our company.

At September 30, 2006, 1.6 million restricted shares subject to performance-based vesting criteria (substantially all of which are considered market-based restricted shares under SFAS No. 123(R)) were outstanding. In February 2006, 974,000 restricted performance-based shares were granted to employees. The number of shares that vests is based upon established performance targets that will be assessed on March 1, 2009. The grant date fair value of these shares was \$23.20 per share for a total value of \$23 million. The expense will be recognized ratably over the service period from February 2006 to March 2009. Under the grants to our executive officers, they are permitted to retire on or after March 1, 2008, if certain other conditions are met, without forfeiting the shares granted. To the extent that our executive officers qualify for retirement based upon this provision, the expense will be recognized ratably over the service period from February 2006 to the applicable retirement eligibility date. Substantially all of the remaining performance-based shares may vest in whole or in part in 2008, 2009 and 2010. The percentage of the shares vesting, if any, in each respective year is subject to the achievement of the targets identified in the respective restricted share agreements.

**Table of Contents****NEWFIELD EXPLORATION COMPANY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

(Unaudited)

Under our non-employee director restricted stock plan, immediately after each annual meeting of our stockholders, each of our nonemployee directors then in office receives a number of restricted shares determined by dividing \$75,000 by the fair market value of one share of our common stock on the date of the annual meeting. In addition, new directors elected after an annual meeting receive a number of restricted shares determined by dividing \$75,000 by the fair market value of one share of our common stock on the date of their election. The forfeiture restrictions lapse on the day before the first annual meeting of stockholders following the date of issuance of the shares if the holder remains a director until that time. At September 30, 2006, 109,913 shares remained available for grants under the plan.

Information about the restricted shares granted during the nine months ended September 30, 2006 and the change in the number of outstanding restricted shares during that period is presented below:

	<b>Service-Based</b>	<b>Performance/ Market-Based</b>	<b>Total</b>
	<b>(In thousands, except per share data)</b>		
Non-vested shares outstanding at December 31, 2005	549	801	1,350
Granted	117	974	1,091
Forfeited	(22)	(25)	(47)
Vested	(48)	(169)	(217)
Non-vested shares outstanding at September 30, 2006	596	1,581	2,177
Weighted average grant date fair value of shares granted during the period	\$44.48	\$23.20	\$25.52
Total fair value of shares vesting during the period	\$ 943	\$2,821	\$3,764

**Employee Stock Purchase Plan.** Pursuant to our employee stock purchase plan, for each six month period beginning on January 1 or July 1 during the term of the plan, each eligible employee has the opportunity to purchase our common stock for a purchase price equal to 85% of the lesser of the fair market value of our common stock on the first day of the period or the last day of the period. No employee may purchase common stock under the plan valued at more than \$25,000 in any calendar year. Employees of our foreign subsidiaries are not eligible to participate in the plan.

During 2006, options to purchase 51,046 shares of our common stock at a weighted average fair value of \$13.34 per share were issued under the plan. The fair value of the options granted since January 1, 2006 was determined using the Black-Scholes option valuation method assuming: no dividends, a risk-free weighted-average interest rate of 4.83%, expected life of 6 months and weighted-average volatility of 40.02%. At September 30, 2006, 686,501 shares of our common stock remained available for issuance pursuant to the plan.

**U.K. Bonus Plan.** We have a cash bonus plan for the employees of our U.K. North Sea operations. The value of the bonus is determined based on the value of the shares of our U.K. subsidiary as determined by our Board of Directors. This plan is accounted for as a liability plan under SFAS No. 123(R) and is not material to our financial statements.

***Pro forma Disclosures.*** Prior to January 1, 2006, we accounted for our employee stock-based compensation using the intrinsic value method prescribed by APB 25. As required by SFAS No. 123(R), we have disclosed below the effect on net income and earnings per share that would have been recorded using the fair value based method for the three and nine months ended September 30, 2005. The weighted average fair value of the options granted in the first nine months of 2005 was determined using the Black-Scholes option valuation method assuming: no dividends, a weighted average risk-free interest rate of 3.87%, expected life of 6.5 years and weighted average volatility of 37.50%.

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**Table of Contents****NEWFIELD EXPLORATION COMPANY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**  
(Unaudited)

	<b>Three Months Ended September 30, 2005</b>	<b>Nine Months Ended September 30, 2005</b>
	<b>(In millions, except per share data)</b>	
Net income:		
As reported <sup>(1)</sup>	\$	\$ 164
Pro forma <sup>(2)</sup>	(3)	157
Basic earnings per common share —		
As reported	\$	\$1.31
Pro forma	(0.02)	1.25
Diluted earnings per common share —		
As reported	\$	\$1.29
Pro forma	(0.02)	1.23

(1) Includes stock-based compensation costs (net of related tax effects) of \$1 million for the three months ended September 30, 2005 and \$3 million for the nine months ended September 30, 2005.

(2) Includes stock-based compensation costs (net of related tax effects) that would have been included in the determination of net income had the fair value based method been applied of \$4 million for the three months ended September 30, 2005 and \$10 million for the nine months ended September 30, 2005.

***New Accounting Developments***

In July 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FAS 109" (Interpretation No. 48). Interpretation No. 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken in a tax return. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. Interpretation No. 48 is effective for fiscal years beginning after December 15, 2006. Earlier application is encouraged if the company has not yet issued financial statements, including interim financial statements, in the period Interpretation No. 48 is adopted. We are reviewing the interpretation and analyzing the potential impact, if any, of this new guidance.

In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R)." SFAS No. 158 requires recognition of the funded status of a benefit plan on the balance sheet and the recognition through other comprehensive income of gains, losses, prior service costs and credits, net of tax, arising during the period but not included as a component of periodic benefit cost. In addition, the measurement date of plan assets and obligations must be as of the balance sheet date. Additional disclosures in the notes to the financial statements will also be required and guidance is prescribed regarding the selection of discount rates to be used in measuring the benefit obligation. The effective date of SFAS No. 158 is as of the end of the fiscal year ending after December 15, 2006. We do not believe that our financial position, results of operations or cash flows will be significantly impacted by SFAS No. 158.

**2. Earnings Per Share:**

Basic earnings per share (EPS) is calculated by dividing net income (the numerator) by the weighted average number of shares of common stock (other than unvested restricted shares) outstanding during the period (the denominator). Diluted earnings per share incorporates the dilutive impact of outstanding stock options and unvested restricted shares (using the treasury stock method).

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**Table of Contents****NEWFIELD EXPLORATION COMPANY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

(Unaudited)

The following is the calculation of basic and diluted weighted average shares outstanding and EPS for the indicated periods:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2006	2005	2006	2005
	(In millions, except per share data)			
Income (numerator):				
Net income — basic	\$ 266	\$	\$ 509	\$ 164
Net income — diluted	\$ 266	\$	\$ 509	\$ 164
Weighted average shares (denominator):				
Weighted average shares — basic	126	126	127	125
Dilution effect of stock options and unvested restricted shares outstanding at end of period	3		2	3
Weighted average shares — diluted	129	126	129	128
Earnings per share:				
Basic	\$ 2.10	\$	\$ 4.02	\$ 1.31
Diluted	\$ 2.06	\$	\$ 3.95	\$ 1.29

The calculation of shares outstanding for diluted EPS does not include the effect of outstanding stock options to purchase 0.2 million shares for the nine months ended September 30, 2005 because to do so would have been antidilutive. There were no antidilutive shares for the three months ended September 30, 2005 and the three and nine months ended September 30, 2006.

**3. Oil and Gas Assets:*****Oil and Gas Properties***

Oil and gas properties consisted of the following at:

	September 30,	December 31,
	2006	2005
	(In millions)	
Subject to amortization	\$ 7,327	\$ 6,141
Not subject to amortization:		
Exploration wells in progress	74	56
Development wells in progress	138	107
Capitalized interest	89	71
Fee mineral interests	23	23
Other capital costs:		
Incurring in 2006	88	—
Incurring in 2005	102	110

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Incurring in 2004	393	413
Incurring in 2003 and prior	92	121
Total not subject to amortization	999	901
Gross oil and gas properties	8,326	7,042
Accumulated depreciation, depletion and amortization	(3,054)	(2,632)
Net oil and gas properties	\$ 5,272	\$ 4,410

We believe that substantially all of the properties associated with costs not currently subject to amortization will be evaluated within four years except the Monument Butte Field. Because of its size, evaluation of the Monument Butte Field in its entirety will take significantly longer than four years. At September 30, 2006 and December 31, 2005, \$307 million and \$316 million, respectively, of costs associated with the Monument Butte Field were not subject to amortization.



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**NEWFIELD EXPLORATION COMPANY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

(Unaudited)

We use the full cost method of accounting for our oil and gas producing activities. Under this method, all costs incurred in the acquisition, exploration and development of oil and gas properties, including salaries, benefits and other internal costs directly attributable to these activities, are capitalized into cost centers that are established on a country-by-country basis.

Capitalized costs and estimated future development and retirement costs are amortized on a unit-of-production method based on proved reserves associated with the applicable cost center. For each cost center, the net capitalized costs of oil and gas properties are limited to the lower of the unamortized cost or the cost center ceiling. A particular cost center ceiling is equal to the sum of:

• the present value (10% per annum discount rate) of estimated future net revenues from proved reserves (based on end of period oil and gas prices as adjusted for location and quality differences and the effects of hedging); plus

• the lower of cost or estimated fair value of properties not included in the costs being amortized, if any; less

• related income tax effects.

Proceeds from the sale of oil and gas properties are applied to reduce the costs in the applicable cost center unless the sale involves a significant quantity of reserves in relation to the cost center, in which case a gain or loss is recognized.

If net capitalized costs of oil and gas properties exceed the cost center ceiling, we are subject to a ceiling test writedown to the extent of such excess. A ceiling test writedown is a charge to earnings. If required, it would reduce earnings and impact stockholders' equity in the period of occurrence and result in lower depreciation, depletion and amortization expense in future periods.

The risk that we will be required to writedown the carrying value of our oil and gas properties increases when oil and gas prices decrease significantly or if we have substantial downward revisions in our estimated proved reserves. At September 30, 2006, the ceiling value of our reserves was calculated based upon quoted market prices of \$4.18 per MMBtu for gas and \$62.82 per barrel for oil, adjusted for market differentials. Using these prices, the unamortized net capitalized costs of our domestic oil and gas properties would have exceeded the ceiling amount by approximately \$180 million (net of tax) at September 30, 2006. Cash flow hedges of oil and gas production in place at September 30, 2006 decreased the calculated ceiling value by approximately \$10 million (net of tax). However, subsequent to quarter end, the market price for gas (Gas Daily – Henry Hub) increased to \$7.92 per MMBtu and the price for oil (Platt's – WTI at Cushing) decreased to \$60.18 per barrel on October 27, 2006, and utilizing these prices, the unamortized costs of our oil and gas properties would not have exceeded the ceiling amount. As a result, we did not record a writedown in the third quarter of 2006. The ceiling value calculated using the October 27, 2006 prices includes approximately \$11 million (net of tax) related to the negative effects of future cash flow hedges of oil and gas production.

In September 2006, we decided to discontinue our operations in Brazil. As a result, we recognized a ceiling test writedown of \$6 million for our Brazil cost center in the third quarter of 2006.

***U.K. Southern Gas Basin - Sale Agreement***

In September 2006, we, through our wholly owned subsidiary, Newfield Petroleum U.K. Limited, announced a sales agreement with Sojitz Energy Project Limited, a wholly owned subsidiary of Sojitz Corporation, relating to our Southern Gas Basin exploration and development program. The proceeds from this sale were \$30 million and have been recorded as an adjustment to our U.K. cost center.

Under the agreement, Sojitz will participate in the ongoing development of our Grove Field and earn an interest in our West Cutter Prospect, the Seven Seas Discovery and two wells planned in the West Sole Area under our existing Exploration and Development Agreement with BP Exploration Operating Company Limited by participating in our 2007 exploration and appraisal drilling program.

**Table of Contents****NEWFIELD EXPLORATION COMPANY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**  
(Unaudited)**4. Debt:**

As of the indicated dates, our long-term debt consisted of the following:

	September 30, 2006	December 31, 2005
	(In millions)	
Senior unsecured debt:		
Bank revolving credit facility:		
Prime rate based loans	\$ —	\$ —
LIBOR based loans	—	—
Total bank revolving credit facility	—	—
7.45% Senior Notes due 2007	125	125
Fair value of interest rate swaps <sup>(1)</sup>	(2)	(2)
7 5/8% Senior Notes due 2011	175	175
Fair value of interest rate swaps <sup>(1)</sup>	(2)	(2)
Total senior unsecured notes	296	296
Total senior unsecured debt	296	296
8 3/8% Senior Subordinated Notes due 2012	—	249
6 5/8% Senior Subordinated Notes due 2014	325	325
6 5/8% Senior Subordinated Notes due 2016	550	—
Total long-term debt	\$ 1,171	\$ 870

(1) We have hedged \$50 million principal amount of our 7.45% Senior Notes due 2007 and \$50 million principal amount of our 7 5/8% Senior Notes due 2011. The hedges provide for us to pay variable and receive fixed interest payments.

***Senior Subordinated Notes***

On April 13, 2006, we sold \$550 million principal amount of our 6 5/8% Senior Subordinated Notes due 2016. The notes are unsecured senior subordinated obligations that rank junior in right of payment to all of our present and future senior indebtedness, equally in right of payment to our outstanding 6 5/8% Senior Subordinated Notes due 2014, and senior to all of our future indebtedness that is expressly subordinated to the notes. We may redeem some or all of the notes at any time on or after April 15, 2011 at a redemption price stated in the indenture governing the notes. Prior to April 15, 2011, we may redeem all, but not part, of the notes at a redemption price based on a makewhole amount plus accrued and unpaid interest to the date of redemption. In addition, before April 15, 2009, we may redeem up to 35% of the original principal amount of the notes with the net cash proceeds of certain sales of our common stock at 106.625% of the principal amount plus accrued and unpaid interest to the date of redemption. Like the indenture governing our other senior subordinated notes, these notes may limit our ability under certain circumstances to incur

additional debt, make restricted payments, pay dividends on or redeem our capital stock, make certain investments, create liens, make certain dispositions of assets, engage in transactions with affiliates and engage in mergers, consolidations and certain sales of assets.

On May 3, 2006, we redeemed all \$250 million principal amount of our 8 3/8% Senior Subordinated Notes due 2012. The redemption included a premium related to the early extinguishment of the notes of \$19 million. This premium and the remaining unamortized original issuance costs of the notes of \$8 million were recorded as an expense under the caption "Operating expenses - Other" on our consolidated statement of income.

**Table of Contents****NEWFIELD EXPLORATION COMPANY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)****(Unaudited)*****Credit Arrangements***

In December 2005, we entered into a revolving credit facility that matures in December 2010. The terms of our credit facility provide for initial loan commitments of \$1 billion from a syndicate of banks, led by JPMorgan Chase as the agent bank. The loan commitments under the credit facility may be increased to a maximum aggregate amount of \$1.5 billion if the lenders increase their loan commitments or new financial institutions are added to our credit facility. Loans under the credit facility bear interest, at our option, based on (a) a rate per annum equal to the higher of the prime rate announced from time to time by JPMorgan Chase Bank or the weighted average of the rates on overnight federal funds transactions with members of the Federal Reserve System during the last preceding business day plus 50 basis points or (b) a base Eurodollar rate substantially equal to the London Interbank Offered Rate, plus a margin that is based on a grid of our debt rating (100 basis points per annum at September 30, 2006). At September 30, 2006, we had no borrowings under our credit facility.

The credit facility has restrictive covenants that include the maintenance of a ratio of total debt to book capitalization not to exceed 0.6 to 1.0; maintenance of a ratio of total debt to earnings before gain or loss on the disposition of assets, interest expense, income taxes, depreciation, depletion and amortization expense, exploration and abandonment expense and other noncash charges and expenses to consolidated interest expense of at least 3.5 to 1.0; and as long as our debt rating is below investment grade, the maintenance of an annual ratio of the calculated net present value of our oil and gas properties to total debt of at least 1.75 to 1.00.

As of September 30, 2006, we had \$58 million of undrawn letters of credit under our credit facility. We also have a total of \$110 million of borrowing capacity under money market lines of credit with various banks. At September 30, 2006, we had no borrowings under our money market lines.

**5. Commitments and Contingencies:*****Lease Commitments***

We have various commitments under non-cancellable operating lease agreements for office space, equipment and drilling rigs. The majority of these commitments are related to multi-year contracts for drilling rigs. Future minimum payments required under our operating leases as of September 30, 2006 are as follows (in millions):

2006	\$ 18
2007	49
2008	38
2009	14
2010	4
Thereafter	18
Total minimum lease payments	\$ 141

***Other Commitments***

As is common in the oil and gas industry, we have various contractual commitments pertaining to exploration, development and production activities. We have work related commitments for, among other things, drilling wells, obtaining and processing seismic data and fulfilling other cash commitments. At September 30, 2006, these work related commitments totaled \$364 million and were comprised of \$256 million in the United States and \$108 million internationally.

***Litigation***

We have been named as a defendant in a number of lawsuits arising in the ordinary course of our business. While the outcome of these lawsuits cannot be predicted with certainty, we do not expect that these matters will have a material adverse effect on our financial position, cash flows or results of operations.

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## NEWFIELD EXPLORATION COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

(Unaudited)

**6. Segment Information:**

While we only have operations in the oil and gas exploration and production industry, we are organizationally structured along geographic operating segments. Our operating segments are the United States, the United Kingdom, Malaysia, China and Other International. The accounting policies of each of our operating segments are the same as those described in Note 1, "Organization and Summary of Significant Accounting Policies."

The following tables provide the geographic operating segment information required by SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information," as well as results of operations of oil and gas producing activities required by SFAS No. 69, "Disclosures about Oil and Gas Producing Activities," as of and for the three and nine months ended September 30, 2006 and 2005. Income tax allocations have been determined based on statutory rates in the applicable geographic segment.

	United States	United Kingdom	Malaysia	China	Other International	Total
	(In millions)					
<b><u>Three Months Ended September 30, 2006:</u></b>						
Oil and gas revenues	\$ 410	\$ —	\$ 13	\$ 2	\$ —	\$ 425
Operating expenses:						
Lease operating	33	—	3	—	—	36
Production and other taxes	10	—	2	—	—	12
Depreciation, depletion and amortization	156	—	2	1	—	159
Ceiling test writedown	—	—	—	—	6	6
General and administrative	31	1	2	—	—	34
Other	(6)	—	—	—	—	(6)
Allocated income taxes	67	—	2	—	—	
Net income (loss) from oil and gas properties	\$ 119	\$ (1)	\$ 2	\$ 1	\$ (6)	
Total operating expenses						241
Income from operations						184
Interest expense, net of interest income, capitalized interest and other						(10)
Commodity derivative income						247
Income before income taxes						\$ 421
Total long-lived assets	\$ 4,891	\$ 182	\$ 134	\$ 64	\$ 1	\$ 5,272

Additions to long-lived assets	\$	404	\$	65	\$	19	\$	7	\$	—	\$	495
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**NEWFIELD EXPLORATION COMPANY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**  
**(Unaudited)**

	<b>United States</b>	<b>United Kingdom</b>	<b>Malaysia</b>	<b>China</b>	<b>Other International</b>	<b>Total</b>
	<b>(In millions)</b>					
<b><u>Three Months Ended September</u></b>						
<b><u>30, 2005:</u></b>						
Oil and gas revenues	\$ 441	\$ —	\$ 19	\$ —	\$ —	\$ 460