

SUNOCO INC  
Form 10-Q  
November 01, 2007  
Table of Contents

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**  
**FORM 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended September 30, 2007

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-6841

**SUNOCO, INC.**

(Exact name of registrant as specified in its charter)

**PENNSYLVANIA**  
(State or other jurisdiction of incorporation  
or organization)

**23-1743282**  
(I.R.S. Employer

Identification No.)

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

(Address of principal executive offices)

(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)

## Edgar Filing: SUNOCO INC - Form 10-Q

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 September 30, 2007, there were 117,582,200 shares of Common Stock, \$1 par value outstanding.

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**Table of Contents**

SUNOCO, INC.

INDEX

	<b>Page No.</b>
<b><u>PART I. FINANCIAL INFORMATION</u></b>	
Item 1. <u>Financial Statements</u> (Unaudited)	
<u>Condensed Consolidated Statements of Income for the Nine Months Ended September 30, 2007 and 2006</u>	1
<u>Condensed Consolidated Statements of Income for the Three Months Ended September 30, 2007 and 2006</u>	2
<u>Condensed Consolidated Balance Sheets at September 30, 2007 and December 31, 2006</u>	3
<u>Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2007 and 2006</u>	4
<u>Notes to Condensed Consolidated Financial Statements</u>	5
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	21
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	36
Item 4. <u>Controls and Procedures</u>	36
<b><u>PART II. OTHER INFORMATION</u></b>	
Item 1. <u>Legal Proceedings</u>	36
Item 1A. <u>Risk Factors</u>	38
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	38
Item 6. <u>Exhibits</u>	38
<u>SIGNATURE</u>	40

**Table of Contents**

## PART I.

## FINANCIAL INFORMATION

**Item 1. Financial Statements (Unaudited)**  
CONDENSED CONSOLIDATED STATEMENTS OF INCOME

Sunoco, Inc. and Subsidiaries

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

	<b>For the Nine Months</b>	
	<b>Ended September 30</b>	
	<b>2007</b>	<b>2006</b>
	<b>(UNAUDITED)</b>	
<b>REVENUES</b>		
Sales and other operating revenue (including consumer excise taxes)	\$ 31,334	\$ 29,624
Interest income	16	29
Other income, net (Notes 2 and 3)	216	26
	31,566	29,679
<b>COSTS AND EXPENSES</b>		
Cost of products sold and operating expenses	26,931	25,179
Consumer excise taxes	1,983	1,970
Selling, general and administrative expenses (Note 2)	678	635
Depreciation, depletion and amortization	355	341
Payroll, property and other taxes	103	98
Interest cost and debt expense	96	78
Interest capitalized	(19)	(10)
	30,127	28,291
Income before income tax expense	1,439	1,388
Income tax expense (Note 4)	539	532
<b>NET INCOME</b>	<b>\$ 900</b>	<b>\$ 856</b>
Earnings per share of common stock:		
Basic	\$ 7.48	\$ 6.56
Diluted	\$ 7.46	\$ 6.53
Weighted-average number of shares outstanding (Notes 5 and 9):		
Basic	120.4	130.4
Diluted	120.7	131.1
Cash dividends paid per share of common stock (Note 9)	\$ .80	\$ .70

(See Accompanying Notes)

**Table of Contents**

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME

Sunoco, Inc. and Subsidiaries

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

	<b>For the Three Months</b>	
	<b>Ended September 30</b>	
	<b>2007</b>	<b>2006</b>
	<b>(UNAUDITED)</b>	
<b>REVENUES</b>		
Sales and other operating revenue (including consumer excise taxes)	\$ 11,475	\$ 10,480
Interest income	7	11
Other income, net (Notes 2 and 3)	15	5
	11,497	10,496
<b>COSTS AND EXPENSES</b>		
Cost of products sold and operating expenses	10,078	8,867
Consumer excise taxes	673	679
Selling, general and administrative expenses (Note 2)	221	215
Depreciation, depletion and amortization	123	115
Payroll, property and other taxes	36	33
Interest cost and debt expense	29	25
Interest capitalized	(5)	(5)
	11,155	9,929
Income before income tax expense	342	567
Income tax expense (Note 4)	126	216
<b>NET INCOME</b>	<b>\$ 216</b>	<b>\$ 351</b>
Earnings per share of common stock:		
Basic	\$ 1.82	\$ 2.77
Diluted	\$ 1.81	\$ 2.76
Weighted-average number of shares outstanding (Notes 5 and 9):		
Basic	119.0	126.8
Diluted	119.2	127.4
Cash dividends paid per share of common stock (Note 9)	\$ .275	\$ .25

(See Accompanying Notes)

**Table of Contents**

## CONDENSED CONSOLIDATED BALANCE SHEETS

Sunoco, Inc. and Subsidiaries

(Millions of Dollars)

	At September 30 2007 (UNAUDITED)	At December 31 2006
<b>ASSETS</b>		
Current Assets		
Cash and cash equivalents	\$ 263	\$ 263
Accounts and notes receivable, net	2,625	2,440
Inventories:		
Crude oil	555	325
Petroleum and chemical products	731	735
Materials, supplies and other	159	159
Deferred income taxes (Note 4)	93	93
Total Current Assets	4,426	4,015
Investments and long-term receivables	134	129
Properties, plants and equipment	11,272	10,540
Less accumulated depreciation, depletion and amortization	4,393	4,175
Properties, plants and equipment, net	6,879	6,365
Deferred charges and other assets	567	473
Total Assets	\$ 12,006	\$ 10,982
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current Liabilities		
Accounts payable	\$ 4,157	\$ 3,615
Accrued liabilities (Note 6)	508	559
Short-term borrowings	250	275
Current portion of long-term debt	4	7
Taxes payable	277	299
Total Current Liabilities	5,196	4,755
Long-term debt	1,785	1,705
Retirement benefit liabilities (Note 8)	529	523
Deferred income taxes (Note 4)	955	829
Other deferred credits and liabilities (Note 6)	530	477
Commitments and contingent liabilities (Note 6)		
Minority interests (Note 2)	445	618
Shareholders' equity (Note 9)	2,566	2,075
Total Liabilities and Shareholders' Equity	\$ 12,006	\$ 10,982

(See Accompanying Notes)

**Table of Contents**

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

Sunoco, Inc. and Subsidiaries

(Millions of Dollars)

	<b>For the Nine Months</b>	
	<b>Ended September 30</b>	
	<b>2007</b>	<b>2006</b>
	<b>(UNAUDITED)</b>	
<b>INCREASES (DECREASES) IN CASH AND CASH EQUIVALENTS</b>		
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 900	\$ 856
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain related to issuance of Sunoco Logistics Partners L.P. limited partnership units (Note 2)	(151)	
Phenol supply contract dispute payment (Note 3)		(95)
Depreciation, depletion and amortization	355	341
Deferred income tax expense	153	74
Payments in excess of expense for retirement plans	(49)	(50)
Changes in working capital pertaining to operating activities, net of effect of acquisitions:		
Accounts and notes receivable	(253)	(462)
Inventories	(226)	(480)
Accounts payable and accrued liabilities	495	513
Taxes payable	7	33
Other	26	2
Net cash provided by operating activities	1,257	732
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Capital expenditures	(876)	(675)
Acquisitions (Note 3)		(123)
Proceeds from divestments (Note 3)	46	39
Other	(30)	4
Net cash used in investing activities	(860)	(755)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net proceeds from (repayments of) short-term borrowings	(25)	150
Net proceeds from issuance of long-term debt	244	361
Repayments of long-term debt	(167)	(426)
Net proceeds from issuance of Sunoco Logistics Partners L.P. limited partnership units (Note 2)		110
Cash distributions to investors in cokemaking operations	(19)	(13)
Cash distributions to investors in Sunoco Logistics Partners L.P.	(41)	(35)
Cash dividend payments	(97)	(92)
Purchases of common stock for treasury	(300)	(734)
Proceeds from issuance of common stock under management incentive plans	6	1
Other	2	
Net cash used in financing activities	(397)	(678)
Net decrease in cash and cash equivalents		(701)
Cash and cash equivalents at beginning of period	263	919

Cash and cash equivalents at end of period	\$ 263	\$ 218
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(See Accompanying Notes)

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**Table of Contents**

**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, except for the gain related to Sunoco Logistics Partners L.P.'s prior issuance of limited partnership units, the charge related to the correction of an error in the computation of the preferential return of third-party investors in Sunoco's cokemaking operations and gains related to income tax matters (Notes 2 and 4). Results for the three and nine months ended September 30, 2007 are not necessarily indicative of results for the full-year 2007.

2. Minority Interests.

Cokemaking Operations

Sunoco received a total of \$309 million in exchange for interests in its Jewell cokemaking operations in two separate transactions in 1995 and 2000. Sunoco also received a total of \$415 million in exchange for interests in its Indiana Harbor cokemaking operations in two separate transactions in 1998 and 2002. Sunoco did not recognize any gain as of the dates of these transactions because the third-party investors were entitled to a preferential return on their respective investments.

In December 2006, Sunoco acquired the limited partnership interest of the third-party investor in the Jewell cokemaking operation for \$155 million. As a result, such third-party investor is no longer entitled to any preferential or residual return in this operation.

The returns of the investors in the Indiana Harbor cokemaking operations are currently equal to 98 percent of the cash flows and tax benefits from such cokemaking operations during the preferential return period, which continues until the investor entitled to the preferential return recovers its investment and achieves a cumulative annual after-tax return of approximately 10 percent. The preferential return period for the Indiana Harbor operations is projected to end no later than the first quarter of 2008. The accuracy of this estimate is somewhat uncertain as the length of the preferential return period is dependent upon estimated future cash flows as well as projected tax benefits which could be impacted by their potential phase-out (see below). Lower-than-expected cash flows and tax benefits could lengthen the investor's preferential return period. After payment of the preferential return, the investors in the Indiana Harbor operations will be entitled to a minority interest in the related cash flows and tax benefits initially amounting to 34 percent and thereafter declining to 10 percent by 2038.

Under existing tax law, most of the coke production at Jewell and all of the production at Indiana Harbor are not eligible to generate nonconventional fuel tax credits after 2007. In addition, during 2007 such 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 \$55.06 to \$69.12 per barrel for 2006, the latest year for which the range is available.) The domestic wellhead price averaged \$59.21 per barrel for the eight months ended August 31, 2007, \$67.78 per barrel for the month of August 2007 and \$59.69 per barrel for the year ended December 31, 2006. The corresponding prices for West Texas Intermediate

**Table of Contents**

( WTI ) crude oil, a widely published reference price for domestic crude oil, were \$64.55 per barrel for the eight months ended August 31, 2007, \$72.36 per barrel for the month of August 2007 and \$66.22 per barrel for the year ended December 31, 2006. Based upon the Company's estimate of domestic wellhead prices for the first nine months of 2007, the Company recorded 70 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 nine months of 2007 by \$6 million after tax. During the first nine months of 2006, a partial phase-out of the tax credits resulting from the high level of crude oil prices reduced earnings by \$10 million after tax during that period. The ultimate amount of the credits to be earned for 2007 will be based upon the average annual price of domestic crude oil at the wellhead.

The Company indemnifies the third-party investors (including the former investor in the Jewell cokemaking operations) 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 remaining third-party investors' interests. Although the Company believes the possibility is remote that it will be required to do so, at September 30, 2007, the maximum potential payment under these tax indemnifications would have been approximately \$280 million.

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):

	Nine Months Ended	
	September 30 2007	2006
Balance at beginning of year	\$ 102	\$ 234
Nonconventional fuel credit and other tax benefits*	(16)	(28)
Preferential return*	16	40
Cash distributions to third-party investors	(19)	(13)
Balance at end of period	\$ 83	\$ 233

\* 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. The preferential return for the nine months ended September 30, 2006 includes an \$11 million increase (\$7 million after tax) attributable to a correction of an error in the computation of the preferential return relating to prior years. Prior-period amounts have not been restated as this adjustment was not deemed to be material.

#### Logistics Operations

In the second quarter of 2006, Sunoco Logistics Partners L.P. (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 these offerings, net of underwriting discounts and offering expenses, totaled approximately \$173 and \$110 million, respectively. These proceeds were used

**Table of Contents**

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 offering, 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 September 30, 2007 and December 31, 2006, Sunoco owned 12.06 million limited partnership units. At December 31, 2006, this ownership interest consisted of 6.37 million common units and 5.69 million subordinated units. Distributions on Sunoco's subordinated units were payable only after the minimum quarterly distributions of \$.45 per unit for the common units held by the public and Sunoco, including any arrearages, had been made. The subordinated units were convertible to common units if certain financial tests related to earning and paying the minimum quarterly distribution for the preceding three consecutive one-year periods had been met. In February 2007, 2006 and 2005, when the quarterly cash distributions pertaining to the fourth quarters of 2006, 2005 and 2004 were paid, all three three-year requirements were satisfied. As a result, all of Sunoco's subordinated units have been converted to common units, 5.69 million in February 2007 and 2.85 million each in February 2006 and February 2005.

The Partnership's prior issuance of common units to the public 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. Prior to February 2007, the resultant gain to Sunoco on these transactions had been deferred as a component of minority interest in the Company's condensed consolidated balance sheets as the common units issued did not represent residual interests in the Partnership due to Sunoco's ownership of the subordinated units. The deferred gain, which amounted to \$151 million (\$90 million after tax), was recognized in income in the first quarter of 2007 when Sunoco's remaining subordinated units converted to common units at which time the common units became residual interests. Any gain or loss resulting from the Partnership's future issuance of common units to the public would be recognized in income at the time of the transaction.

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):

	Nine Months Ended	
	September 30 2007	2006
Balance at beginning of year	\$ 503	\$ 397
Gain recognized in income related to prior issuance of the Partnership's limited partnership units	(151)	
Net proceeds from public equity offering		110
Minority interest share of income*	40	29
Increase attributable to Partnership management incentive plan	2	1
Cash distributions to third-party investors**	(41)	(35)
<b>Balance at end of period</b>	<b>\$ 353</b>	<b>\$ 502</b>

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

\*\* During 2006 and the first nine months of 2007, the Partnership increased its quarterly cash distribution per unit from \$.7125 to \$.85.

**Table of Contents**

## 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. Epsilon was unable to repay its \$120 million term loan that was due in September 2006 and \$31 million of borrowings under its \$40 million revolving credit facility that matured in September 2006. Upon such default, the lenders made a demand on Sunoco, Inc., as guarantor, and Sunoco, Inc. satisfied its guarantee obligations in the third quarter of 2006. Sunoco, Inc. is now subrogated to the rights and privileges of the former debtholders. In January 2007, Sunoco, Inc., as subrogee, made a demand for payment of the outstanding amounts, but Epsilon was unable to make payment. Sunoco, Inc., Epsilon and the Epsilon joint-venture partners are currently in litigation to resolve this matter.

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):

	Nine Months Ended September 30	
	2007	2006
Balance at beginning of year	\$ 13	\$ 16
Minority interest share of loss*	(4)	(2)
Balance at end of period	\$ 9	\$ 14

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

## 3. Changes in Business and Other Matters.

## Acquisitions

**Logistics Assets** In August 2006, the Partnership purchased from Sunoco for \$65 million a company that has a 55 percent interest in Mid-Valley Pipeline Company ( Mid-Valley ), a joint venture which owns a crude oil pipeline system in the Midwest. 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. for \$68 million. The Black Hills acquisition also includes a lease acquisition marketing business and related inventory.

The purchase prices of these acquisitions have been included in properties, plants and equipment in the condensed consolidated balance sheets (except for \$2 million allocated to inventories related to the Black Hills acquisition). 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** Since the beginning of 2004, Sunoco has generated \$234 million of divestment proceeds related to the sale of 367 sites under a Retail Portfolio Management ( RPM ) program to selectively reduce the Company's invested capital in Company-owned or leased retail sites. Most of these sites were converted to contract dealers or

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**Table of Contents**

distributors thereby retaining most of the gasoline sales volume attributable to the divested sites within the Sunoco branded business. During the first nine months of 2007 and 2006, net gains of \$27 and \$13 million, respectively (\$17 and \$8 million after tax, respectively), were recognized in other income, net, in the condensed consolidated statements of income in connection with the RPM program.

**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 finalized pricing for 2005 and beyond under provisions of a 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. Such damages, which were paid to Honeywell in April 2006, were recorded as a charge against earnings in 2005. 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. The prices charged to Honeywell during 2006 and the first nine months of 2007 have been based on this formula.

**4. Income Tax Matters.**

Effective January 1, 2007, the Company adopted FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 ( FASB Interpretation No. 48 ). This interpretation 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. As a result of the implementation of FASB Interpretation No. 48, the Company recorded a \$12 million reduction in retained earnings at January 1, 2007 to recognize the cumulative effect of the adoption of this standard. As of September 30, 2007, unrecognized tax benefits amounted to \$35 million and are included in other deferred credits and liabilities in the condensed consolidated balance sheet. Included in this balance is \$27 million related to tax positions which, if recognized, would impact the Company's effective tax rate.

The Company recognizes interest related to unrecognized tax benefits in interest cost and debt expense and penalties in income tax expense in the condensed consolidated statements of income. During the first nine months of 2007, the Company recognized \$3 million in interest on unrecognized tax benefits. Accruals for interest and penalties totaled \$16 million at September 30, 2007, which are included in other deferred credits and liabilities in the condensed consolidated balance sheet.

The Company's federal income tax returns are closed through the tax year 2002 and there are no outstanding tax controversies other than whether the Company is entitled to interest on previously overpaid taxes. The Internal Revenue Service is currently examining the Company's 2003 and 2004 tax years. State and other income tax returns are generally subject to examination for a period of three to five years after the filing of the respective returns. The state impact of any amended federal returns remains

**Table of Contents**

subject to examination by various states for a period of up to one year after formal notification of such amendments to the states. The Company and its subsidiaries have various state and other income tax returns in the process of examination or administrative appeal. The Company does not expect that any unrecognized tax benefits will significantly increase or decrease in the next twelve months.

During the third quarter of 2006, Sunoco recorded a \$5 million net after-tax gain consisting of a \$12 million deferred tax benefit as a result of state law changes and a \$7 million net provision, primarily attributable to an increase in state income taxes reflecting the impact of an unfavorable court decision against an unrelated taxpayer. In the second quarter of 2006, Sunoco recorded a \$5 million deferred tax benefit as a result of another state law change.

#### 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):

	Nine Months Ended		Three Months Ended	
	September 30 2007	September 30 2006	September 30 2007	September 30 2006
Weighted-average number of common shares outstanding basic	120.4	130.4	119.0	126.8
Add effect of dilutive stock incentive awards	.3	.7	.2	.6
Weighted-average number of shares diluted	120.7	131.1	119.2	127.4

#### 6. Commitments and Contingent Liabilities.

##### Commitments

Sunoco is contingently liable under various arrangements which guarantee debt of third parties aggregating to approximately \$3 million at September 30, 2007. 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 the 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.

##### 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

**Table of Contents**

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 September 30 2007	At December 31 2006
Accrued liabilities	\$ 38	\$ 36
Other deferred credits and liabilities	86	85
	\$ 124	\$ 121

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

	Retail	Chemicals	and	Pipelines	Hazardous	Other	Total
	Refineries	Sites	Facilities	Terminals	Sites	Waste	
Balance at January 1, 2006	\$ 36	\$ 78	\$ 3	\$ 15	\$ 3	\$ 2	\$ 137
Accruals	5	15	1		1		22
Payments	(7)	(18)	(1)	(3)	(1)	(1)	(31)
Other		(2)					(2)
Balance at September 30, 2006	\$ 34	\$ 73	\$ 3	\$ 12	\$ 3	\$ 1	\$ 126
Balance at January 1, 2007	\$ 34	\$ 69	\$ 3	\$ 12	\$ 2	\$ 1	\$ 121
Accruals	10	15	1	4	1		31
Payments	(8)	(15)	(1)	(4)	(1)		(29)
Other					1		1
Balance at September 30, 2007	\$ 36	\$ 69	\$ 3	\$ 12	\$ 3	\$ 1	\$ 124

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 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 nature of operations at each site, 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 and regulations, 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



## **Table of Contents**

possible (i.e., less than probable but greater than remote) that additional environmental remediation losses will be incurred. At September 30, 2007, 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 retail 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 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. Sunoco does not currently, nor does it intend to, manufacture or sell gasoline containing MTBE (see Regulatory Matters below).

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

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**Table of Contents**

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 September 30, 2007, Sunoco had been named as a PRP at 35 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 level of 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 \$8 million at September 30, 2007. 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 laws or regulations occur, such changes could impact multiple Sunoco facilities, formerly owned facilities 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 former 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 \$15 million at September 30, 2007 and are included principally in deferred charges and other assets in the condensed consolidated balance sheets.

**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 phased 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, providing refiners flexibility through 2006 for the low-sulfur gasoline and through May 2010 for the on-road low-sulfur diesel. Tier II capital spending, which was completed in 2006, totaled \$755 million. In addition, higher operating costs are being incurred as the low-sulfur fuels are produced. In May 2004, the EPA adopted another rule which is phasing in limitations on the allowable sulfur content in off-road diesel fuel beginning in June 2007. This rule also provides for banking and trading credit systems. The ultimate impact of this rule may depend upon the effectiveness of the related banking and trading credit systems, Sunoco's flexibility to modify its production slate and the impact on any capital expenditures of technology selection, permitting requirements and construction schedules, as well as any effect on prices created by the changes in the level of off-road diesel fuel production.

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**Table of Contents**

In connection with the phase-in of these new off-road diesel fuel rules, Sunoco intends to commence an approximately \$400 million capital project at the Tulsa refinery to enable the production of diesel fuel that meets the new specifications and which is expected to result in increased crude flexibility and an upgraded product slate at this facility. The majority of such capital expenditures is not likely to occur until the 2009-2010 timeframe.

National Ambient Air Quality Standards ( NAAQS ) for ozone and fine particles promulgated in 2004 by the EPA have resulted in identification of non-attainment areas throughout the country, including Texas, Pennsylvania, Ohio, New Jersey and West Virginia, where Sunoco operates facilities. The EPA has designated certain areas, including Philadelphia and Houston, as moderate non-attainment areas for ozone, which requires them to meet the ozone requirements by 2010, before currently mandated federal control programs would take effect. 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 ( SIP ), there could be other negative consequences. In December 2006, the District of Columbia Circuit Court of Appeals overturned the EPA s ozone attainment plan, including revocation of Clean Air Act Section 185(a) fee provisions. Sunoco will likely be subject to non-attainment fees in Houston, but any additional costs are not expected to be material. In March 2007, the EPA and various industry groups filed petitions seeking a rehearing by the court. In June 2007, the court clarified its decision as requested by the EPA, and denied the industry groups petition for rehearing. 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. In September 2006, the EPA issued a final rule tightening the standard for fine particles. This standard is currently being challenged in federal court by various states and environmental groups. In March 2007, the EPA issued final rules to implement the 1997 fine particle matter (PM 2.5) standards. States have until April 2008 to submit plans to the EPA demonstrating attainment by 2010 or, at the latest, 2015. However, the March 2007 rule does not address attainment of the September 2006 standard. In June 2007, the EPA published a proposed ozone standard with a range of values that is more stringent than the one in the existing standard. Regulatory programs, when established to implement the EPA s air quality 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 SIPs to respond to the new regulations.

Through the operation of its refineries, chemical plants and coke plants, Sunoco s operations emit carbon dioxide. There are various legislative and regulatory measures to address greenhouse gas ( GHG ) emissions which are in various stages of review, discussion or implementation. These include federal and state actions to develop programs for the reduction of GHG emissions. While it is currently not possible to predict the impact, if any, that these issues will have on the Company or the industry in general, they could result in increases in costs to operate and maintain the Company s facilities, as well as capital outlays for new emission control equipment at these facilities. In addition, regulations limiting GHG emissions which target specific industries such as petroleum refining or chemical or coke manufacturing could adversely affect the Company s ability to conduct its business and also may reduce demand for its products.

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**Table of Contents**

Under a law that was enacted in August 2005, a 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. 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, and manufacturers and sellers of gasoline are defendants in approximately 76 lawsuits in 18 states and the Commonwealth of Puerto Rico, which allege MTBE contamination in groundwater. Plaintiffs, who include water purveyors and municipalities responsible for supplying drinking water and private well owners, 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 and additional claims including nuisance, trespass, negligence, violation of environmental laws and deceptive business practices. In addition, several actions commenced by state authorities allege natural resource damages. Plaintiffs may seek to rely on the application of a market share theory of liability at trial, although there has been no ruling as to whether the plaintiffs will be permitted to pursue this theory. Plaintiffs are seeking compensatory damages, and in some cases injunctive relief, punitive damages and attorneys' fees.

The majority of MTBE 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) ( MDL Litigation ). Discovery is proceeding in four focus cases. Sunoco is a defendant in three of those cases. In one of the four cases, the *Suffolk County Water Authority* case, the court has set a trial date in March 2008. In addition, several private well owner cases are moving forward. Sunoco is a defendant in two of those cases. The Second Circuit Court of Appeals ( Second Circuit ) recently rendered a decision in two MTBE cases that are part of the MDL Litigation in which it held that there was no federal jurisdiction for the removal of these cases to federal court and consequently ordered that the cases be remanded back to the state courts from which they originated. The parties and the judge in the MDL Litigation are evaluating the impact of the Second Circuit's decision on the remaining cases that are part of the MDL Litigation and a number of additional cases have been remanded back to the state court. The defendants in the *Suffolk County Water Authority* case filed a motion to remand the case to state court, which was recently denied by the court. A number of defendants in that case are seeking a review of this decision by the Second Circuit.

Thus far, 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 to Sunoco. 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.

**Table of Contents**

## Conclusion

Many other legal and administrative proceedings are pending or may be brought against Sunoco arising out of its current and past operations, including matters 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. Although the ultimate outcome of these proceedings and other matters identified above cannot be ascertained at this time, it is reasonably possible that some of these matters 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 September 30, 2007. 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.

## 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	
	Nine Months Ended		Nine Months Ended	
	September 30 2007	September 30 2006	September 30 2007	September 30 2006
Service cost (cost of benefits earned during the year)	\$ 38	\$ 39	\$ 7	\$ 7
Interest cost on benefit obligations	62	64	19	17
Expected return on plan assets	(73)	(71)		
Amortization of:				
Prior service cost (benefit)	1	2	(1)	(2)
Actuarial losses	24	24	2	2
Special termination benefits	2			
Total expense	\$ 54	\$ 58	\$ 27	\$ 24

**Table of Contents**

	Defined Benefit		Postretirement	
	Plans		Benefit Plans	
	Three Months Ended		Three Months Ended	
	September 30		September 30	
	2007	2006	2007	2006
Service cost (cost of benefits earned during the year)	\$ 13	\$ 13	\$ 2	\$ 2
Interest cost on benefit obligations	21	21	7	6
Expected return on plan assets	(25)	(24)		
Amortization of:				
Prior service cost (benefit)		1		