HESS CORP
Form 10-K
March 01, 2007

Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K

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

For the fiscal year ended December 31, 2006
or

o **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 1-1204

Hess Corporation
(Exact name of Registrant as specified in its charter)

DELAWARE	**13-4921002**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification Number)*
1185 AVENUE OF THE AMERICAS, NEW YORK, N.Y.	**10036**
(Address of principal executive offices)	*(Zip Code)*

(Registrant s telephone number, including area code, is (212) 997-8500)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock (par value $1.00)	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:
None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes þ   No o

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes o   No þ

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 þ   No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. þ

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. Large accelerated filer þ   Accelerated filer o   Non-accelerated filer o

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

The aggregate market value of voting stock held by non-affiliates of the Registrant amounted to $12,765,000,000 as of June 30, 2006.

At December 31, 2006, there were 315,017,951 shares of Common Stock outstanding.

Part III is incorporated by reference from the Proxy Statement for the annual meeting of stockholders to be held on May 2, 2007.

HESS CORPORATION

Form 10-K

TABLE OF CONTENTS

Item No.		Page
	PART I	
1. and 2.	Business and Properties	2
1A.	Risk Factors Related to Our Business and Operations	10
3.	Legal Proceedings	12
4.	Submission of Matters to a Vote of Security Holders	15
	Executive Officers of the Registrant	15
	PART II	
5.	Market for the Registrant s Common Stock and Related Stockholder Matters	16
6.	Selected Financial Data	19
7.	Management s Discussion and Analysis of Financial Condition and Results of Operations	20
7A.	Quantitative and Qualitative Disclosures About Market Risk	38
8.	Financial Statements and Supplementary Data	42
9.	Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	85
9A.	Controls and Procedures	85
9B.	Other Information	85
	PART III	
10.	Directors, Executive Officers and Corporate Governance of the Registrant	85
11.	Executive Compensation	85
12.	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	85
13.	Certain Relationships and Related Transactions, and Director Independence	85
14.	Principal Accounting Fees and Services	86
	PART IV	
15.	Exhibits, Financial Statement Schedules, and Reports on Form 8-K	86
	Signatures	89

EX-10.7: SAVINGS AND STOCK BONUS PLAN
EX-10.10: AMENDED PENSION RESTORATION PLAN
EX-21: SUBSIDIARIES
EX-31.1: CERTIFICATION
EX-31.2: CERTIFICATION
EX-32.1: CERTIFICATION
EX-32.2: CERTIFICATION

Table of Contents

PART I

Items 1 and 2. *Business and Properties*

Hess Corporation (formerly Amerada Hess Corporation) (the Registrant) is a Delaware corporation, incorporated in 1920. On May 3, 2006, Amerada Hess Corporation changed its name to Hess Corporation. The Registrant and its subsidiaries (collectively referred to as the Corporation or Hess) is a global integrated energy company that operates in two segments, Exploration and Production (E&P) and Marketing and Refining (M&R). The E&P segment explores for, develops, produces, purchases, transports and sells crude oil and natural gas. These exploration and production activities take place in the United States, United Kingdom, Norway, Denmark, Equatorial Guinea, Algeria, Malaysia, Thailand, Russia, Gabon, Azerbaijan, Indonesia, Libya, Egypt, and other countries. The M&R segment manufactures, purchases, transports, trades and markets refined petroleum products, natural gas and electricity. The Corporation owns 50% of a refinery joint venture in the United States Virgin Islands, and another refining facility, terminals and retail gasoline stations, most of which include convenience stores, located on the East Coast of the United States.

Exploration and Production

The Corporation s total proved reserves at December 31 were as follows:

	2006	**2005**
Crude oil and natural gas liquids (millions of barrels)	**832**	692
Natural gas (millions of mcf)	**2,466**	2,406
Total barrels of oil equivalent* (millions of barrels)	**1,243**	1,093

* *Reflects natural gas reserves converted on the basis of relative energy content (six mcf equals one barrel).*

Of the total proved reserves (on a barrel of oil equivalent basis), 14% are located in the United States, 36% are located in Europe (consisting of reserves in the North Sea and Russia), 25% are located in Africa and the remainder are located in Indonesia, Thailand, Malaysia, and Azerbaijan. On a barrel of oil equivalent basis, 40% of the Corporation s December 31, 2006 worldwide proved reserves are undeveloped (42% in 2005). Proved reserves at December 31, 2006 include 26% and 56%, respectively, of crude oil and natural gas reserves held under production sharing contracts.

Worldwide crude oil and natural gas liquids production amounted to 257,000 barrels per day in 2006 compared with 244,000 barrels per day in 2005. Worldwide natural gas production was 612,000 mcf per day in 2006 compared with 544,000 mcf per day in 2005. On a barrel of oil equivalent basis, production was 359,000 barrels per day in 2006 compared with 335,000 barrels per day in 2005.

Worldwide crude oil, natural gas liquids and natural gas production was as follows:

	2006	**2005**
Crude oil (thousands of barrels per day)		

United States		
Onshore	**15**	21
Offshore	**21**	23
	36	44
Europe		
United Kingdom	**50**	54
Norway	**22**	26
Denmark	**19**	24
Russia	**18**	6
	109	110

2

	2006	2005
Africa		
Equatorial Guinea	**28**	30
Algeria	**22**	25
Gabon	**12**	12
Libya	**23**	
	85	67
Asia and other		
Azerbaijan	**7**	4
Other	**5**	3
	12	7
Total	**242**	228
Natural gas liquids (thousands of barrels per day)		
United States		
Onshore	**7**	8
Offshore	**3**	4
	10	12
Europe		
United Kingdom	**4**	3
Norway	**1**	1
	5	4
Total	**15**	16
Natural gas (thousands of mcf per day)		
United States		
Onshore	**54**	74
Offshore	**56**	63
	110	137
Europe		
United Kingdom	**244**	222
Norway	**22**	28
Denmark	**17**	24
	283	274
Asia and other		

Joint Development Area of Malaysia and Thailand	**131**	51
Thailand	**60**	57
Indonesia	**26**	25
Other	**2**	
	219	133
Total	**612**	544
Barrels of oil equivalent*	**359**	335

* *Reflects natural gas production converted on the basis of relative energy content (six mcf equals one barrel).*

The Corporation presently estimates that its 2007 barrel of oil equivalent production will be approximately 370,000 to 380,000 barrels per day. The Corporation is developing a number of oil and gas fields and has an inventory of domestic and foreign exploration prospects.

Table of Contents

United States

During 2006, 18% of the Corporation s crude oil and natural gas liquids production and 18% of its natural gas production were from United States operations. The Corporation operates mainly offshore in the Gulf of Mexico and onshore in Texas and North Dakota. During 2006, the Corporation completed the sale of its interests in certain producing properties in the Permian Basin in Texas and New Mexico and certain U.S. Gulf Coast oil and gas producing assets. Total net production from assets sold was approximately 8,000 barrels of oil equivalent per day at the time of sale.

In the second quarter of 2006, the Shenzi development (Hess 28%) in the Green Canyon Block area of the deepwater Gulf of Mexico was sanctioned by the operator and first oil is expected in the second half of 2009. Plans for the Shenzi development in 2007 include the drilling of development wells and continued construction of platform components and subsea equipment installation. In February 2007, the Corporation acquired a 28% interest in the Genghis Khan oil and gas development located in the deepwater Gulf of Mexico on Green Canyon Blocks 652 and 608 for $371 million. The Genghis Khan development is part of the same geologic structure as the Shenzi development and first production from this development is expected in the second half of 2007.

In 2006, an exploration well on the Corporation s Pony prospect (Hess 100%) on Green Canyon Block 468 in the deepwater Gulf of Mexico encountered 475 feet of oil saturated sandstone in Miocene age reservoirs. Drilling of an appraisal sidetrack well on the Pony Prospect was completed in January 2007 which encountered 280 feet of oil saturated sandstone in Miocene age reservoirs after penetrating sixty percent of its geological objective. Drilling of the sidetrack well was stopped for mechanical reasons after successfully recovering 450 feet of conventional core. The Corporation is currently drilling an appraisal well about 7,400 feet northwest of the discovery well.

In 2006, on the Tubular Bells prospect (Hess 20%) in the Mississippi Canyon area of the deepwater Gulf of Mexico a successful appraisal well encountered hydrocarbons approximately 5 miles from the initial discovery well. The operator intends to drill two sidetrack wells in 2007 which will further delineate the field.

The Corporation has an interest in the Seminole-San Andres Unit (Hess 34.3%) in the Permian Basin. A residual oil zone development at the Seminole-San Andres Unit is expected to commence in 2007 and it is anticipated that production from this development will begin in 2009. The Corporation intends to use carbon dioxide gas from its interests in the West Bravo Dome and Bravo Dome fields in New Mexico for the enhanced recovery effort in this residual oil zone development.

At December 31, 2006, the Corporation has interests in over 400 exploration blocks in the Gulf of Mexico. The Corporation has 1,525,304 net undeveloped acres in the Gulf of Mexico.

Europe

During 2006, 44% of the Corporation s crude oil and natural gas liquids production and 46% of its natural gas production were from European operations.

United Kingdom: Production of crude oil and natural gas liquids from the United Kingdom North Sea was 54,000 barrels per day in 2006 compared with 57,000 barrels per day in 2005, principally from the Corporation s non-operated interests in the Beryl (Hess 22.2%), Bittern (Hess 28.3%), Schiehallion (Hess 15.7%) and Clair (Hess 9.3%) fields. Natural gas production from the United Kingdom in 2006 was 244,000 mcf of natural gas per day compared with 222,000 mcf per day in 2005, primarily from gas fields in the Easington Catchment Area (Hess 28.8%), as well as Everest (Hess 18.7%), Lomond (Hess 16.7%) and Beryl (Hess 22.2%). In addition, production

from the Atlantic (Hess 25%) and Cromarty (Hess 90%) fields commenced in June of 2006 and the fields produced at a combined rate of approximately 95,000 mcf per day net to Hess in the second half of 2006.

In the first half of 2007, the Corporation expects to complete the sale of its interests in the Scott and Telford fields with an effective date of January 1, 2007 for approximately $100 million. The Corporation s share of net production from these fields was 9,000 barrels of oil equivalent per day at the end of 2006.

Norway: Crude oil and natural gas liquids production was 23,000 barrels per day in 2006 and 27,000 barrels per day in 2005. Natural gas production averaged 22,000 mcf per day in 2006 and 28,000 mcf per day in 2005. Substantially all of the Norwegian production is from the Corporation s interest in the Valhall field (Hess 28.1%).

Table of Contents

Denmark: Net production from the Corporation s interest in the South Arne field (Hess 57.5%) was 19,000 barrels of crude oil per day in 2006 and 24,000 barrels of crude oil per day in 2005. Natural gas production was 17,000 mcf per day in 2006 and 24,000 mcf per day in 2005.

Russia: The Corporation s activities in Russia are conducted through its 80%-owned interest in a corporate joint venture operating in the Volga-Urals region of Russia. Production averaged 18,000 barrels of crude oil per day in 2006 compared to 6,000 barrels per day in 2005. The Corporation s initial interest in its Russian joint venture was acquired during 2005.

Africa

During 2006, 33% of the Corporation s crude oil and natural gas liquids production was from African operations.

Equatorial Guinea: The Corporation is the operator and owns an interest in Block G (Hess 85%) which contains the Ceiba field and Okume Complex. Net production from the Ceiba field averaged 28,000 barrels of crude oil per day in 2006 and 30,000 barrels per day in 2005. Production of crude oil from the Okume Complex commenced in December 2006. The Corporation estimates that its net share of 2007 production from the Okume Complex will average approximately 20,000 barrels of oil per day. In 2007, the Corporation plans to complete the construction of offshore production facilities and to drill additional development wells at the Okume Complex.

Algeria: The Corporation has a 49% interest in a venture with the Algerian national oil company that is redeveloping three oil fields. The Corporation s share of production averaged 22,000 and 25,000 barrels of crude oil per day in 2006 and 2005, respectively. The Corporation has also submitted a plan of development for a small oil discovery on Block 401C, which is currently awaiting government approval.

Libya: In January 2006, the Corporation, in conjunction with its Oasis Group partners, re-entered its former oil and gas production operations in the Waha concessions in Libya (Hess 8.16%). The re-entry terms included a 25-year extension of the concessions and payments by the Corporation to the Libyan National Oil Corporation of $359 million. The Corporation s net share of 2006 production from Libya averaged 23,000 barrels of oil per day. The Corporation also owns a 100% interest in offshore exploration Area 54.

Gabon: Through its 77.5% owned Gabonese subsidiary, the Corporation has interests in the Rabi Kounga, Toucan and Atora fields. The Corporation s share of production averaged 12,000 barrels of crude oil per day in 2006 and 2005.

Egypt: In January 2006, the Corporation acquired a 55% working interest in the deepwater section of the West Mediterranean Block 1 Concession (the West Med Block) in Egypt for $413 million. The Corporation has a 25-year development lease for the West Med Block, which contains four existing natural gas discoveries and additional exploration opportunities.

Asia and Other

During 2006, 5% of the Corporation s crude oil and natural gas liquids production and 36% of its natural gas production were from Asian operations.

Joint Development Area of Malaysia and Thailand: The Corporation owns an interest in the production sharing agreement covering Block A-18 of the Joint Development Area (JDA) (Hess 50%) in the Gulf of Thailand. Net production averaged 131,000 mcf of natural gas and 2,000 barrels of crude oil per day in 2006 compared to 51,000 mcf of natural gas and 1,000 barrels of crude oil per day in 2005. In 2007, the Corporation s capital investments in the

JDA will be primarily focused on facilities expansion and development drilling associated with the additional contracted gas sales of 400,000 mcf per day (gross) in 2008. It is anticipated that production associated with these additional gas sales will begin ramping up in the fourth quarter of 2007.

Thailand: The Corporation has an interest in the Pailin gas field (Hess 15%) offshore Thailand. Net production from the Corporation s interest averaged 60,000 mcf and 57,000 mcf of natural gas per day in 2006 and 2005, respectively. The Corporation is the operator and owns an interest in the onshore natural gas project in the Phu

Horm Block (Hess 35%) which commenced production in November 2006. The Corporation estimates its net share of 2007 production from Phu Horm will average approximately 30,000 mcf of natural gas per day.

Indonesia: The Corporation s net share of natural gas production from Indonesia averaged 26,000 mcf per day in 2006 and 25,000 mcf per day in 2005 primarily from its interest in the Natuna A gas field (Hess 23%). The Ujung Pangkah project (Hess 75%), where the Corporation is the operator, is expected to commence gas sales by mid 2007 under an existing gas sales agreement for 440 million mcf (gross) over a 20 year period with an expected plateau rate of 100,000 mcf per day (gross). The Corporation s plans for Ujung Pangkah in 2007 include drilling additional development wells, the completion of onshore and offshore gas facilities and the commencement of a crude oil development project. The Corporation also owns an interest in the Jambi Merang natural gas project (Hess 25%).

Azerbaijan: The Corporation has an interest in the Azeri-Chirag-Gunashli (ACG) fields (Hess 2.72%) in the Caspian Sea. Net production from its interest averaged 7,000 barrels of crude oil per day in 2006 and 4,000 barrels per day in 2005. Phase 2 production from the ACG fields commenced during 2006. The Corporation also holds an interest in the Baku-Tbilisi-Ceyhan (BTC) Pipeline (Hess 2.36%), which started operation in the second quarter of 2006.

Oil and Gas Reserves

The Corporation s net proved oil and gas reserves at the end of 2006, 2005 and 2004 are presented under Supplementary Oil and Gas Data on pages 80 and 81 in the accompanying financial statements.

During 2006, the Corporation provided oil and gas reserve estimates for 2005 to the United States Department of Energy. Such estimates are compatible with the information furnished to the SEC on Form 10-K for the year ended December 31, 2005, although not necessarily directly comparable due to the requirements of the individual requests. There were no differences in excess of 5%.

The Corporation has no contracts or agreements to sell fixed quantities of its crude oil production. In the United States, natural gas is sold on a spot basis and under contracts for varying periods to local distribution companies, and commercial, industrial and other purchasers. The Corporation s United States natural gas production is expected to approximate 20% of its 2007 sales commitments under long-term contracts. The Corporation attempts to minimize price and supply risks associated with its United States natural gas supply commitments by entering into purchase contracts with third parties having adequate sources of supply, on terms substantially similar to those under its commitments and by leasing storage facilities. In international markets, the Corporation generally sells its natural gas production under long-term sales contracts. In the United Kingdom, the Corporation also sells a portion of its natural gas production on a spot basis.

Average selling prices and average production costs

	2006	2005	2004
Average selling prices (including the effects of hedging) (Note A)			
Crude oil, including condensate and natural gas liquids (per barrel)			
United States	**$ 57.41**	$ 33.86	$ 27.87
Europe	**55.80**	33.30	26.24
Africa	**51.18**	32.10	26.35
Asia and other	**61.52**	54.69	38.36
Worldwide	**54.81**	33.69	26.86
Natural gas (per mcf)			

United States	**$ 6.59**	$ 7.93	$ 5.18
Europe	**6.20**	5.29	3.96
Asia and other	**4.05**	4.02	3.90
Worldwide	**5.50**	5.65	4.31

	2006	2005	2004
Average production (lifting) costs per barrel of oil equivalent produced (Note B)			
United States	**$ 9.54**	$ 7.46	$ 6.42
Europe	**10.73**	8.13	6.35
Africa	**9.03**	7.99	7.72
Asia and other	**6.54**	7.29	6.05
Worldwide	**9.55**	7.91	6.59

Note A: Includes inter-company transfers valued at approximate market prices and the effect of the Corporation s hedging activities.

Note B: Production (lifting) costs consist of amounts incurred to operate and maintain the Corporation s producing oil and gas wells, related equipment and facilities (including lease costs of floating production and storage facilities) and production and severance taxes. Production costs in 2005 exclude Gulf of Mexico hurricane related expenses. The average production costs per barrel of oil equivalent reflect the crude oil equivalent of natural gas production converted based on the basis of relative energy content (six mcf equals one barrel).

The table above does not include costs of finding and developing proved oil and gas reserves, or the costs of related general and administrative expenses, interest expense and income taxes.

Gross and net undeveloped acreage at December 31, 2006

	Undeveloped Acreage (Note A)	
	Gross	Net
	(In thousands)	
United States	2,199	1,672
Europe	2,893	984
Africa	13,527	9,572
Asia and other	16,486	10,016
Total (Note B)	35,105	22,244

Note A: Includes acreage held under production sharing contracts.

Note B: Approximately 5% of net undeveloped acreage held at December 31, 2006 will expire during the next three years.

Gross and net developed acreage and productive wells at December 31, 2006

	Developed Acreage Applicable to	Productive Wells (Note A)

	Productive Wells		Oil		Gas	
	Gross	Net	Gross	Net	Gross	Net
	(In thousands)					
United States	450	385	708	396	74	59
Europe	1,183	587	283	98	163	37
Africa	9,919	958	844	105	3	
Asia and other	2,185	624	40	3	320	60
Total	13,737	2,554	1,875	602	560	156

Note A: Includes multiple completion wells (wells producing from different formations in the same bore hole) totaling 301 gross wells and 62 net wells.

Table of Contents

Number of net exploratory and development wells drilled

	Net Exploratory Wells			Net Development Wells		
	2006	**2005**	**2004**	**2006**	**2005**	**2004**
Productive wells						
United States	**1**		4	**24**	28	32
Europe	**1**	3		**20**	6	5
Africa		1	1	**17**	12	12
Asia and other	**6**	1	1	**11**	8	2
Total	**8**	5	6	**72**	54	51
Dry holes						
United States	**4**	2	1		2	
Europe		1	1			1
Africa		1	2		1	1
Asia and other			1			1
Total	**4**	4	5		3	3
Total	**12**	9	11	**72**	57	54

Number of wells in process of drilling at December 31, 2006

	Gross Wells	Net Wells
United States	12	7
Europe	13	6
Africa	21	8
Asia and other	19	4
Total	65	25

Number of waterfloods and pressure maintenance projects in process of installation at December 31, 2006 2

Marketing and Refining

Refined product sales of the M&R businesses were as follows:

	2006	**2005**

	(Thousands of barrels per day)	
Gasoline	**218**	213
Distillates	**144**	136
Residuals	**60**	64
Other	**37**	43
Total	**459**	456

Refining: The Corporation owns a 50% interest in HOVENSA L.L.C. (HOVENSA), a refining joint venture in the United States Virgin Islands with a subsidiary of Petroleos de Venezuela S.A. (PDVSA). In addition, it owns and operates a refining facility in Port Reading, New Jersey.

HOVENSA: Refining operations at HOVENSA consist of crude units, a fluid catalytic cracking unit and a delayed coker unit. The following table summarizes capacity and utilization rates for HOVENSA:

	Refinery Capacity (Thousands of barrels per day)	Refinery Utilization	
		2006	2005
Crude	500	**89.7%**	92.2%
Fluid catalytic cracker	150	**84.3%**	81.9%
Coker	58	**84.3%**	92.8%

The fluid catalytic cracking unit at HOVENSA was shut down for approximately 22 days of unscheduled maintenance in 2006.

The delayed coker unit permits HOVENSA to run lower-cost heavy crude oil. HOVENSA has a long-term supply contract with PDVSA to purchase 115,000 barrels per day of Venezuelan Merey heavy crude oil. PDVSA also supplies 155,000 barrels per day of Venezuelan Mesa medium gravity crude oil to HOVENSA under a long-term crude oil supply contract. The remaining crude oil requirements are purchased mainly under contracts of one year or less from third parties and through spot purchases on the open market. After sales of refined products by HOVENSA to unrelated third parties, the Corporation purchases 50% of HOVENSA s remaining production at market prices.

Port Reading Facility: The Corporation owns and operates a fluid catalytic cracking facility in Port Reading, New Jersey, with a capacity of 65,000 barrels per day. This facility processes residual fuel oil and vacuum gas oil and operated at a rate of approximately 63,000 barrels per day in 2006 and 55,000 barrels per day in 2005. Substantially all of Port Reading s production is gasoline and heating oil.

Marketing: The Corporation markets refined petroleum products on the East Coast of the United States to the motoring public, wholesale distributors, industrial and commercial users, other petroleum companies, governmental agencies and public utilities. It also markets natural gas and electricity to utilities and other industrial and commercial customers. During 2006 and 2005, the Corporation selectively expanded its energy marketing business by acquiring natural gas and electricity customer accounts.

The Corporation has 1,350 HESS® gasoline stations at December 31, 2006, including stations owned by the WilcoHess joint venture (Hess 44%). Approximately 88% of the gasoline stations are operated by the Company or WilcoHess. Of the operated stations, 92% have convenience stores on the sites. Most of the Corporation s gasoline stations are in New York, New Jersey, Pennsylvania, Florida, Massachusetts, North Carolina and South Carolina.

Refined product sales averaged 459,000 barrels per day in 2006 and 456,000 barrels per day in 2005. Of total refined products sold in 2006, approximately 50% was obtained from HOVENSA and Port Reading. The Corporation purchased the balance from others under short-term supply contracts and by spot purchases from various sources.

The Corporation has 22 terminals with an aggregate storage capacity of 22 million barrels in its East Coast marketing areas.

The Corporation has a 50% voting interest in a consolidated partnership that trades energy commodities and derivatives. The Corporation also takes energy commodity and derivative trading positions for its own account.

The Corporation also has a 50% interest in a joint venture, Hess LNG, which is pursuing investments in liquefied natural gas (LNG) terminals and related supply, trading and marketing opportunities. The joint venture is pursuing the development of LNG terminal projects located in Fall River, Massachusetts and Shannon, Ireland.

The Corporation has a wholly-owned subsidiary that provides distributed electricity generating equipment to industrial and commercial customers as an alternative to purchasing electricity from local utilities. The Corporation also has invested in long-term technology to develop fuel cells for electricity generation through a venture with other parties.

Competition and Market Conditions

See Item 1A, Risk Factors Related to Our Business and Operations, for a discussion of competition and market conditions.

Other Items

Compliance with various existing environmental and pollution control regulations imposed by federal, state, local and foreign governments is not expected to have a material adverse effect on the Corporation s earnings and competitive position within the industry. The Corporation spent $15 million in 2006 for environmental remediation. The United States Environmental Protection Agency (EPA) has adopted rules that limit the amount of sulfur in gasoline and diesel fuel. Capital expenditures necessary to comply with the low-sulfur gasoline requirements at Port Reading were $72 million, of which $23 million was spent in 2005 and the remainder was spent in 2006. Capital expenditures to comply with low-sulfur gasoline and diesel fuel requirements at HOVENSA are expected to be approximately $420 million, of which $360 million has been spent to date and the remainder will be spent in 2007. HOVENSA expects to finance these capital expenditures through cash flow from operations.

The number of persons employed by the Corporation at year end was approximately 13,700 in 2006 and 12,800 in 2005.

The Corporation s Internet address is www.hess.com. On its website, the Corporation makes available free of charge its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after the Corporation electronically files with or furnishes such material to the Securities and Exchange Commission. Copies of the Corporation s Code of Business Conduct and Ethics, its Corporate Governance Guidelines and the charters of the Audit Committee, the Compensation and Management Development Committee and the Corporate Governance and Nominating Committee of the Board of Directors are available on the Corporation s website and are also available free of charge upon request to the Secretary of the Corporation at its principal executive offices. The Corporation has also filed with the New York Stock Exchange (NYSE) its annual certification that the Corporation s chief executive officer is unaware of any violation of the NYSE s corporate governance standards.

Item 1A. ***Risk Factors Related to Our Business and Operations***

Our business activities and the value of our securities are subject to significant risk factors, including those described below. The risk factors described below could negatively affect our operations, financial condition, liquidity and results of operations, and as a result holders and purchasers of our securities could lose part or all of their investments. It is possible additional risks relating to our securities may be described in a prospectus supplement if we issue securities in the future.

Commodity Price Risk: Our estimated proved reserves, revenue, operating cash flows, operating margins, future earnings and trading operations are highly dependent on the prices of crude oil, natural gas and refined petroleum products, which are influenced by numerous factors beyond our control. Historically these prices have been very volatile. The major foreign oil producing countries, including members of the Organization of Petroleum Exporting Countries (OPEC), exert considerable influence over the supply and price of crude oil and refined petroleum products. Their ability or inability to agree on a common policy on rates of production and other matters has a significant impact on the oil markets. The derivatives markets may also influence the selling prices of crude oil, natural gas and refined petroleum products. A significant downward trend in commodity prices would have a material adverse effect on our revenues, profitability and cash flow and could result in a reduction in the carrying value of our oil and gas assets,

goodwill and proved oil and gas reserves. To the extent that we engage in hedging activities to mitigate commodity price volatility, we will not realize the benefit of price increases above the hedged price.

Technical Risk: We own or have access to a finite amount of oil and gas reserves which will be depleted over time. Replacement of oil and gas reserves is subject to successful exploration drilling, development activities, and enhanced recovery programs. Therefore, future oil and gas production is dependent on technical success in finding

and developing additional hydrocarbon reserves. Exploration activity involves the interpretation of seismic and other geological and geophysical data, which does not always successfully predict the presence of commercial quantities of hydrocarbons. Drilling risks include adverse unexpected conditions, irregularities in pressure or formations, equipment failure, blowouts and weather interruptions. Future developments may be affected by unforeseen reservoir conditions which negatively affect recovery factors or flow rates. The costs of drilling and development activities have also been increasing, which could negatively affect expected economic returns. Although due diligence is used in evaluating acquired oil and gas properties, similar uncertainties may be encountered in the production of oil and gas on properties acquired from others.

Oil and Gas Reserves and Discounted Future Net Cash Flow Risks: Numerous uncertainties exist in estimating quantities of proved reserves and future net revenues from those reserves. Actual future production, oil and gas prices, revenues, taxes, capital expenditures, operating expenses, geologic success and quantities of recoverable oil and gas reserves may vary substantially from those assumed in the estimates and could materially affect the estimated quantities and future net revenues of our proved reserves. In addition, reserve estimates may be subject to downward or upward revisions based on production performance, purchases or sales of properties, results of future development, prevailing oil and gas prices, production sharing contracts which may decrease reserves as crude oil and natural gas prices increase, and other factors.

Political Risk: Federal, state, local, territorial and foreign laws and regulations relating to tax increases and retroactive tax claims, expropriation of property, cancellation of contract rights, and changes in import regulations, as well as other political developments may affect our operations. For example, during 2006, the governments of the United Kingdom and Algeria increased taxation on our crude oil and natural gas revenues in response to higher crude oil and natural gas prices. Some of the international areas in which we operate may be politically less stable than our domestic operations. In addition, the increasing threat of terrorism around the world poses additional risks to the operations of the oil and gas industry. In our M&R segment, we market motor fuels through lessee-dealers and wholesalers in certain states where legislation prohibits producers or refiners of crude oil from directly engaging in retail marketing of motor fuels. Similar legislation has been periodically proposed in the U.S. Congress and in various other states.

Environmental Risk: Our oil and gas operations, like those of the industry, are subject to environmental hazards such as oil spills, produced water spills, gas leaks and ruptures and discharges of substances or gases that could expose us to substantial liability for pollution or other environmental damage. Our operations are also subject to numerous United States federal, state, local and foreign environmental laws and regulations. Non-compliance with these laws and regulations may subject us to administrative, civil or criminal penalties, remedial clean-ups and natural resource damages or other liabilities. In addition, increasingly stringent environmental regulations, particularly relating to the production of motor and other fuels, has resulted, and will likely continue to result, in higher capital expenditures and operating expenses for us and the oil and gas industry generally.

Competitive Risk: The petroleum industry is highly competitive and very capital intensive. We encounter competition from numerous companies in each of our activities, particularly in acquiring rights to explore for crude oil and natural gas and in the purchasing and marketing of refined products and natural gas. Many competitors, including national oil companies, are larger and have substantially greater resources. We are also in competition with producers and marketers of other forms of energy. Increased competition for worldwide oil and gas assets has significantly increased the cost of acquisitions. In addition, competition for drilling services and equipment has affected the availability of drilling rigs and increased capital and operating costs.

Catastrophic Risk: Although we maintain an appropriate level of insurance coverage against property and casualty losses, our oil and gas operations are subject to unforeseen occurrences which may damage or destroy assets or interrupt operations. Examples of catastrophic risks include hurricanes, fires, explosions and blowouts. These

occurrences have affected us from time to time. During 2005, our annual Gulf of Mexico production of crude oil and natural gas was reduced by 7,000 barrels of oil equivalent per day (boepd) due to the impact of Hurricanes Katrina and Rita.

Item 3. ***Legal Proceedings***

Purported class actions consolidated under a complaint captioned: *In re Amerada Hess Securities* Litigation were filed in United States District Court for the District of New Jersey against the Registrant and certain executive officers and former executive officers of the Registrant alleging that these individuals sold shares of the Registrant s common stock in advance of the Registrant s acquisition of Triton Energy Limited (Triton) in 2001 in violation of federal securities laws. In April 2003, the Registrant and the other defendants filed a motion to dismiss for failure to state a claim and failure to plead fraud with particularity. On March 31, 2004, the court granted the defendants motion to dismiss the complaint. The plaintiffs were granted leave to file an amended complaint. Plaintiffs filed an amended complaint in June 2004. Defendants moved to dismiss the amended complaint. In June 2005, this motion was denied. On January 30, 2007, the District Court issued an order preliminarily approving settlement of this action and providing for notice to members of the class of plaintiffs. While continuing to deny the allegations of the complaint and all charges of wrongdoing or liability arising in connection with the subject matter of the action, the defendants agreed with plaintiffs to settle the action on the terms set forth in the stipulation of settlement in order to avoid the cost, inconvenience and uncertainty of continued protracted litigation. Under the terms of the settlement, defendants have caused to be deposited into an escrow account the sum of $9 million, which after payment of certain administrative expenses and plaintiffs attorney fees, will be distributed according to a plan of allocation to class members who submit valid and timely proof of claim and release forms. All of the amount deposited was paid by the defendants insurer. The settlement is subject to final approval of the district court and certain other conditions, including that not more than 5% of shares owned by class members eligible to participate in the settlement elect to opt out of the settlement.

The Registrant, along with many other companies engaged in refining and marketing of gasoline, has been a party to lawsuits and claims related to the use of methyl tertiary butyl ether (MTBE) in gasoline. A series of substantially identical lawsuits, many involving water utilities or governmental entities, were filed in jurisdictions across the United States against producers of MTBE and petroleum refiners who produce gasoline containing MTBE, including the Registrant. These cases have been consolidated in the Southern District of New York and the Registrant is named as a defendant in 43 of the 69 cases pending. The principal allegation in all cases is that gasoline containing MTBE is a defective product and that these parties are strictly liable in proportion to their share of the gasoline market for damage to groundwater resources and are required to take remedial action to ameliorate the alleged effects on the environment of releases of MTBE. In some cases, punitive damages are also sought. In April 2005, the District Court denied the primary legal aspects of the defendants motion to dismiss these actions. While the damages claimed in these actions are substantial, only limited information is available to evaluate the factual and legal merits of those claims. The Corporation also believes that significant legal uncertainty remains regarding the validity of causes of action asserted and availability of the relief sought by plaintiffs. Accordingly, based on the information currently available, there is insufficient information on which to evaluate the Corporation s exposure in these cases.

Over the last several years, many refiners have entered into consent agreements to resolve the EPA s assertions that refining facilities were modified or expanded without complying with New Source Review regulations that require permits and new emission controls in certain circumstances and other regulations that impose emissions control requirements. These consent agreements, which arise out of an EPA enforcement initiative focusing on petroleum refiners and utilities, have typically imposed substantial civil fines and penalties and required (i) significant capital expenditures to install emissions control equipment over a three to eight year time period and (ii) changes to operations which resulted in increased operating costs. Settlements under Petroleum Refining Initiative consent agreements to date have averaged $335 per barrel per day of refining capacity. However the capital expenditures, penalties and supplemental environmental projects for individual refineries covered by the settlements can vary significantly, depending on the size and configuration of the refinery, the circumstances of the alleged modifications

and whether the refinery has previously installed more advanced pollution controls. EPA initially contacted Registrant and HOVENSA L.L.C. (HOVENSA), its 50% owned joint venture with Petroleos de Venezuela, regarding the Petroleum Refinery Initiative in August 2003 and discussions resumed in August 2005. The Registrant and HOVENSA have had and expect to have further discussions with the EPA regarding the Petroleum Refining Initiative, although both the Registrant and HOVENSA have already installed many of the pollution controls required of other refiners under the consent agreements and the EPA has not made any specific

assertions that either Registrant or HOVENSA violated either New Source Review or other regulations which would require additional controls. While the effect on the Corporation of the Petroleum Refining Initiative cannot be estimated at this time, additional future capital expenditures and operating expenses may be incurred. The amount of penalties, if any, is not expected to be material to the Corporation.

In December 2006, HOVENSA received a Notice of Violation (NOV) from the EPA alleging non-compliance with emissions limits in a permit issued by the Virgin Islands Department of Planning and Natural Resources (DPNR) for the two process heaters in the delayed coking unit. The NOV was issued in response to a voluntary investigation and submission by HOVENSA regarding potential non-compliance with the permit emissions limits for two pollutants. Any exceedances were minor from the perspective of the amount of pollutants emitted in excess of the limits. HOVENSA intends to work with the appropriate governmental agency to reach resolution of this matter and does not believe that it will result in material liability.

Registrant is one of over 60 companies that have received a directive from the New Jersey Department of Environmental Protection (NJDEP) to remediate contamination in the sediments of the lower Passaic River and NJDEP is also seeking natural resource damages. The directive, insofar as it affects Registrant, relates to alleged releases from a petroleum bulk storage terminal in Newark, New Jersey now owned by the Registrant. EPA has also issued an Administrative Order on Consent relating to the same contamination. While NJDEP has suggested a remedial cost of over $900 million, the costs of remediation of the Passaic River sediments are the subject of a remedial investigation and feasibility study currently being conducted on a portion of the river by the EPA under an agreement with Registrant and over 40 other companies. Thus, remedial costs cannot be reliably estimated at this time. Based on currently known facts and circumstances, the Registrant does not believe that this matter will result in material liability because its terminal could not have contributed contamination along most of the river s length and did not store or use contaminants which are of the greatest concern in the river sediments, and because there are numerous other parties who will likely share in the cost of remediation and damages.

On or about July 15, 2004, Hess Oil Virgin Islands Corp. (HOVIC), a wholly owned subsidiary of the Registrant, and HOVENSA, in which Registrant owns a 50% interest, each received a letter from the Commissioner of the Virgin Islands Department of Planning and Natural Resources and Natural Resources Trustees, advising of the Trustee s intention to bring suit against HOVIC and HOVENSA under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA). The letter alleges that HOVIC and HOVENSA are potentially responsible for damages to natural resources arising from releases of hazardous substances from the HOVENSA Oil Refinery. HOVENSA currently owns and operates a petroleum refinery on the south shore of St. Croix, United States Virgin Islands, which had been operated by HOVIC until October 1998. An action was filed on May 5, 2005 in the District Court of the Virgin Islands against HOVENSA, HOVIC and other companies that operated industrial facilities on the south shore of St. Croix asserting that the defendants are liable under CERCLA and territorial statutory and common law for damages to natural resources. HOVIC and HOVENSA do not believe that this matter will result in a material liability as they believe that they have strong defenses to this complaint, and they intend to vigorously defend this matter.

The Securities and Exchange Commission (SEC) has notified the Registrant that on July 21, 2005, it commenced a private investigation into payments made to the government of Equatorial Guinea or to officials and persons affiliated with officials of the government of Equatorial Guinea. The staff of the SEC has requested documents and information from the Registrant and other oil and gas companies that have operations or interests in Equatorial Guinea. The staff of the SEC had previously been conducting an informal inquiry into such matters. The Registrant has been cooperating and continues to cooperate with the SEC investigation.

Registrant has been served with a complaint from the New York State Department of Environmental Conservation (DEC) relating to alleged violations at its petroleum terminal in Brooklyn, New York. The complaint, which seeks an

order to shut down the terminal and penalties in unspecified amounts, alleges violations involving the structural integrity of certain tanks, the erosion of shorelines and bulkheads, petroleum discharges and improper certification of tank repairs. DEC is also seeking relief relating to remediation of certain gasoline stations in the New York metropolitan area. Registrant believes that many of the allegations are factually inaccurate or based on an incorrect interpretation of applicable law. Registrant has already addressed the primary conditions discussed in the

Table of Contents

complaint. Registrant intends to vigorously contest the complaint, but is involved in settlement discussions with DEC. Any settlement is not expected to be material to the Corporation.

The Registrant periodically receives notices from EPA that it is a potential responsible party under the Superfund legislation with respect to various waste disposal sites. Under this legislation, all potentially responsible parties are jointly and severally liable. For certain sites, EPA s claims or assertions of liability against the Corporation relating to these sites have not been fully developed. With respect to the remaining sites, EPA s claims have been settled, or a proposed settlement is under consideration, in all cases for amounts that are not material. The ultimate impact of these proceedings, and of any related proceedings by private parties, on the business or accounts of the Corporation cannot be predicted at this time due to the large number of other potentially responsible parties and the speculative nature of clean-up cost estimates, but is not expected to be material.

The Corporation is from time to time involved in other judicial and administrative proceedings, including proceedings relating to other environmental matters. Although the ultimate outcome of these proceedings cannot be ascertained at this time and some of them may be resolved adversely to the Corporation, no such proceeding is required to be disclosed under applicable rules of the Securities and Exchange Commission. In management s opinion, based upon currently known facts and circumstances, such proceedings in the aggregate will not have a material adverse effect on the financial condition of the Corporation.

Item 4. ***Submission of Matters to a Vote of Security Holders***

During the fourth quarter of 2006, no matter was submitted to a vote of security holders through the solicitation of proxies or otherwise.

Executive Officers of the Registrant

The following table presents information as of February 1, 2007 regarding executive officers of the Registrant:

Name	Age	Office Held*	Year Individual Became an Executive Officer
John B. Hess	52	Chairman of the Board, Chief Executive Officer and Director	1983
J. Barclay Collins II	62	Executive Vice President, General Counsel and Director	1986
John J. O Connor	60	Executive Vice President, President of Worldwide Exploration and Production and Director	2001
F. Borden Walker	53	Executive Vice President and President of Marketing and Refining and Director	1996
Brian J. Bohling	46	Senior Vice President	2004
E. Clyde Crouch	58	Senior Vice President	2003
John A. Gartman	59	Senior Vice President	1997
Scott Heck	49	Senior Vice President	2005
Lawrence H. Ornstein	55	Senior Vice President	1995
Howard Paver	56	Senior Vice President	2002
John P. Rielly	44	Senior Vice President and Chief Financial Officer	2002
George F. Sandison	50	Senior Vice President	2003
John J. Scelfo	49	Senior Vice President	2004
Robert P. Strode	50	Senior Vice President	2000
Robert J. Vogel	47	Vice President & Treasurer	2004

* *All officers referred to herein hold office in accordance with the By-Laws until the first meeting of the Directors following the annual meeting of stockholders of the Registrant and until their successors shall have been duly chosen and qualified. Each of said officers was elected to the office set forth opposite his name on May 3, 2006. The first meeting of Directors following the next annual meeting of stockholders of the Registrant is scheduled to be held May 2, 2007.*

Except for Messrs. Bohling, Sandison and Scelfo, each of the above officers has been employed by the Registrant or its subsidiaries in various managerial and executive capacities for more than five years. Mr. Bohling was employed in senior human resource positions with American Standard Corporation and CDI Corporation before joining the

Registrant in 2004. Mr. Scelfo was chief financial officer of Sirius Satellite Radio and a division of Dell Computer before his employment by the Registrant in 2003. Mr. Sandison served in senior executive positions in the area of global drilling with Texaco, Inc. before he was employed by the Registrant in 2003.

PART II

Item 5. ***Market for the Registrant s Common Stock and Related Stockholder Matters***

Stock Market Information

The common stock of Hess Corporation is traded principally on the New York Stock Exchange (ticker symbol: HES). High and low sales prices were as follows:

Quarter Ended*	2006 High	2006 Low	2005 High	2005 Low
March 31	**$ 52.00**	**$ 42.83**	$ 34.65	$ 25.94
June 30	**53.46**	**43.23**	37.39	28.75
September 30	**56.45**	**38.30**	47.50	35.53
December 31	**52.70**	**37.62**	46.33	36.67

* *Prices for all periods reflect the impact of a 3-for-1 stock split on May 31, 2006.*

The high and low sales prices of the Corporation s 7% cumulative mandatory convertible preferred stock (traded on the New York Stock Exchange, ticker symbol: HESPR) were as follows**:

Quarter Ended	2006 High	2006 Low	2005 High	2005 Low
March 31	**$ 130.65**	**$ 111.11**	$ 90.33	$ 70.47
June 30	**133.65**	**109.90**	95.75	74.75
September 30	**140.20**	**98.61**	120.17	91.32
December 31**	**124.94**	**95.00**	117.56	95.33

** *On December 1, 2006, each share of the Corporation s 7% Mandatory Convertible Preferred Stock was converted into 2.4915 shares of its common stock.*

Table of Contents

Performance Graph

Set forth below is a line graph comparing the cumulative total shareholder return, assuming reinvestment of dividends, on the Corporation s common stock with the cumulative total return, assuming reinvestment of dividends, of:

Standard & Poor s 500 Stock Index, which includes the Corporation, and

AMEX Oil Index, which is comprised of companies involved in various phases of the oil industry including the Corporation.

As of each December 31, over a five-year period commencing on December 31, 2001 and ending on December 31, 2006:

Total Shareholder Returns
(Dividends Reinvested)
Years Ended December 31

As a result of consolidations in the oil and gas industry, the Corporation believes that the peer group it had used previously had too few participants and has selected the AMEX Oil Index, a published industry index that includes the Corporation and 12 additional oil and gas companies, for purposes of the performance graph shown above.

Holders

At December 31, 2006, there were 5,572 stockholders (based on number of holders of record) who owned a total of 315,017,951 shares of common stock.

Dividends

Cash dividends on common stock totaled $.40 per share ($.10 per quarter) during 2006 and 2005 on a split adjusted basis. Dividends on the 7% cumulative mandatory convertible preferred stock totaled $3.21 per share in 2006 prior to conversion on December 1, 2006 and $3.50 per share ($.875 per quarter) in 2005. See note 8, Long-Term Debt, in the notes to the financial statements for a discussion of restrictions on dividends.

Table of Contents

Equity Compensation Plans

Following is information on the Registrant s equity compensation plans at December 31, 2006:

Plan Category	Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights (a)	Weighted Average Exercise Price of Outstanding Options, Warrants and Rights (b)	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a)) (c)
Equity compensation plans approved by security holders	12,923,000	$ 29.68	11,698,000*
Equity compensation plans not approved by security holders**			

* *These securities may be awarded as stock options, restricted stock or other awards permitted under the Registrant s equity compensation plan.*

** *Registrant has a Stock Award Program pursuant to which each non-employee director receives $150,000 in value of Registrant s common stock each year. These awards are made from shares purchased by the Company in the open market. Stockholders did not approve this equity compensation plan.*

See note 9, Share-Based Compensation, in the notes to the financial statements for further discussion of the Corporation s equity compensation plans.

Table of Contents

Item 6. ***Selected Financial Data***

A five-year summary of selected financial data follows:

	2006	2005	2004	2003	2002
	(Millions of dollars, except per share amounts)				
Sales and other operating revenues					
Crude oil and natural gas liquids	**$ 5,307**	$ 3,219	$ 2,594	$ 2,295	$ 2,702
Natural gas (including sales of purchased gas)	**6,826**	6,423	4,638	4,522	3,077
Petroleum and other energy products	**14,411**	11,690	8,125	6,250	4,635
Convenience store sales and other operating revenues	**1,523**	1,415	1,376	1,244	1,137
Total	**$ 28,067**	$ 22,747	$ 16,733	$ 14,311	$ 11,551
Income (loss) from continuing operations	**$ 1,916(a)**	$ 1,242(b)	$ 970(c)	$ 467(d)	$ (245)(e)
Discontinued operations			7	169	27
Cumulative effect of change in accounting principle				7	
Net income (loss)	**$ 1,916**	$ 1,242	$ 977	$ 643	$ (218)
Less preferred stock dividends	**44**	48	48	5	
Net income (loss) applicable to common shareholders	**$ 1,872**	$ 1,194	$ 929	$ 638	$ (218)
Basic earnings (loss) per share *					
Continuing operations	**$ 6.73**	$ 4.38	$ 3.43	$ 1.74	$ (.93)
Net income (loss)	**6.73**	4.38	3.46	2.40	(.83)
Diluted earnings (loss) per share *					
Continuing operations	**$ 6.07**	$ 3.98	$ 3.17	$ 1.72	$ (.93)
Net income (loss)	**6.07**	3.98	3.19	2.37	(.83)
Total assets	**$ 22,404**	$ 19,115	$ 16,312	$ 13,983	$ 13,262
Total debt	**3,772**	3,785	3,835	3,941	4,992
Stockholders equity	**8,111**	6,286	5,597	5,340	4,249
Dividends per share of common stock *	**$ .40**	$ .40	$ .40	$ .40	$ .40

* *Per share amounts in all periods reflect the impact of a 3-for-1 stock split on May 31, 2006.*

(a)

Includes net after-tax income of $173 million primarily from sales of assets, partially offset by income tax adjustments and accrued leased office closing costs.

(b) Includes after-tax expenses of $37 million primarily relating to income taxes on repatriated earnings, premiums on bond repurchases and hurricane related expenses, partially offset by gains from asset sales and a LIFO inventory liquidation.

(c) Includes net after-tax income of $76 million primarily from sales of assets and income tax adjustments.

(d) Includes net after-tax expenses of $25 million, principally from premiums on bond repurchases and accrued severance and leased office closing costs, partially offset by income tax adjustments and asset sales.

(e) Includes net after-tax expenses aggregating $708 million, principally resulting from asset impairments.

Table of Contents

Item 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

Overview

The Corporation is a global integrated energy company that operates in two segments, Exploration and Production (E&P) and Marketing and Refining (M&R). The E&P segment explores for, develops, produces, purchases, transports and sells crude oil and natural gas. The M&R segment manufactures, purchases, transports, trades and markets refined petroleum products, natural gas and electricity.

Net income in 2006 was $1,916 million compared with $1,242 million in 2005 and $977 million in 2004. Diluted earnings per share were $6.07 in 2006 compared with $3.98 in 2005 and $3.19 in 2004.

Exploration and Production

The Corporation s strategy for the E&P segment is to profitably grow reserves and production in a sustainable and financially disciplined manner. At December 31, 2006 and 2005, the Corporation s total proved reserves were 1,243 million and 1,093 million barrels of oil equivalent. The following table summarizes the components of proved reserves as of December 31:

	2006		2005	
Crude oil and condensate (millions of barrels)				
U.S.	**138**	**17%**	124	18%
International	**694**	**83**	568	82
Total	**832**	**100%**	692	100%
Natural gas (millions of mcf)				
U.S.	**236**	**10%**	282	12%
International	**2,230**	**90**	2,124	88
Total	**2,466**	**100%**	2,406	100%

E&P net income was $1,763 million in 2006, $1,058 million in 2005 and $762 million in 2004. The improved results were primarily driven by higher average crude oil selling prices during the reporting period and lower hedged crude oil volumes in 2006. See further discussion in Comparison of Results on page 24.

Production totaled 359,000 barrels of oil equivalent per day (boepd) in 2006, 335,000 boepd in 2005 and 342,000 boepd in 2004. The Corporation estimates that production will be approximately 370,000 boepd to 380,000 boepd in 2007.

During 2006, the Corporation commenced production from four new field developments:

The Atlantic (Hess 25%) and Cromarty (Hess 90%) natural gas fields in the United Kingdom came onstream in June 2006 and produced at a combined net rate of approximately 95,000 mcf per day in the second half of the year.

The Okume Complex development (Hess 85%) in Equatorial Guinea commenced production in December. Additional development activities are planned throughout 2007. The Corporation estimates that its net share of 2007 production will average approximately 20,000 boepd.

First production from the Phu Horm onshore gas project (Hess 35%) in Thailand commenced in November. The Corporation estimates that its net share of 2007 production will average approximately 30,000 mcf per day.

Phase 2 production from the ACG fields (Hess 2.7%) in Azerbaijan also commenced during 2006.

The Corporation has several additional development projects that will also increase production in the future:

Development of the Shenzi field (Hess 28%) in the deepwater Gulf of Mexico was sanctioned and first production is anticipated in the second half of 2009.

The Genghis Khan field (Hess 28%) was acquired by the Shenzi partners in February 2007. The field is part of the same geologic structure as the Shenzi development and first production is anticipated in the second half of 2007.

The Ujung Pangkah field (Hess 75%) in Indonesia is scheduled to commence production of natural gas by mid 2007 under an existing gas sales agreement for 440 million mcf (gross) over a 20 year period with an expected plateau rate of 100,000 mcf per day (gross). The Corporation s plans for Ujung Pangkah in 2007 also include drilling additional development wells and the commencement of a crude oil development project.

Capital investments in the JDA (Hess 50%) will be made during 2007 which will be primarily focused on facilities expansion and development drilling associated with the anticipated commencement of additional contracted gas sales of 400,000 mcf per day (gross) in 2008. It is anticipated that production associated with these additional gas sales will begin ramping up in the fourth quarter of 2007.

Development of the residual oil zone at the Seminole - San Andres Unit (Hess 34.3%) in the Permian Basin is expected to commence in 2007 and production is anticipated to begin in 2009.

During 2006, the Corporation s exploration program had several successes, particularly in the deepwater Gulf of Mexico:

An exploration well on the Corporation s Pony prospect on Green Canyon Block 468 (Hess 100%) in the deepwater Gulf of Mexico encountered 475 feet of oil saturated sandstone in Miocene age reservoirs. Drilling of an appraisal sidetrack well on the Pony Prospect was completed in January 2007 which encountered 280 feet of oil saturated sandstone in Miocene age reservoirs after penetrating 60% of its geological objective. Drilling of the sidetrack well was stopped for mechanical reasons after successfully recovering 450 feet of conventional core. The Corporation is currently drilling an appraisal well about 7,400 feet northwest of the discovery well.

On the Tubular Bells prospect (Hess 20%) in the Mississippi Canyon area of the deepwater Gulf of Mexico a successful appraisal well encountered hydrocarbons approximately 5 miles from the initial discovery well. The operator intends to drill two sidetrack wells in 2007 which will further delineate the field.

In addition, during 2006, the Corporation made the following acquisitions and also disposed of several producing properties:

In January 2006, the Corporation, in conjunction with its Oasis Group partners, re-entered its former oil and gas production operations in the Waha concessions (Hess 8.16%) in Libya. The re-entry terms include a 25-year extension of the concessions and payments by the Corporation to the Libyan National Oil Corporation of $359 million. The Corporation s net share of 2006 production from Libya averaged 23,000 barrels of oil per day.

The Corporation acquired a 55% working interest in the deepwater section of the West Mediterranean Block 1 Concession (the West Med Block) in Egypt for $413 million. The Corporation has a 25-year development lease for the West Med Block, which contains four existing natural gas discoveries and additional exploration opportunities.

During 2006, the Corporation completed the sale of its interests in certain producing properties in the Permian Basin in Texas and New Mexico and certain U.S. Gulf Coast oil and gas producing assets. These asset sales generated total proceeds of $444 million after closing adjustments and an aggregate after-tax gain of

$236 million ($369 million before income taxes). Total net production from assets sold was approximately 8,000 boepd at the time of sale.

Marketing and Refining

The Corporation s strategy for the M&R segment is to deliver consistent financial performance and generate free cash flow. M&R net income was $390 million in 2006, $515 million in 2005 and $451 million in 2004. Total Marketing and Refining earnings decreased in 2006 due to lower margins on refined product sales. Refining

operations contributed net income of $236 million in 2006, $346 million in 2005 and $302 million in 2004. Profitability in 2006 was adversely affected by lower refined product margins. Refining facilities at the HOVENSA joint venture and at Port Reading performed reliably in 2006 with the exception of 22 days of unplanned downtime at HOVENSA early in the year. The Corporation received cash distributions from HOVENSA totaling $400 million in 2006 and $275 million in 2005.

In 2006, the Corporation s Port Reading facility completed its $72 million program for complying with low-sulfur gasoline requirements. Capital expenditures to comply with low-sulfur gasoline and diesel fuel requirements at HOVENSA are estimated to be approximately $420 million, of which $360 million has been incurred through the end of 2006 with the remainder to be spent in 2007.

Marketing earnings were $108 million in 2006, $136 million in 2005 and $112 million in 2004. During 2006 and 2005, the Corporation selectively expanded its energy marketing business by acquiring natural gas and electricity customer accounts.

Liquidity and Capital and Exploratory Expenditures

Net cash provided by operating activities was $3,491 million in 2006 compared with $1,840 million in 2005. At December 31, 2006, cash and cash equivalents totaled $383 million compared with $315 million at December 31, 2005. Total debt was $3,772 million at December 31, 2006 compared with $3,785 million at December 31, 2005. The Corporation s debt to capitalization ratio at December 31, 2006 was 31.7% compared with 37.6% at the end of 2005. The Corporation has debt maturities of $27 million in 2007 and $28 million in 2008.

Capital and exploratory expenditures were as follows for the years ended December 31:

	2006	2005
	(Millions of dollars)	
Exploration and Production		
United States	**$ 908**	$ 353
International	**2,979**	2,031
Total Exploration and Production	**3,887**	2,384
Marketing, Refining and Corporate	**169**	106
Total Capital and Exploratory Expenditures	**$ 4,056**	$ 2,490
Exploration expenses charged to income included above:		
United States	**$ 110**	$ 89
International	**102**	60
	$ 212	$ 149

The Corporation anticipates $4.0 billion in capital and exploratory expenditures in 2007, of which $3.9 billion relates to E&P operations. These expenditures include $371 million for the acquisition of a 28% interest in the Genghis Khan development in the deepwater Gulf of Mexico.

22

Consolidated Results of Operations

The after-tax results by major operating activity are summarized below:

	2006	2005	2004
	(Millions of dollars, except per share data)		
Exploration and Production	**$ 1,763**	$ 1,058	$ 755
Marketing and Refining	**390**	515	451
Corporate	**(110)**	(191)	(85)
Interest expense	**(127)**	(140)	(151)
Income from continuing operations	**1,916**	1,242	970
Discontinued operations			7
Net income	**$ 1,916**	$ 1,242	$ 977
Income per share from continuing operations diluted*	**$ 6.07**	$ 3.98	$ 3.17
Net income per share diluted*	**$ 6.07**	$ 3.98	$ 3.19

* *Per share amounts in all periods reflect the impact of a 3-for-1 stock split on May 31, 2006.*

In the discussion that follows, the financial effects of certain transactions are disclosed on an after-tax basis. Management reviews segment earnings on an after-tax basis and uses after-tax amounts in its review of variances in segment earnings. Management believes that after-tax amounts are a preferable method of explaining variances in earnings, since they show the entire effect of a transaction rather than only the pre-tax amount. After-tax amounts are determined by applying the appropriate income tax rate in each tax jurisdiction to pre-tax amounts.

The following items of income (expense), on an after-tax basis, are included in net income:

	2006	2005	2004
	(Millions of dollars)		
Exploration and Production			
Gains from asset sales	**$ 236**	$ 41	$ 54
Income tax adjustments	**(45)**	11	19
Accrued office closing costs	**(18)**		(9)
Hurricane related costs		(26)	
Legal settlement		11	
Marketing and Refining			
LIFO inventory liquidation		32	12
Charge related to customer bankruptcy		(8)	

Corporate			
Tax on repatriated earnings		(72)	
Premiums on bond repurchases		(26)	
Income tax adjustments			13
Insurance accrual			(13)
	$ 173	$ (37)	$ 76

The items in the table above are explained, and the pre-tax amounts are shown, on pages 26 through 29.

Comparison of Results

Exploration and Production

Following is a summarized income statement of the Corporation s Exploration and Production operations:

	2006	2005	2004
	(Millions of dollars)		
Sales and other operating revenues	**$ 6,524**	$ 4,210	$ 3,416
Non-operating income	**428**	94	90
Total revenues	**6,952**	4,304	3,506
Costs and expenses			
Production expenses, including related taxes	**1,250**	1,007	825
Exploration expenses, including dry holes and lease impairment	**552**	397	287
General, administrative and other expenses	**209**	140	150
Depreciation, depletion and amortization	**1,159**	965	918
Total costs and expenses	**3,170**	2,509	2,180
Results of operations from continuing operations before income taxes	**3,782**	1,795	1,326
Provision for income taxes	**2,019**	737	571
Results from continuing operations	**1,763**	1,058	755
Discontinued operations			7
Results of operations	**$ 1,763**	$ 1,058	$ 762

After considering the Exploration and Production items in the table on page 23, the remaining changes in Exploration and Production earnings are primarily attributable to changes in selling prices, production volumes, operating costs, exploration expenses and income taxes, as discussed below.

Selling prices: Higher average crude oil selling prices and reduced hedge positions increased Exploration and Production revenues by approximately $1,900 million in 2006 compared with 2005. In 2005, the change in average selling prices increased revenues by approximately $870 million compared with 2004.

The Corporation s average selling prices were as follows:

	2006	2005	2004
Crude oil-per barrel (including hedging)			
United States	**$ 60.45**	$ 32.64	$ 27.42
Europe	**56.19**	33.13	26.18

Africa	**51.18**	32.10	26.35
Asia and other	**61.52**	54.71	38.36
Worldwide	**55.31**	33.38	26.70
Crude oil-per barrel (excluding hedging)			
United States	**$ 60.45**	$ 51.16	$ 38.56
Europe	**58.46**	52.22	37.57
Africa	**62.80**	51.70	37.07
Asia and other	**61.52**	54.71	38.36
Worldwide	**60.41**	51.94	37.64

Table of Contents

	2006	2005	2004
Natural gas liquids-per barrel			
United States	**$ 46.22**	$ 38.50	$ 29.50
Europe	**47.30**	37.13	27.44
Worldwide	**46.59**	38.08	28.81
Natural gas-per mcf			
United States	**$ 6.59**	$ 7.93	$ 5.18
Europe	**6.20**	5.29	3.96
Asia and other	**4.05**	4.02	3.90
Worldwide	**5.50**	5.65	4.31

The after-tax impacts of hedging reduced earnings by $285 million ($449 million before income taxes) in 2006, $989 million ($1,582 million before income taxes) in 2005 and $583 million ($935 million before income taxes) in 2004.

Production and sales volumes: The Corporation s crude oil and natural gas production was 359,000 boepd in 2006, 335,000 boepd in 2005 and 342,000 boepd in 2004. The Corporation anticipates that its 2007 production will average between 370,000 and 380,000 boepd. The Corporation s net daily worldwide production was as follows:

	2006	2005	2004
Crude oil (thousands of barrels per day)			
United States	**36**	44	44
Europe	**109**	110	119
Africa	**85**	67	61
Asia and other	**12**	7	4
Total	**242**	228	228
Natural gas liquids (thousands of barrels per day)			
United States	**10**	12	12
Europe	**5**	4	6
Total	**15**	16	18
Natural gas (thousands of mcf per day)			
United States	**110**	137	171
Europe	**283**	274	319
Asia and other	**219**	133	85
Total	**612**	544	575
Barrels of oil equivalent* (thousands of barrels per day)	**359**	335	342

* *Reflects natural gas production converted on the basis of relative energy content (six mcf equals one barrel).*

Crude oil and natural gas production in the United States was lower in 2006 due to asset sales and natural decline. Production in Europe was comparable in 2006 and 2005, reflecting increased production from Russia and new production from the Atlantic and Cromarty natural gas fields in the United Kingdom, which offset lower production due to maintenance and natural decline. Increased crude oil production in Africa in 2006 was primarily due to production from Libya. Natural gas production in Asia was higher in 2006 due to increased production from the JDA.

Higher sales volumes increased revenue by approximately $400 million in 2006 compared with 2005. Decreased sales volumes resulted in lower revenue of approximately $80 million in 2005 compared with 2004.

Operating costs and depreciation, depletion and amortization: Cash operating costs, consisting of production expenses and general and administrative expenses, increased by $322 million in 2006 and $147 million in 2005 compared with the corresponding amounts in prior years, excluding the charges for vacated leased office space and hurricane related costs discussed below. Production expenses increased in 2006 and 2005, principally reflecting higher maintenance expenses, increased costs of services, materials and fuel and higher production taxes resulting from higher oil prices. Production expenses also increased in 2006 due to the re-entry into Libya and continued expansion of operations in Russia and the JDA. Depreciation, depletion and amortization charges were higher in 2006, principally reflecting increased production volumes and higher per barrel rates, due to new production from the Atlantic and Cromarty fields and higher asset retirement obligations. Depreciation, depletion and amortization charges were higher in 2005 versus 2004, principally due to higher per barrel rates.

Cash operating costs per barrel of oil equivalent were $10.92 in 2006, $9.07 in 2005 and $7.67 in 2004. Cash operating costs for 2007 are estimated to be in the range of $12.00 to $13.00 per barrel, reflecting industry-wide cost increases and the timing of achieving peak production from new fields. Depreciation, depletion and amortization costs per barrel of oil equivalent were $8.85 in 2006, $7.88 in 2005 and $7.34 in 2004. Depreciation, depletion and related costs for 2007 are expected to be in the range of $10.00 to $11.00 per barrel. The anticipated increase is due to new fields, including the Okume Complex, which has allocated acquisition cost in its depreciable base.

Exploration expenses: Exploration expenses were higher in 2006, primarily reflecting higher dry hole costs. Exploration expenses were higher in 2005 compared with 2004 as a result of increased drilling and seismic activity.

Income Taxes: The effective income tax rate for Exploration and Production operations was 53% in 2006, 41% in 2005 and 43% in 2004. After considering the items in the table below, the effective income tax rates were 54% in 2006, 42% in 2005 and 46% in 2004. The increase in the 2006 effective income tax rate was primarily due to taxes on Libyan operations and the increase in the supplementary tax on petroleum operations in the United Kingdom from 10% to 20%. During 2006, the Algerian government amended its hydrocarbon tax laws effective August 1, 2006 and the Corporation recorded a net charge of $6 million for the estimated impact of the tax. The effective income tax rate for E&P operations in 2007 is expected to be in the range of 52% to 56%.

Other: After-tax foreign currency gains were $10 million ($21 million before income taxes) in 2006, $20 million ($3 million loss before income taxes) in 2005, and $6 million ($29 million before income taxes) in 2004.

Reported Exploration and Production earnings include the following items of income (expense) before and after income taxes:

	Before Income Taxes			**After Income Taxes**		
	2006	**2005**	**2004**	**2006**	**2005**	**2004**
			(Millions of dollars)			
Gains from asset sales	**$ 369**	$ 48	$ 55	**$ 236**	$ 41	$ 54
Income tax adjustments				**(45)**	11	19
Accrued office closing costs	**(30)**		(15)	**(18)**		(9)
Hurricane related costs		(40)			(26)	
Legal settlement		19			11	

	$ 339	$ 27	$ 40	**$ 173**	$ 37	$ 64

2006: The gains from asset sales relate to the sale of certain United States oil and gas producing properties located in the Permian Basin in Texas and New Mexico and onshore Gulf Coast. The accrued office closing cost relates to vacated leased office space in the United Kingdom. The income tax adjustment represents a one-time adjustment to the Corporation s deferred tax liability resulting from an increase in the supplementary tax on petroleum operations in the United Kingdom from 10% to 20%.

2005: The gains from asset sales represent the disposal of non-producing properties in the United Kingdom and the exchange of a mature North Sea asset for an increased interest in the Pangkah development in Indonesia. The Corporation incurred incremental expenses in 2005, principally repair costs and higher insurance premiums, as a result of hurricane damage in the Gulf of Mexico that are included in production expenses in the income statement. The income tax adjustment reflects the effect on deferred income taxes of a reduction in the income tax rate in Denmark and a tax settlement in the United Kingdom. The legal settlement reflects the favorable resolution of contingencies on a prior year asset sale, which is reflected in non-operating income in the income statement.

2004: The Corporation recognized gains from the sales of an office building in Scotland, a non-producing property in Malaysia and two mature Gulf of Mexico properties. It also recorded foreign income tax benefits resulting from a change in tax law and a tax settlement. The Corporation recorded an after-tax charge for vacated leased office space in the United Kingdom and severance costs, which is reflected in general and administrative expenses in the income statement.

The Corporation s future Exploration and Production earnings may be impacted by external factors, such as political risk, volatility in the selling prices of crude oil and natural gas, reserve and production changes, industry cost inflation, exploration expenses, the effects of weather and changes in foreign exchange and income tax rates.

Marketing and Refining

Earnings from Marketing and Refining activities amounted to $390 million in 2006, $515 million in 2005 and $451 million in 2004. After considering the Marketing and Refining items in the table on page 23, the earnings amounted to $390 million in 2006, $491 million in 2005 and $439 million in 2004 and are discussed in the paragraphs below. The Corporation s downstream operations include HOVENSA, a 50% owned refining joint venture with a subsidiary of Petroleos de Venezuela S.A. (PDVSA) that is accounted for using the equity method. Additional Marketing and Refining activities include a fluid catalytic cracking facility in Port Reading, New Jersey, as well as retail gasoline stations, energy marketing and trading operations.

Refining: Refining earnings, which consist of the Corporation s share of HOVENSA s results, Port Reading earnings, interest income on a note receivable from PDVSA and other miscellaneous items were $236 million in 2006, $346 million in 2005 and $302 million in 2004.

The Corporation s share of HOVENSA s net income was $125 million ($203 million before income taxes) in 2006 and $231 million ($376 million before income taxes) in 2005 and $216 million ($244 million before income taxes) in 2004. The lower earnings in 2006 were principally due to lower refined product margins. Refined product margins were higher in 2005 compared with 2004. In 2006 and 2005, the Corporation provided income taxes at the Virgin Islands statutory rate of 38.5% on HOVENSA s income and the interest income on the note receivable from PDVSA. In 2004, income taxes on HOVENSA s earnings were partially offset by available loss carryforwards. In 2006, the fluid catalytic cracking unit was shutdown for approximately 22 days of unscheduled maintenance. During 2005, a crude unit and the fluid catalytic cracking unit at HOVENSA were each shutdown for approximately 30 days of scheduled maintenance. Cash distributions from HOVENSA were $400 million in 2006, $275 million in 2005 and $88 million in 2004.

Pre-tax interest on the PDVSA note was $15 million, $20 million and $25 million in 2006, 2005 and 2004, respectively. Interest income is reflected in non-operating income in the income statement. At December 31, 2006, the remaining balance of the PDVSA note was $137 million, which is scheduled to be fully repaid by February 2009.

Port Reading s after-tax earnings were $99 million in 2006, $100 million in 2005 and $60 million in 2004. Higher refined product sales volumes were offset by lower margins in 2006 compared with 2005. Refined product margins were higher in 2005 compared with 2004. In 2005, the Port Reading facility was shutdown for 36 days of planned maintenance.

Table of Contents

The following table summarizes refinery utilization rates:

	Refinery Capacity (Thousands of barrels per day)	Refinery Utilization 2006	2005	2004
HOVENSA				
Crude	500	**89.7%**	92.2%	96.7%
Fluid catalytic cracker	150	**84.3%**	81.9%	92.9%
Coker	58	**84.3%**	92.8%	94.5%
Port Reading	65	**97.4%**	85.3%	83.4%

Marketing: Marketing operations, which consist principally of retail gasoline and energy marketing activities, generated income of $108 million in 2006, $112 million in 2005 and $100 million in 2004, excluding the income from liquidation of LIFO inventories and the charge related to a customer bankruptcy described below. The decrease in 2006 primarily reflects lower margins on refined product sales. The increase in 2005 was primarily due to higher margins and increased sales volumes compared with 2004. Total refined product sales volumes were 459,000 barrels per day in 2006, 456,000 barrels per day in 2005 and 428,000 barrels per day in 2004.

The Corporation has a 50% voting interest in a consolidated partnership that trades energy commodities and energy derivatives. The Corporation also takes trading positions for its own account. The Corporation s after-tax results from trading activities, including its share of the earnings of the trading partnership, amounted to income of $46 million in 2006, $33 million in 2005 and $37 million in 2004. Before income taxes, the trading income amounted to $83 million in 2006, $60 million in 2005 and $72 million in 2004 and is included in operating revenues in the income statement.

Marketing expenses increased due to higher expenses resulting from an increased number of retail convenience stores, growth in energy marketing operations, and higher utility and compensation related costs.

Reported Marketing and Refining earnings include the following items of income (expense) before and after income taxes:

	Before Income Taxes 2006	2005	2004	After Income Taxes 2006	2005	2004
	(Millions of dollars)					
LIFO inventory liquidation	**$**	$ 51	$ 20	**$**	$ 32	$ 12
Charge related to customer bankruptcy		(13)			(8)	
	$	$ 38	$ 20	**$**	$ 24	$ 12

In 2005 and 2004, Marketing and Refining earnings include income from the liquidation of prior year LIFO inventories. In 2005, earnings include a charge resulting from the bankruptcy of a customer in the utility industry, which is included in marketing expenses.

The Corporation s future Marketing and Refining earnings may be impacted by volatility in Marketing and Refining margins, competitive industry conditions, government regulatory changes, credit risk and supply and demand factors, including the effects of weather.

Table of Contents

Corporate

The following table summarizes corporate expenses:

	2006	2005	2004
	(Millions of dollars)		
Corporate expenses (excluding the items listed below)	**$ 156**	$ 119	$ 116
Income taxes (benefits) on the above	**(46)**	(26)	(31)
	110	93	85
Items affecting comparability between periods, after tax			
Tax on repatriated earnings		72	
Premiums on bond repurchases		26	
Income tax adjustments			(13)
Insurance accrual			13
Net corporate expenses	**$ 110**	$ 191	$ 85

Excluding the items affecting comparability between periods, the increase in corporate expenses in 2006 compared to 2005 primarily reflects the expensing of stock options commencing January 1, 2006 and increases in insurance costs. Recurring after-tax corporate expenses in 2007 are estimated to be in the range of $115 to $125 million.

In 2005, the American Jobs Creation Act provided for a one-time reduction in the income tax rate to 5.25% on the remittance of eligible dividends from foreign subsidiaries to a United States parent. The Corporation repatriated $1.9 billion of previously unremitted foreign earnings resulting in the recognition of an income tax provision of $72 million. The pre-tax amount of bond repurchase premiums in 2005 was $39 million and is reflected in non-operating income in the income statement. The pre-tax amount of the 2004 corporate insurance accrual was $20 million and is reflected in non-operating income.

Interest

After-tax interest expense was as follows:

	2006	2005	2004
	(Millions of dollars)		
Total interest incurred	**$ 301**	$ 304	$ 295
Less capitalized interest	**100**	80	54
Interest expense before income taxes	**201**	224	241
Less income taxes	**74**	84	90
After-tax interest expense	**$ 127**	$ 140	$ 151

After-tax interest expense in 2007 is expected to be in the range of $170 to $180 million, principally reflecting an anticipated decrease in capitalized interest due to the achievement of first production from several development projects.

Sales and Other Operating Revenues

Sales and other operating revenues totaled $28,067 million in 2006, an increase of 23% compared with 2005. The increase reflects higher selling prices of crude oil, higher sales volumes and reduced crude oil hedge positions in Exploration and Production activities and higher selling prices and sales volumes in marketing activities. In 2005, sales and other operating revenues totaled $22,747 million, an increase of 36% compared with 2004. This increase principally reflects higher selling prices of crude oil and natural gas in Exploration and Production and higher

selling prices and sales volumes in marketing activities. The change in cost of goods sold in each year reflects the change in sales volumes and prices of refined products and purchased natural gas.

Liquidity and Capital Resources

The following table sets forth certain relevant measures of the Corporation s liquidity and capital resources as of December 31:

	2006	2005
	(Millions of dollars)	
Cash and cash equivalents	**$ 383**	$ 315
Current portion of long-term debt	**$ 27**	$ 26
Total debt	**$ 3,772**	$ 3,785
Stockholders equity	**$ 8,111**	$ 6,286
Debt to capitalization ratio*	**31.7%**	37.6%

* *Total debt as a percentage of the sum of total debt plus stockholders equity.*

Cash Flows

The following table sets forth a summary of the Corporation s cash flows:

	2006	2005	2004
		(Millions of dollars)	
Net cash provided by (used in):			
Operating activities	**$ 3,491**	$ 1,840	$ 1,903
Investing activities	**(3,289)**	(2,255)	(1,371)
Financing activities	**(134)**	(147)	(173)
Net increase (decrease) in cash and cash equivalents	**$ 68**	$ (562)	$ 359

Operating Activities: In 2006, net cash provided by operating activities, including changes in operating assets and liabilities, was $3,491 million, an increase of $1,651 million from 2005, principally reflecting higher earnings, changes in working capital accounts and increased distributions from HOVENSA. Net cash provided by operating activities was $1,840 million in 2005 compared with $1,903 million in 2004. The change was due to higher earnings in 2005, offset by a decrease from changes in operating assets and liabilities, principally working capital, of $408 million. The Corporation received cash distributions from HOVENSA of $400 million in 2006, $275 million in 2005 and $88 million in 2004.

Investing Activities: The following table summarizes the Corporation s capital expenditures:

	2006	2005	2004

	(Millions of dollars)		
Exploration and Production			
Exploration	**$ 590**	$ 229	$ 168
Production and development	**2,164**	1,598	1,204
Acquisitions (including leasehold)	**921**	408	62
	3,675	2,235	1,434
Marketing, Refining and Corporate	**169**	106	87
Total	**$ 3,844**	$ 2,341	$ 1,521

Capital expenditures in 2006 include payments of $359 million to acquire the Corporation s former oil and gas production operations in the Waha concessions in Libya and $413 million to acquire a 55% working interest in the West Med Block in Egypt.

30

Proceeds from asset sales in 2006 totaled $444 million, including the sale of the Corporation s interests in certain producing properties in the Permian Basin and onshore U.S. Gulf Coast. Proceeds from asset sales were $74 million and $57 million in 2005 and 2004, respectively, principally from the sale of non-producing properties.

Financing Activities: The Corporation reduced debt by $13 million in 2006, $50 million in 2005 and $106 million in 2004. The net reductions in debt in 2006, 2005 and 2004 were funded by available cash and cash flow from operations. In 2005, bond repurchases of $600 million were funded by borrowings on the revolving credit facility in connection with the repatriation of foreign earnings to the United States.

Dividends paid were $161 million in 2006, $159 million in 2005 and $157 million in 2004. The Corporation received proceeds from the exercise of stock options totaling $40 million, $62 million and $90 million in 2006, 2005 and 2004, respectively.

Future Capital Requirements and Resources

The Corporation anticipates $4.0 billion in capital and exploratory expenditures in 2007, of which $3.9 billion relates to Exploration and Production operations. The Corporation has maturities of long-term debt of $27 million in 2007 and $28 million in 2008. The Corporation anticipates that it can fund its 2007 operations, including capital expenditures, dividends, pension contributions and required debt repayments, with existing cash on-hand, cash flow from operations and its available credit facilities.

During 2006, the Corporation amended and restated its existing syndicated, revolving credit facility (the facility) to increase the credit line to $3.0 billion from $2.5 billion and extend the term to May 2011 from December 2009. The facility can be used for borrowings and letters of credit. At December 31, 2006, the Corporation has $2.7 billion available under this facility.

The Corporation has a 364-day asset-backed credit facility securitized by certain accounts receivable from its Marketing and Refining operations, which are sold to a wholly-owned subsidiary. Under the terms of this financing arrangement, the Corporation has the ability to borrow up to $800 million, subject to the availability of sufficient levels of eligible receivables. At December 31, 2006, the Corporation has $318 million in outstanding borrowings under this facility which was collateralized by approximately $1,100 million of receivables. These receivables are not available to pay the general obligations of the Corporation before repayment of outstanding borrowings under the asset-backed facility.

The Corporation has additional unused lines of credit of approximately $370 million, primarily for letters of credit, under uncommitted arrangements with banks. The Corporation also has a shelf registration under which it may issue additional debt securities, warrants, common stock or preferred stock.

Outstanding letters of credit at December 31, were as follows:

	2006	**2005**
	(Millions of dollars)	
Lines of Credit		
Revolving credit facility	**$ 1**	$ 28
Committed short-term letter of credit facilities	**1,875**	1,675
Uncommitted lines	**1,603**	982

	2006	2005
	$ 3,479	$ 2,685

Loan agreement covenants allow the Corporation to borrow up to an additional $9.7 billion for the construction or acquisition of assets at December 31, 2006. The Corporation has the ability to borrow up to an additional $2.2 billion of secured debt at December 31, 2006 under the loan agreement covenants. At December 31, 2006, the maximum amount of dividends or stock repurchases that can be paid from borrowings under the loan agreement covenants is $3.7 billion.

Credit Ratings

There are three major credit rating agencies that rate the Corporation s debt. Two credit agencies have assigned an investment grade rating to the Corporation s debt and one agency has rated it below investment grade. The interest rate and facility fee are subject to adjustment if the Corporation s credit rating changes. In addition, if any one of the three rating agencies were to reduce their rating on the Corporation s senior unsecured debt, margin requirements with non-trading and trading counterparties at December 31, 2006 would increase by up to approximately $140 million.

Contractual Obligations and Contingencies

Following is a table showing aggregated information about certain contractual obligations at December 31, 2006:

	Payments Due by Period				
	Total	2007	2008 and 2009	2010 and 2011	Thereafter
	(Millions of dollars)				
Long-term debt(a)	$ 3,772	$ 27	$ 171	$ 1,340	$ 2,234
Operating leases	2,471	630	567	198	1,076
Purchase obligations					
Supply commitments	25,800	8,381	8,990	8,429	(b)
Capital expenditures	1,109	809	263	37	
Operating expenses	794	477	187	89	41
Other long-term liabilities	1,316	65	285	220	746

(a) At December 31, 2006, the Corporation s debt bears interest at a weighted average rate of 7.0%.

(b) The Corporation intends to continue purchasing refined product supply from HOVENSA. Estimated future purchases amount to approximately $4.2 billion annually using year-end 2006 prices.

In the preceding table, the Corporation s supply commitments include its estimated purchases of 50% of HOVENSA s production of refined products, after anticipated sales by HOVENSA to unaffiliated parties. The value of future supply commitments will fluctuate based on prevailing market prices at the time of purchase, the actual output from HOVENSA, and the level of sales to unaffiliated parties. Also included are term purchase agreements at market prices for additional gasoline necessary to supply the Corporation s retail marketing system and feedstocks for the Port Reading refining facility. In addition, the Corporation has commitments to purchase refined products, natural gas and electricity for use in supplying contracted customers in its energy marketing business. These commitments were computed based on year-end market prices.

The table also reflects that portion of the Corporation s planned $4 billion capital investment program for 2007 that is contractually committed at December 31, 2006. Obligations for operating expenses include commitments for transportation, seismic purchases, oil and gas production expenses and other normal business expenses. Other long-term liabilities reflect contractually committed obligations on the balance sheet at December 31, including asset retirement obligations and pension plan funding requirements.

At December 31, 2006, the Corporation had a remaining accrual of $49 million for vacated leased office space costs. In 2006, the Corporation recorded an additional $30 million charge for vacated leased office space ($18 million after income taxes) and made payments of $12 million. At December 31, 2005, the accrual was $31 million after reduction for payments of $8 million during 2005.

The Corporation has a contingent purchase obligation, expiring in April 2010, to acquire the remaining interest in WilcoHess, a retail gasoline station joint venture, for approximately $140 million as of December 31, 2006.

The Corporation guarantees the payment of up to 50% of HOVENSA s crude oil purchases from suppliers other than PDVSA. The amount of the Corporation s guarantee fluctuates based on the volume of crude oil purchased and related prices and at December 31, 2006, amounted to $229 million. In addition, the Corporation has

Table of Contents

agreed to provide funding up to a maximum of $15 million to the extent HOVENSA does not have funds to meet its senior debt obligations.

At December 31, 2006, the Corporation has $3,427 million of letters of credit principally relating to accrued liabilities with hedging and trading counterparties recorded on its balance sheet. In addition, the Corporation is contingently liable under letters of credit and under guarantees of the debt of other entities directly related to its business, as follows:

	Total (Millions of dollars)
Letters of credit	$ 52
Guarantees	301*
	$ 353

* *Includes $15 million HOVENSA debt and $229 million crude oil purchase guarantees discussed above. The remainder relates to a loan guarantee of $57 million for an oil pipeline in which the Corporation owns a 2.36% interest.*

Off-Balance Sheet Arrangements

The Corporation has leveraged leases not included in its balance sheet, primarily related to retail gasoline stations that the Corporation operates. The net present value of these leases is $490 million at December 31, 2006 compared with $480 million at December 31, 2005. The Corporation s December 31, 2006 debt to capitalization ratio would increase from 31.7% to 34.4% if these leases were included as debt.

See also *Contractual Obligations and Contingencies* above, note 5, Refining Joint Venture, and note 16, Guarantees and Contingencies, in the notes to the financial statements.

Stock Split

On May 3, 2006, the Corporation s shareholders voted to increase the number of authorized common shares from 200 million to 600 million and the board of directors declared a three-for-one stock split. The stock split was completed in the form of a stock dividend that was issued on May 31, 2006 to shareholders of record on May 17, 2006. The common share par value remained at $1.00 per share. All common share and per share amounts in the financial statements and notes and management s discussion and analysis are on an after-split basis for all periods presented.

Foreign Operations

The Corporation conducts exploration and production activities in the United Kingdom, Norway, Denmark, Equatorial Guinea, Algeria, Malaysia, Thailand, Russia, Gabon, Azerbaijan, Indonesia, Libya, Egypt and other countries. Therefore, the Corporation is subject to the risks associated with foreign operations. These exposures include political risk (including tax law changes) and currency risk.

HOVENSA L.L.C., owned 50% by the Corporation and 50% by Petroleos de Venezuela, S.A. (PDVSA), owns and operates a refinery in the United States Virgin Islands. In the past, there have been political disruptions in Venezuela that reduced the availability of Venezuelan crude oil used in refining operations; however, these disruptions did not have a material adverse effect on the Corporation s financial position. The Corporation has a note receivable of $137 million at December 31, 2006 from a subsidiary of PDVSA. All payments are current and the Corporation anticipates collection of the remaining balance.

Subsequent Events

In February 2007, the Corporation completed the acquisition of a 28% interest in the Genghis Khan oil and gas development located in the deepwater Gulf of Mexico on Green Canyon Blocks 652 and 608 for $371 million. The Genghis Khan development is part of the same geologic structure as the Shenzi development (Hess 28%) and first production from this development is expected in the second half of 2007.

Table of Contents

Accounting Policies

Critical Accounting Policies and Estimates

Accounting policies and estimates affect the recognition of assets and liabilities on the Corporation s balance sheet and revenues and expenses on the income statement. The accounting methods used can affect net income, stockholders equity and various financial statement ratios. However, the Corporation s accounting policies generally do not change cash flows or liquidity.

Accounting for Exploration and Development Costs: Exploration and production activities are accounted for using the successful efforts method. Costs of acquiring unproved and proved oil and gas leasehold acreage, including lease bonuses, brokers fees and other related costs, are capitalized. Annual lease rentals, exploration expenses and exploratory dry hole costs are expensed as incurred. Costs of drilling and equipping productive wells, including development dry holes, and related production facilities are capitalized.

The costs of exploratory wells that find oil and gas reserves are capitalized pending determination of whether proved reserves have been found. Exploratory drilling costs remain capitalized after drilling is completed if (1) the well has found a sufficient quantity of reserves to justify completion as a producing well and (2) sufficient progress is being made in assessing the reserves and the economic and operating viability of the project. If either of those criteria is not met, or if there is substantial doubt about the economic or operational viability of the project, the capitalized well costs are charged to expense. Indicators of sufficient progress in assessing reserves and the economic and operating viability of a project include: commitment of project personnel, active negotiations for sales contracts with customers, negotiations with governments, operators and contractors and firm plans for additional drilling and other factors.

Crude Oil and Natural Gas Reserves: The determination of estimated proved reserves is a significant element in arriving at the results of operations of exploration and production activities. The estimates of proved reserves affect well capitalizations, the unit of production depreciation rates of proved properties and wells and equipment, as well as impairment testing of oil and gas assets and goodwill.

The Corporation s oil and gas reserves are calculated in accordance with SEC regulations and interpretations and the requirements of the Financial Accounting Standards Board. For reserves to be booked as proved they must be commercially producible, government and project operator approvals must be obtained and depending on the amount of the project cost, senior management or the board of directors, must commit to fund the project. The Corporation s oil and gas reserve estimation and reporting process involves an annual independent third party reserve determination as well as internal technical appraisals of reserves. The Corporation maintains its own internal reserve estimates that are calculated by technical staff that work directly with the oil and gas properties. The Corporation s technical staff updates reserve estimates throughout the year based on evaluations of new wells, performance reviews, new technical data and other studies. To provide consistency throughout the Corporation, standard reserve estimation guidelines, definitions, reporting reviews and approval practices are used. The internal reserve estimates are subject to internal technical audits and senior management reviews the estimates.

The oil and gas reserve estimates reported in the Supplementary Oil and Gas Data in accordance with Statement of Financial Accounting Standards (FAS) No. 69 *Disclosures about Oil and Gas Producing Activities* (FAS No. 69) are determined independently by the consulting firm of DeGolyer and MacNaughton (D&M) and are consistent with internal estimates. Annually, the Corporation provides D&M with engineering, geological and geophysical data, actual production histories and other information necessary for the reserve determination. The Corporation s and D&M s technical staffs meet to review and discuss the information provided. Senior management and the Board of Directors review the final reserve estimates issued by D&M.

Impairment of Long-Lived Assets and Goodwill: As explained below there are significant differences in the way long-lived assets and goodwill are evaluated and measured for impairment testing. The Corporation reviews long-lived assets, including oil and gas fields, for impairment whenever events or changes in circumstances indicate that the carrying amounts may not be recovered. Long-lived assets are tested based on identifiable cash flows (the field level for oil and gas assets) and are largely independent of the cash flows of other assets and liabilities. If the carrying amounts of the long-lived assets are not expected to be recovered by undiscounted future net cash flow

estimates, the assets are impaired and an impairment loss is recorded. The amount of impairment is based on the estimated fair value of the assets determined by discounting anticipated future net cash flows.

In the case of oil and gas fields, the present value of future net cash flows is based on management s best estimate of future prices, which is determined with reference to recent historical prices and published forward prices, applied to projected production volumes of individual fields and discounted at a rate commensurate with the risks involved. The projected production volumes represent reserves, including probable reserves, expected to be produced based on a stipulated amount of capital expenditures. The production volumes, prices and timing of production are consistent with internal projections and other externally reported information. Oil and gas prices used for determining asset impairments will generally differ from those used in the standardized measure of discounted future net cash flows, since the standardized measure requires the use of actual prices on the last day of the year.

The Corporation s impairment tests of long-lived Exploration and Production producing assets are based on its best estimates of future production volumes (including recovery factors), selling prices, operating and capital costs and the timing of future production, which are updated each time an impairment test is performed. The Corporation could have impairments if the projected production volumes from oil and gas fields were reduced. Significant extended declines in crude oil and natural gas selling prices could also result in asset impairments.

In accordance with FAS No. 142 *Goodwill and Other Intangible Assets* (FAS No. 142), the Corporation s goodwill is not amortized, but is tested for impairment annually in the fourth quarter at a reporting unit level. The reporting unit or units used to evaluate and measure goodwill for impairment are determined primarily from the manner in which the business is managed. The Corporation s goodwill is assigned to the Exploration and Production operating segment and it expects that the benefits of goodwill will be recovered through the operation of that segment.

The Corporation s fair value estimate of the Exploration and Production segment is the sum of: (1) the discounted anticipated cash flows of producing assets and known developments, (2) the estimated risk adjusted present value of exploration assets, and (3) an estimated market premium to reflect the market price an acquirer would pay for potential synergies including cost savings, access to new business opportunities, enterprise control, improved processes and increased market share. The Corporation also considers the relative market valuation of similar Exploration and Production companies.

The determination of the fair value of the Exploration and Production operating segment depends on estimates about oil and gas reserves, future prices, timing of future net cash flows and market premiums. Significant extended declines in crude oil and natural gas prices or reduced reserve estimates could lead to a decrease in the fair value of the Exploration and Production operating segment that could result in an impairment of goodwill.

Because there are significant differences in the way long-lived assets and goodwill are evaluated and measured for impairment testing, there may be impairments of individual assets that would not cause an impairment of the goodwill assigned to the Exploration and Production segment.

Segments: The Corporation has two operating segments, Exploration and Production and Marketing and Refining. Management has determined that these are its operating segments because, in accordance with FAS No. 131 *Disclosures about Segments of an Enterprise and Related Information* (FAS No. 131), these are the segments of the Corporation (i) that engage in business activities from which revenues are earned and expenses are incurred, (ii) whose operating results are regularly reviewed by the Corporation s chief operating decision maker (CODM) to make decisions about resources to be allocated to the segment and assess its performance and (iii) for which discrete financial information is available. The Chairman of the Board and Chief Executive Officer of the Corporation, is the CODM as defined in FAS No. 131, because he is responsible for performing the functions within the Corporation of allocating resources to, and assessing the performance of, the Corporation s operating segments.

Derivatives: The Corporation utilizes derivative instruments for both non-trading and trading activities. In non-trading activities, the Corporation uses futures, forwards, options and swaps, individually or in combination to mitigate its exposure to fluctuations in the prices of crude oil, natural gas, refined products and electricity, and changes in foreign currency exchange rates. In trading activities, the Corporation, principally through a consolidated

partnership, trades energy commodities derivatives, including futures, forwards, options and swaps, based on expectations of future market conditions.

All derivative instruments are recorded at fair value in the Corporation s balance sheet. The Corporation s policy for recognizing the changes in fair value of derivatives varies based on the designation of the derivative. The changes in fair value of derivatives that are not designated as hedges under FAS No. 133 are recognized currently in earnings. Derivatives may be designated as hedges of expected future cash flows or forecasted transactions (cash flow hedges) or hedges of firm commitments (fair value hedges). The effective portion of changes in fair value of derivatives that are designated as cash flow hedges is recorded as a component of other comprehensive income (loss). Amounts included in accumulated other comprehensive income (loss) for cash flow hedges are reclassified into earnings in the same period that the hedged item is recognized in earnings. The ineffective portion of changes in fair value of derivatives designated as cash flow hedges is recorded currently in earnings. Changes in fair value of derivatives designated as fair value hedges are recognized currently in earnings. The change in fair value of the related hedged commitment is recorded as an adjustment to its carrying amount and recognized currently in earnings.

Derivatives that are designated as either cash flow or fair value hedges are tested for effectiveness prospectively before they are executed and both prospectively and retrospectively on an on-going basis to determine whether they continue to qualify for hedge accounting. The prospective and retrospective effectiveness calculations are performed using either historical simulation or other statistical models, which utilize historical observable market data consisting of futures curves and spot prices.

Income Taxes: Judgments are required in the determination and recognition of income tax assets and liabilities in the financial statements. The Corporation has net operating loss carryforwards in several jurisdictions, including the United States, and has recorded deferred tax assets for those losses. Additionally, the Corporation has deferred tax assets due to temporary differences between the book basis and tax basis of certain assets and liabilities. Regular assessments are made as to the likelihood of those deferred tax assets being realized. If it is more likely than not that some or all of the deferred tax assets will not be realized, a valuation allowance is recorded to reduce the deferred tax assets to the amount that is expected to be realized. In evaluating realizability of deferred tax assets, the Corporation refers to the reversal periods for temporary differences, available carryforward periods for net operating losses, estimates of future taxable income, the availability of tax planning strategies, the existence of appreciated assets and other factors. Estimates of future taxable income are based on assumptions of oil and gas reserves and selling prices that are consistent with the Corporation s internal business forecasts.

Changes in Accounting Policies

Effective January 1, 2006, the Corporation adopted the provisions of FAS No. 123R, *Share-Based Payment* (FAS No. 123R). FAS No. 123R requires that the fair value of all stock-based compensation to employees, including grants of stock options, be expensed over the vesting period. Through December 31, 2005, the Corporation used the intrinsic value method to account for employee stock options. Because the exercise prices of employee stock options equaled or exceeded the market price of the stock on the date of grant, the Corporation did not recognize compensation expense under the intrinsic value method. See note 9, Share-Based Compensation, in the notes to the consolidated financial statements.

In September 2006, the Financial Accounting Standards Board (FASB) issued FAS No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans* (FAS No. 158). FAS No. 158 requires recognition on the balance sheet of the overfunded or underfunded status of a defined benefit postretirement plan measured as the difference between the fair value of plan assets and the benefit obligation. As required, the Corporation prospectively adopted the provisions of FAS No. 158 on December 31, 2006. See note 11, Retirement Plans, in the notes to the consolidated financial statements.

Recently Issued Accounting Standards

In September 2006, the FASB issued Staff Position (FSP) AUG AIR-1, *Accounting for Planned Major Maintenance Activities.* This FSP eliminates the previously acceptable accrue-in-advance method of accounting for planned major maintenance. As a result, the Corporation will retrospectively change its method of accounting for

Table of Contents

refinery turnarounds on January 1, 2007, the effective date of this pronouncement, to recognize expenses associated with refinery turnarounds when such costs are incurred. Under the retrospective method of adoption, the Corporation expects to increase 2006 earnings by approximately $4 million, reduce 2005 earnings by approximately $16 million and increase retained earnings as of January 1, 2005 by approximately $66 million.

In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). FIN 48 prescribes the financial statement recognition and measurement criteria for a tax position taken or expected to be taken in a tax return. FIN 48 also requires additional disclosures related to uncertain income tax positions. As required, the Corporation will adopt the provisions of FIN 48 effective January 1, 2007. The Corporation has not concluded its evaluation of the impact of adopting FIN 48 on its results of operations, financial position or cash flows.

In September 2006, the FASB issued FAS No. 157, *Fair Value Measurements* (FAS No. 157). FAS No. 157 establishes a fair value hierarchy, which applies broadly to financial and non-financial assets and liabilities measured at fair value under other authoritative accounting pronouncements. Additionally, the standard requires increased disclosure of the methods of determining fair value. The Corporation is currently evaluating the impact of adoption on its financial statements and, as required, the Corporation will adopt the provisions of FAS No. 157 effective January 1, 2008.

Environment, Health and Safety

The Corporation has implemented a values-based, socially-responsible strategy focused on improving environment, health and safety performance and making a positive impact on communities. The strategy is supported by the Corporation s environment, health, safety and social responsibility (EHS & SR) policies and by environment and safety management systems that help protect the Corporation s workforce, customers and local communities. The Corporation s management systems are designed to uphold or exceed international standards and are intended to promote internal consistency, adherence to policy objectives and continual improvement in EHS & SR performance. Improved performance may, in the short-term, increase the Corporation s operating costs and could also require increased capital expenditures to reduce potential risks to assets, reputation and license to operate. In addition to enhanced EHS & SR performance, improved productivity and operational efficiencies may be captured as collateral benefits from investments in EHS & SR. The Corporation has programs in place to evaluate regulatory compliance, audit facilities, train employees and to generally meet corporate EHS & SR goals.

The production of motor and other fuels in the United States and elsewhere has faced increasing regulatory pressures in recent years. In 2004, new regulations went into effect that have already significantly reduced gasoline sulfur content and additional regulations to reduce the allowable sulfur content in diesel fuel went into effect in 2006. Additional reductions in gasoline and fuel oil sulfur content are under consideration. Fuels production will likely continue to be subject to more stringent regulation in future years and as such may require additional capital expenditures.

Capital expenditures necessary to comply with low-sulfur gasoline requirements at Port Reading were $72 million, of which $23 million was spent in 2005 and the remainder was spent in 2006. Capital expenditures to comply with low-sulfur gasoline and diesel fuel requirements at HOVENSA are presently expected to be approximately $420 million in total, $360 million of which has already been spent and the remainder is expected to be spent in 2007. HOVENSA has and continues to plan to finance these capital expenditures through cash flow from operations.

The Energy Policy Act of 2005 eliminated the Clean Air Act s mandatory oxygen content requirement for reformulated gasoline and imposes on refiners a requirement to use specific quantities of renewable content in gasoline. Many states have also enacted bans on the use of MTBE in gasoline, many of which will take effect between 2007 and 2009. As a result, several companies have announced their intention to cease using MTBE, since it will no

longer be needed in reformulated gasoline to comply with the Clean Air Act and does not meet the new renewable content requirement. In response to these changes in the gasoline marketplace, the Corporation and HOVENSA phased out the use of ether based oxygenates during 2006. Both companies are reviewing the most cost effective means to replace ether unit processing capabilities, which may necessitate additional capital investments.

Table of Contents

As described in Item 3 Legal Proceedings, in 2003 the Corporation and HOVENSA began discussions with the U.S. EPA regarding the EPA s Petroleum Refining Initiative (PRI). The PRI is an ongoing program that is designed to reduce certain air emissions at all U.S. refineries. Since 2000, the EPA has entered into settlements addressing these emissions with petroleum refining companies that control over 77% of the domestic refining capacity. Negotiations with the EPA are continuing and depending on the outcome of these discussions, the Corporation and HOVENSA may experience increased capital expenditures and operating expenses related to air emissions controls. Settlements with other refiners allow for controls to be phased in over several years.

HOVENSA is constructing a new wastewater treatment system at the refinery. This project will significantly enhance the refinery s ability to treat wastewater and better protect the marine environment of St. Croix. The cost to complete the project is approximately $120 million, of which $55 million has already been incurred.

The Corporation has undertaken a program to assess, monitor and reduce the emission of greenhouse gases, including carbon dioxide and methane. The challenges associated with this program are significant, not only from the standpoint of technical feasibility, but also from the perspective of adequately measuring the Corporation s greenhouse gas inventory. The Corporation has completed a revised monitoring protocol which will allow for better measurement of greenhouse gases and is conducting an independently verified audit of its emissions. Once completed, the monitoring protocol will allow for better control of these emissions and assist the Corporation in complying with any future regulatory restrictions.

The Corporation expects continuing expenditures for environmental assessment and remediation related primarily to existing conditions. Sites where corrective action may be necessary include gasoline stations, terminals, onshore exploration and production facilities, refineries (including solid waste management units under permits issued pursuant to the Resource Conservation and Recovery Act) and, although not currently significant, Superfund sites where the Corporation has been named a potentially responsible party.

The Corporation accrues for environmental assessment and remediation expenses when the future costs are probable and reasonably estimable. At year-end 2006, the Corporation s reserve for its estimated environmental liability was approximately $75 million. The Corporation expects that existing reserves for environmental liabilities will adequately cover costs to assess and remediate known sites. The Corporation s remediation spending was $15 million in 2006 and 2005 and $12 million in 2004. Capital expenditures for facilities, primarily to comply with federal, state and local environmental standards, other than for low sulfur projects discussed above, were $22 million in 2006, $3 million in 2005 and $1 million in 2004.

Forward-Looking Information

Certain sections of Management s Discussion and Analysis of Financial Condition and Results of Operations and Quantitative and Qualitative Disclosures about Market Risk, including references to the Corporation s future results of operations and financial position, liquidity and capital resources, capital expenditures, oil and gas production, tax rates, debt repayment, hedging, derivative, market risk and environmental disclosures, off-balance sheet arrangements and contractual obligations and contingencies include forward-looking information. Forward-looking disclosures are based on the Corporation s current understanding and assessment of these activities and reasonable assumptions about the future. Actual results may differ from these disclosures because of changes in market conditions, government actions and other factors.

Item 7A. ***Quantitative and Qualitative Disclosures About Market Risk***

In the normal course of its business, the Corporation is exposed to commodity risks related to changes in the price of crude oil, natural gas, refined products and electricity, as well as to changes in interest rates and foreign currency values. In the disclosures that follow, these operations are referred to as non-trading activities. The Corporation also has trading operations, principally through a 50% voting interest in a trading partnership. These activities are also exposed to commodity risks primarily related to the prices of crude oil, natural gas and refined products. The following describes how these risks are controlled and managed.

Controls: The Corporation maintains a control environment under the direction of its chief risk officer and through its corporate risk policy, which the Corporation s senior management has approved. Controls include

Table of Contents

volumetric, term and value-at-risk limits. In addition, the chief risk officer must approve the use of new instruments or commodities. Risk limits are monitored daily and exceptions are reported to business units and to senior management. The Corporation s risk management department also performs independent verifications of sources of fair values and validations of valuation models. These controls apply to all of the Corporation s non-trading and trading activities, including the consolidated trading partnership. The Corporation s treasury department administers foreign exchange rate and interest rate hedging programs.

Instruments: The Corporation primarily uses forward commodity contracts, foreign exchange forward contracts, futures, swaps, options and energy commodity based securities in its non-trading and trading activities. These contracts are generally widely traded instruments with standardized terms. The following describes these instruments and how the Corporation uses them:

Forward Commodity Contracts: The forward purchase and sale of commodities is performed as part of the Corporation s normal activities. At settlement date, the notional value of the contract is exchanged for physical delivery of the commodity. Forward contracts that are designated as normal purchase and sale contracts under FAS No. 133 are excluded from the quantitative market risk disclosures.

Forward Foreign Exchange Contracts: Forward contracts include forward purchase contracts for both the British pound sterling and the Danish kroner. These foreign currency contracts commit the Corporation to purchase a fixed amount of pound sterling and kroner at a predetermined exchange rate on a certain date.

Exchange Traded Contracts: The Corporation uses exchange traded contracts, including futures, on a number of different underlying energy commodities. These contracts are settled daily with the relevant exchange and may be subject to exchange position limits.

Swaps: The Corporation uses financially settled swap contracts with third parties as part of its hedging and trading activities. Cash flows from swap contracts are determined based on underlying commodity prices and are typically settled over the life of the contract.

Options: Options on various underlying energy commodities include exchange traded and third party contracts and have various exercise periods. As a seller of options, the Corporation receives a premium at the outset and bears the risk of unfavorable changes in the price of the commodity underlying the option. As a purchaser of options, the Corporation pays a premium at the outset and has the right to participate in the favorable price movements in the underlying commodities. These premiums are a component of the fair value of the options.

Energy Securities: Energy securities include energy related equity or debt securities issued by a company or government or related derivatives on these securities.

Value-at-Risk: The Corporation uses value-at-risk to monitor and control commodity risk within its trading and non-trading activities. The value-at-risk model uses historical simulation and the results represent the potential loss in fair value over one day at a 95% confidence level. The model captures both first and second order sensitivities for options. The following table summarizes the value-at-risk results for trading and non-trading activities. These

Table of Contents

results may vary from time to time as strategies change in trading activities or hedging levels change in non-trading activities.

	Trading Activities	Non-Trading Activities						
	(Millions of dollars)							
2006								
At December 31	**$ 17**	**$ 62**						
Average for the year	**20**	**75**						
High during the year	**22**	**86**—		—	—	—		
Recognized net actuarial loss	86	101	261	303	3	4	10	12
Net periodic benefit cost	$ 73	$ 88	$224	$264	$8	$8	$24	$26

During the nine months ended June 30, 2018, the Company made $366 million of contributions to its pension and postretirement medical plans. The Company currently does not expect to make any additional material contributions to its pension and postretirement medical plans during the remainder of fiscal 2018. However, final funding amounts for fiscal 2018 will be assessed based on our January 1, 2018 funding actuarial valuation, which will be available by the end of the fourth quarter of fiscal 2018.

16

THE WALT DISNEY COMPANY
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited; tabular dollars in millions, except for per share data)

9. Earnings Per Share

Diluted earnings per share amounts are based upon the weighted average number of common and common equivalent shares outstanding during the period and are calculated using the treasury stock method for equity-based compensation awards (Awards). A reconciliation of the weighted average number of common and common equivalent shares outstanding and the number of Awards excluded from the diluted earnings per share calculation, as they were anti-dilutive, are as follows:

	Quarter Ended		Nine Months Ended	
	June 30, 2018	July 1, 2017	June 30, 2018	July 1, 2017
Shares (in millions):				
Weighted average number of common and common equivalent shares outstanding (basic)	1,491	1,562	1,502	1,578
Weighted average dilutive impact of Awards	7	10	8	10
Weighted average number of common and common equivalent shares outstanding (diluted)	1,498	1,572	1,510	1,588
Awards excluded from diluted earnings per share	12	8	12	11

10. Equity

The Company paid the following dividends in fiscal 2018 and 2017:

Per Share	Total Paid	Payment Timing	Related to Fiscal Period
$0.84	$1.2 billion	Fourth Quarter of Fiscal 2018	First Half of 2018
$0.84	$1.3 billion	Second Quarter of Fiscal 2018	Second Half 2017
$0.78	$1.2 billion	Fourth Quarter of Fiscal 2017	First Half 2017
$0.78	$1.2 billion	Second Quarter of Fiscal 2017	Second Half 2016

During the nine months ended June 30, 2018, the Company repurchased 35 million shares of its common stock for $3.6 billion. As of June 30, 2018, the Company had remaining authorization in place to repurchase approximately 158 million additional shares. The repurchase program does not have an expiration date.

THE WALT DISNEY COMPANY
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited; tabular dollars in millions, except for per share data)

The following tables summarize the changes in each component of accumulated other comprehensive income (loss) (AOCI) including our proportional share of equity method investee amounts:

AOCI, before tax	Market Value Adjustments		Unrecognized Pension and Postretirement Medical Expense	Foreign Currency Translation and Other	AOCI
	Investments	Cash Flow Hedges			
Balance at March 31, 2018	$ 24	$ (197)	$ (4,690)	$ (358)	$(5,221)
Quarter Ended June 30, 2018:					
Unrealized gains (losses) arising during the period	1	296	—	(286)	11
Reclassifications of realized net (gains) losses to net income	—	26	96	—	122
Balance at June 30, 2018	$ 25	$ 125	$ (4,594)	$ (644)	$(5,088)
Balance at April 1, 2017	$ 28	$ 141	$ (5,638)	$ (599)	$(6,068)
Quarter Ended July 1, 2017:					
Unrealized gains (losses) arising during the period	(1)	(108)	—	54	(55)
Reclassifications of realized net (gains) losses to net income	—	(41)	108	—	67
Balance at July 1, 2017	$ 27	$ (8)	$ (5,530)	$ (545)	$(6,056)
Balance at September 30, 2017	$ 15	$ (108)	$ (4,906)	$ (523)	$(5,522)
Nine Months Ended June 30, 2018:					
Unrealized gains (losses) arising during the period	10	150	24	(121)	63
Reclassifications of net (gains) losses to net income	—	83	288	—	371
Balance at June 30, 2018	$ 25	$ 125	$ (4,594)	$ (644)	$(5,088)
Balance at October 1, 2016	$ 44	$ (38)	$ (5,859)	$ (521)	$(6,374)
Nine Months Ended July 1, 2017:					
Unrealized gains (losses) arising during the period	(11)	192	5	(24)	162
Reclassifications of net (gains) losses to net income	(6)	(162)	324	—	156
Balance at July 1, 2017	$ 27	$ (8)	$ (5,530)	$ (545)	$(6,056)

THE WALT DISNEY COMPANY
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited; tabular dollars in millions, except for per share data)

Tax on AOCI	Market Value Adjustments		Unrecognized Pension and Postretirement Medical Expense	Foreign Currency Translation and Other	AOCI
	Investments	Cash Flow Hedges			
Balance at March 31, 2018	$ (10)	$ 41	$ 1,778	$ 67	$1,876
Quarter Ended June 30, 2018:					
Unrealized gains (losses) arising during the period	—	(56)	(2)	38	(20)
Reclassifications of realized net (gains) losses to net income	—	(6)	(24)	—	(30)
Balance at June 30, 2018	$ (10)	$ (21)	$ 1,752	$ 105	$1,826
Balance at April 1, 2017	$ (12)	$ (50)	$ 2,113	$ 137	$2,188
Quarter Ended July 1, 2017:					
Unrealized gains (losses) arising during the period	(4)	42	—	(9)	29
Reclassifications of realized net (gains) losses to net income	—	15	(40)	—	(25)
Balance at July 1, 2017	$ (16)	$ 7	$ 2,073	$ 128	$2,192
Balance at September 30, 2017	$ (7)	$ 46	$ 1,839	$ 116	$1,994
Nine Months Ended June 30, 2018:					
Unrealized gains (losses) arising during the period	(3)	(44)	(5)	(11)	(63)
Reclassifications of net (gains) losses to net income	—	(23)	(82)	—	(105)
Balance at June 30, 2018	$ (10)	$ (21)	$ 1,752	$ 105	$1,826
Balance at October 1, 2016	$ (18)	$ 13	$ 2,208	$ 192	$2,395
Nine Months Ended July 1, 2017:					
Unrealized gains (losses) arising during the period	—	(66)	(15)	(64)	(145)
Reclassifications of net (gains) losses to net income	2	60	(120)	—	(58)
Balance at July 1, 2017	$ (16)	$ 7	$ 2,073	$ 128	$2,192

THE WALT DISNEY COMPANY
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited; tabular dollars in millions, except for per share data)

AOCI, after tax	Market Value Adjustments		Unrecognized Pension and Postretirement Medical Expense	Foreign Currency Translation and Other	AOCI
	Investments	Cash Flow Hedges			
Balance at March 31, 2018	$ 14	$ (156)	$ (2,912)	$ (291)	$(3,345)
Quarter Ended June 30, 2018:					
Unrealized gains (losses) arising during the period	1	240	(2)	(248)	(9)
Reclassifications of realized net (gains) losses to net income	—	20	72	—	92
Balance at June 30, 2018	$ 15	$ 104	$ (2,842)	$ (539)	$(3,262)
Balance at April 1, 2017	$ 16	$ 91	$ (3,525)	$ (462)	$(3,880)
Quarter Ended July 1, 2017:					
Unrealized gains (losses) arising during the period	(5)	(66)	—	45	(26)
Reclassifications of realized net (gains) losses to net income	—	(26)	68	—	42
Balance at July 1, 2017	$ 11	$ (1)	$ (3,457)	$ (417)	$(3,864)
Balance at September 30, 2017	$ 8	$ (62)	$ (3,067)	$ (407)	$(3,528)
Nine Months Ended June 30, 2018:					
Unrealized gains (losses) arising during the period	7	106	19	(132)	—
Reclassifications of net (gains) losses to net income	—	60	206	—	266
Balance at June 30, 2018	$ 15	$ 104	$ (2,842)	$ (539)	$(3,262)
Balance at October 1, 2016	$ 26	$ (25)	$ (3,651)	$ (329)	$(3,979)
Nine Months Ended July 1, 2017:					
Unrealized gains (losses) arising during the period	(11)	126	(10)	(88)	17
Reclassifications of net (gains) losses to net income	(4)	(102)	204	—	98
Balance at July 1, 2017	$ 11	$ (1)	$ (3,457)	$ (417)	$(3,864)

THE WALT DISNEY COMPANY
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited; tabular dollars in millions, except for per share data)

Details about AOCI components reclassified to net income are as follows:

Gains/(losses) in net income:	Affected line item in the Condensed Consolidated Statements of Income:	Quarter Ended		Nine Months Ended	
		June 30, 2018	July 1, 2017	June 30, 2018	July 1, 2017
Investments, net	Interest expense, net	$ —	$ —	$ —	$ 6
Estimated tax	Income taxes	—	—	—	(2)
		—	—	—	4
Cash flow hedges	Primarily revenue	(26)	41	(83)	162
Estimated tax	Income taxes	6	(15)	23	(60)
		(20)	26	(60)	102
Pension and postretirement medical expense	Costs and expenses	(96)	(108)	(288)	(324)
Estimated tax	Income taxes	24	40	82	120
		(72)	(68)	(206)	(204)
Total reclassifications for the period		$ (92)	$ (42)	$ (266)	$ (98)

At June 30, 2018 and September 30, 2017, unrealized gains and losses on available-for-sale investments were not material.

11. Equity-Based Compensation

Compensation expense related to stock options and restricted stock units (RSUs) is as follows:

	Quarter Ended		Nine Months Ended	
	June 30, 2018	July 1, 2017	June 30, 2018	July 1, 2017
Stock options	$ 21	$ 20	$ 67	$ 62
RSUs	92	69	240	216
Total equity-based compensation expense [1]	$ 113	$ 89	$ 307	$ 278
Equity-based compensation expense capitalized during the period	$ 17	$ 19	$ 54	$ 61

(1) Equity-based compensation expense is net of capitalized equity-based compensation and excludes amortization of previously capitalized equity-based compensation costs.

Unrecognized compensation cost related to unvested stock options and RSUs was $146 million and $520 million, respectively, as of June 30, 2018.

The weighted average grant date fair values of options granted during the nine months ended June 30, 2018 and July 1, 2017 were $28.01 and $25.66, respectively.

During the nine months ended June 30, 2018, the Company made equity compensation grants consisting of 4.0 million stock options and 4.5 million RSUs.

12. Commitments and Contingencies

Legal Matters

The Company, together with, in some instances, certain of its directors and officers, is a defendant or codefendant in various legal actions involving copyright, breach of contract and various other claims incident to the conduct of its businesses. Management does not believe that the Company has incurred a probable material loss by reason of any of those actions.

Contractual Guarantees

The Company has guaranteed bond issuances by the Anaheim Public Authority that were used by the City of Anaheim to finance construction of infrastructure and a public parking facility adjacent to the Disneyland Resort. Revenues from sales,

21

THE WALT DISNEY COMPANY
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited; tabular dollars in millions, except for per share data)

occupancy and property taxes from the Disneyland Resort and non-Disney hotels are used by the City of Anaheim to repay the bonds, which mature in 2037. In the event of a debt service shortfall, the Company will be responsible to fund the shortfall. As of June 30, 2018, the remaining debt service obligation guaranteed by the Company was $301 million. To the extent that tax revenues exceed the debt service payments subsequent to the Company funding a shortfall, the Company would be reimbursed for any previously funded shortfalls. To date, tax revenues have exceeded the debt service payments for these bonds.

The Company has guaranteed $113 million of Hulu LLC’s $338 million term loan, which expires in August 2022. The Company is also committed to make a capital contribution of approximately $450 million to Hulu in calendar 2018. For the nine months ended June 30, 2018, the Company made contributions of $227 million against this commitment. Hulu is a joint venture in which the Company has a 30% ownership interest.

Long-Term Receivables and the Allowance for Credit Losses

The Company has accounts receivable with original maturities greater than one year related to the sale of television program rights and vacation ownership units. Allowances for credit losses are established against these receivables as necessary.

The Company estimates the allowance for credit losses related to receivables from the sale of television programs based upon a number of factors, including historical experience and the financial condition of individual companies with which we do business. The balance of television program sales receivables recorded in other non-current assets, net of an immaterial allowance for credit losses, was $0.9 billion as of June 30, 2018. The activity in the current period related to the allowance for credit losses was not material.

The Company estimates the allowance for credit losses related to receivables from sales of its vacation ownership units based primarily on historical collection experience. Estimates of uncollectible amounts also consider the economic environment and the age of receivables. The balance of mortgage receivables recorded in other non-current assets, net of a related allowance for credit losses of approximately 4%, was approximately $0.7 billion as of June 30, 2018. The activity in the current period related to the allowance for credit losses was not material.

13. Fair Value Measurements

Fair value is defined as the amount that would be received for selling an asset or paid to transfer a liability in an orderly transaction between market participants and is generally classified in one of the following categories:

Level 1 - Quoted prices for identical instruments in active markets

Level 2 - Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets

Level 3 - Valuations derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable

The Company’s assets and liabilities measured at fair value are summarized in the following tables by fair value measurement Level:

	Fair Value Measurement at June 30, 2018			
	Level 1	Level 2	Level 3	Total
Assets				
Investments	$41	$—	$—	$41
Derivatives				
Foreign exchange	—	479	—	479
Other	—	14	—	14
Liabilities				
Derivatives				

Interest rate	—	(370)	—	(370)
Foreign exchange	—	(311)	—	(311)
Total recorded at fair value	$41	$(188)	$—	$(147)
Fair value of borrowings	$—	$22,442	$1,223	$23,665

THE WALT DISNEY COMPANY
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited; tabular dollars in millions, except for per share data)

	Fair Value Measurement at September 30, 2017			
	Level 1	Level 2	Level 3	Total
Assets				
Investments	$36	$—	$—	$36
Derivatives				
Interest rate	—	10	—	10
Foreign exchange	—	403	—	403
Other	—	8	—	8
Liabilities				
Derivatives				
Interest rate	—	(122)	—	(122)
Foreign exchange	—	(427)	—	(427)
Total recorded at fair value	$36	$(128)	$—	$(92)
Fair value of borrowings	$—	$23,110	$2,764	$25,874

The fair values of Level 2 derivatives are primarily determined by internal discounted cash flow models that use observable inputs such as interest rates, yield curves and foreign currency exchange rates. Counterparty credit risk, which is mitigated by master netting agreements and collateral posting arrangements with certain counterparties, did not have a material impact on derivative fair value estimates.

Level 2 borrowings, which include commercial paper, U.S. medium-term notes and certain foreign currency denominated borrowings, are valued based on quoted prices for similar instruments in active markets.

Level 3 borrowings include the Asia Theme Park borrowings, which are valued based on the current borrowing cost and credit risk of the Asia Theme Parks as well as historical market transactions and prevailing market interest rates. Level 3 borrowings at September 30, 2017 also include borrowings in connection with the acquisition of BAMTech, which were paid in the second quarter of fiscal 2018 (see Note 4).

The Company's financial instruments also include cash, cash equivalents, receivables and accounts payable. The carrying values of these financial instruments approximate the fair values.

14. Derivative Instruments

The Company manages its exposure to various risks relating to its ongoing business operations according to a risk management policy. The primary risks managed with derivative instruments are interest rate risk and foreign exchange risk.

The Company's derivative positions measured at fair value are summarized in the following tables:

	As of June 30, 2018			
	Current Assets	Other Assets	Other Current Liabilities	Other Long-Term Liabilities
Derivatives designated as hedges				
Foreign exchange	$172	$ 192	$ (108)	$ (60)
Interest rate	—	—	(297)	—
Other	11	3	—	—
Derivatives not designated as hedges				
Foreign exchange	92	23	(99)	(44)
Interest rate	—	—	—	(73)
Gross fair value of derivatives	275	218	(504)	(177)
Counterparty netting	(184)	(173)	245	112

Cash collateral (received)/paid	—	—	137	17
Net derivative positions	$91	$ 45	$ (122)	$ (48)

THE WALT DISNEY COMPANY
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited; tabular dollars in millions, except for per share data)

	As of September 30, 2017			
	Current Assets	Other Assets	Other Current Liabilities	Other Long-Term Liabilities
Derivatives designated as hedges				
Foreign exchange	$175	$ 190	$ (192)	$ (170)
Interest rate	—	10	(106)	—
Other	6	2	—	—
Derivatives not designated as hedges				
Foreign exchange	38	—	(46)	(19)
Interest rate	—	—	—	(16)
Gross fair value of derivatives	219	202	(344)	(205)
Counterparty netting	(142)	(190)	188	144
Cash collateral (received)/paid	(20)	(7)	19	—
Net derivative positions	$57	$ 5	$ (137)	$ (61)

Interest Rate Risk Management

The Company is exposed to the impact of interest rate changes primarily through its borrowing activities. The Company's objective is to mitigate the impact of interest rate changes on earnings and cash flows and on the market value of its borrowings. In accordance with its policy, the Company targets its fixed-rate debt as a percentage of its net debt between a minimum and maximum percentage. The Company primarily uses pay-floating and pay-fixed interest rate swaps to facilitate its interest rate risk management activities.

The Company designates pay-floating interest rate swaps as fair value hedges of fixed-rate borrowings effectively converting fixed-rate borrowings to variable rate borrowings indexed to LIBOR. As of June 30, 2018 and September 30, 2017, the total notional amount of the Company's pay-floating interest rate swaps was $7.8 billion and $8.2 billion, respectively. The following table summarizes adjustments related to fair value hedges included in "Interest expense, net" in the Condensed Consolidated Statements of Income.

	Quarter Ended		Nine Months Ended	
	June 30, 2018	July 1, 2017	June 30, 2018	July 1, 2017
Gain (loss) on interest rate swaps	$ (25)	$ 39	$(191)	$(203)
Gain (loss) on hedged borrowings	25	(39)	191	203

In addition, during the quarter and nine months ended June 30, 2018, the Company realized net expense of $9 million and $3 million, respectively in "Interest expense, net" related to pay-floating interest rate swaps. During the quarter and nine months ended July 1, 2017, the Company realized net benefits of $7 million and $29 million, respectively in "Interest expense, net" related to pay-floating interest rate swaps.

The Company may designate pay-fixed interest rate swaps as cash flow hedges of interest payments on floating-rate borrowings. Pay-fixed swaps effectively convert floating-rate borrowings to fixed-rate borrowings. The unrealized gains or losses from these cash flow hedges are deferred in AOCI and recognized in interest expense as the interest payments occur. The Company did not have pay-fixed interest rate swaps that were designated as cash flow hedges of interest payments at June 30, 2018 or at September 30, 2017, and gains and losses related to pay-fixed swaps recognized in earnings for the quarter and nine months ended June 30, 2018 and July 1, 2017 were not material.

To facilitate its interest rate risk management activities, the Company sold options in November 2016, October 2017 and April 2018 to enter into a future pay-floating interest rate swaps indexed to LIBOR for $2.0 billion in future borrowings. The fair values of these contracts as of June 30, 2018 were not material. The options are not designated as hedges and do not qualify for hedge accounting; accordingly, changes in their fair value are recorded in earnings.

Foreign Exchange Risk Management

The Company transacts business globally and is subject to risks associated with changing foreign currency exchange rates. The Company's objective is to reduce earnings and cash flow fluctuations associated with foreign currency exchange rate changes, enabling management to focus on core business issues and challenges.

The Company enters into option and forward contracts that change in value as foreign currency exchange rates change to protect the value of its existing foreign currency assets, liabilities, firm commitments and forecasted but not firmly committed foreign currency transactions. In accordance with policy, the Company hedges its forecasted foreign currency transactions for periods generally not to exceed four years within an established minimum and maximum range of annual exposure. The gains and losses on these contracts offset changes in the U.S. dollar equivalent value of the related forecasted transaction, asset, liability or firm commitment. The principal currencies hedged are the euro, Japanese yen, Canadian dollar and British pound. Cross-currency swaps are used to effectively convert foreign currency denominated borrowings into U.S. dollar denominated borrowings.

The Company designates foreign exchange forward and option contracts as cash flow hedges of firmly committed and forecasted foreign currency transactions. As of June 30, 2018 and September 30, 2017, the notional amounts of the Company's net foreign exchange cash flow hedges were $6.1 billion and $6.3 billion, respectively. Mark-to-market gains and losses on these contracts are deferred in AOCI and are recognized in earnings when the hedged transactions occur, offsetting changes in the value of the foreign currency transactions. Gains and losses recognized related to ineffectiveness for the nine months ended June 30, 2018 and July 1, 2017 were not material. Net deferred gains recorded in AOCI for contracts that will mature in the next twelve months totaled $73 million.

Foreign exchange risk management contracts with respect to foreign currency denominated assets and liabilities are not designated as hedges and do not qualify for hedge accounting. The notional amounts of these foreign exchange contracts at June 30, 2018 and September 30, 2017 were $2.8 billion and $3.6 billion, respectively. The following table summarizes the net foreign exchange gains or losses recognized on foreign currency denominated assets and liabilities and the net foreign exchange gains or losses on the foreign exchange contracts we entered into to mitigate our exposure with respect to foreign currency denominated assets and liabilities for the quarter and nine months ended June 30, 2018 and July 1, 2017 by the corresponding line item in which they are recorded in the Condensed Consolidated Statements of Income:

	Costs and Expenses		Interest expense, net		Income Tax expense	
Quarter Ended:	June 30, 2018	July 1, 2017	June 30, 2018	July 1, 2017	June 30, 2018	July 1, 2017
Net gains (losses) on foreign currency denominated assets and liabilities	$(175)	$148	$28	$(7)	$35	$4
Net gains (losses) on foreign exchange risk management contracts not designated as hedges	164	(144)	(34)	6	(31)	21
Net gains (losses)	$(11)	$4	$(6)	$(1)	$4	$25
Nine Months Ended:						
Net gains (losses) on foreign currency denominated assets and liabilities	$(94)	$25	$55	$(3)	$23	$16
Net gains (losses) on foreign exchange risk management contracts not designated as hedges	73	(26)	(62)	2	(15)	4
Net gains (losses)	$(21)	$(1)	$(7)	$(1)	$8	$20

Commodity Price Risk Management

The Company is subject to the volatility of commodities prices and the Company designates certain commodity forward contracts as cash flow hedges of forecasted commodity purchases. Mark-to-market gains and losses on these contracts are deferred in AOCI and are recognized in earnings when the hedged transactions occur, offsetting changes in the value of commodity purchases. The notional amount of these commodities contracts at June 30, 2018 and September 30, 2017 and related gains or losses recognized in earnings for the quarter and nine months ended June 30, 2018 and July 1, 2017 were not material.

Risk Management – Other Derivatives Not Designated as Hedges

The Company enters into certain other risk management contracts that are not designated as hedges and do not qualify for hedge accounting. These contracts, which include certain swap contracts, are intended to offset economic exposures of the Company and are carried at market value with any changes in value recorded in earnings. The notional amount and fair value of these contracts at June 30, 2018 and September 30, 2017 were not material. The related gains or losses recognized in earnings for the quarter and nine months ended June 30, 2018 and July 1, 2017 were not material.

25

THE WALT DISNEY COMPANY
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited; tabular dollars in millions, except for per share data)

Contingent Features and Cash Collateral

The Company has master netting arrangements by counterparty with respect to certain derivative financial instrument contracts. The Company may be required to post collateral in the event that a net liability position with a counterparty exceeds limits defined by contract and that vary with the Company's credit rating. In addition, these contracts may require a counterparty to post collateral to the Company in the event that a net receivable position with a counterparty exceeds limits defined by contract and that vary with the counterparty's credit rating. If the Company's or the counterparty's credit ratings were to fall below investment grade, such counterparties or the Company would also have the right to terminate our derivative contracts, which could lead to a net payment to or from the Company for the aggregate net value by counterparty of our derivative contracts. The aggregate fair values of derivative instruments with credit-risk-related contingent features in a net liability position by counterparty were $324 million and $217 million on June 30, 2018 and September 30, 2017, respectively.

15. Restructuring and Impairment Charges and Other Income

The Company recorded $28 million of restructuring and impairment charges in the current nine-month period, primarily for severance costs.

The Company recorded $94 million of other income in the current nine-month period, which included a gain from the sale of property rights and insurance proceeds related to a legal matter. In the prior-year quarter, the Company recorded a $177 million charge, net of committed insurance recoveries, in connection with the settlement of litigation.

16. New Accounting Pronouncements

Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income

In February 2018, the Financial Accounting Standards Board (FASB) issued guidance as a result of the Tax Act to permit the reclassification of certain tax effects in accumulated other comprehensive income (AOCI) to retained earnings. Current accounting guidance requires that adjustments to deferred tax assets and liabilities for changes in enacted tax rates be recorded through income from continuing operations even if the deferred taxes were originally established through comprehensive income. The new guidance allows companies to make a one-time election to reclassify the tax effects resulting from the Tax Act on items in AOCI to retained earnings. The new guidance is effective beginning with the first quarter of the Company's 2020 fiscal year (with early adoption permitted). The guidance should be applied either retrospectively to each period (or periods) in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Act is recognized or as a cumulative adjustment in the first period of adoption. The Company is still assessing whether it will make the one-time election to reclassify the tax-effects to retained earnings.

Targeted Improvements to Accounting for Hedging Activities

In August 2017, the FASB issued guidance to improve certain aspects of the hedge accounting model including making more risk management strategies eligible for hedge accounting and simplifying the assessment of hedge effectiveness. We do not expect the adoption of the new standard will have a material impact on our consolidated financial statements as our historical hedging ineffectiveness has been immaterial. The new guidance is effective beginning with the Company's 2020 fiscal year (with early adoption permitted) and requires prospective adoption with a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption for existing hedging relationships.

Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost

In March 2017, the FASB issued guidance that requires presentation of the components of net periodic pension and postretirement benefit costs other than service costs in an income statement line item outside of a subtotal of income from operations. The service cost component will continue to be presented in the same line items as other employee compensation costs. In addition, under the guidance only service costs are eligible for capitalization, for example, as part of a self-constructed fixed asset or a film production. The new guidance is effective beginning with the first quarter of the Company's 2019 fiscal year. The guidance is required to be adopted retrospectively with respect to income statement presentation and prospectively for the capitalization requirement. We do not expect the change in

capitalization requirement to have a material impact on our financial statements. See Note 8 of this filing and Note 10 to the Consolidated Financial Statements in the 2017 Annual Report on Form 10-K for the amount of each component of net periodic pension and postretirement benefit costs we have reported historically. These amounts of net periodic pension and postretirement benefit costs are not necessarily indicative of future amounts that may arise in years following implementation of the new accounting pronouncement.

Intra-Entity Transfers of Assets Other Than Inventory

In October 2016, the FASB issued guidance that requires recognition of the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs instead of when the asset is ultimately sold to an outside party. The new guidance is effective beginning with the first quarter of the Company’s 2019 fiscal year. The guidance requires

prospective adoption with a cumulative-effect adjustment to retained earnings as of the beginning of the adoption period. Based upon our analysis, we estimate that approximately $0.1 billion will be recorded as an increase to retained earnings upon adoption, which we do not believe is material to our consolidated financial statements. Our assessment may change if we enter into new transactions between now and the date of adoption.

Leases

In February 2016, the FASB issued a new lease accounting standard, which requires the present value of committed operating lease payments to be recorded as right-of-use lease assets and lease liabilities on the balance sheet. The Company is currently assessing the impact of the new guidance on its financial statements. The standard can be adopted either as of the effective date without restating prior periods or retrospectively by restating prior periods. The guidance is effective at the beginning of the Company's 2020 fiscal year (with early adoption permitted). As of September 30, 2017, the Company had an estimated $3.3 billion in undiscounted future minimum lease commitments.

Revenue from Contracts with Customers

In May 2014, the FASB issued guidance that replaces the existing accounting standards for revenue recognition with a single comprehensive five-step model, eliminating industry-specific accounting rules. The core principle is to recognize revenue upon the transfer of control of goods or services to customers at an amount that reflects the consideration expected to be received. Since its issuance, the FASB has amended several aspects of the new guidance, including provisions that address revenue recognition associated with the licensing of intellectual property (IP). The new guidance, including the amendments, is effective at the beginning of the Company's 2019 fiscal year.

We have reviewed our significant revenue streams and identified required changes to our revenue recognition policies. Based on our existing customer contracts and relationships, we do not expect the implementation of the new guidance will have a material impact on our consolidated financial statements upon adoption. The Company's evaluation of the impact could change if we enter into new revenue arrangements or interpretations of the new guidance further evolve. While not expected to be material, the more significant changes to the Company's revenue recognition policies are in the following areas:

- For television and film content licensing agreements with multiple availability windows with the same licensee, the Company will defer more revenues to future windows than is currently deferred.
- For licenses of character images, brands and trademarks subject to minimum guaranteed license fees, we currently recognize the difference between the minimum guaranteed amount and actual royalties earned from licensee merchandise sales ("shortfalls") at the end of the contract period. Under the new guidance, projected guarantee shortfalls will be recognized straight-line over the remaining license period once an expected shortfall is identified.
- For licenses that include multiple television and film titles subject to minimum guaranteed license fees that are recoupable against the licensee's aggregate underlying sales from all titles, the Company will allocate the minimum guaranteed license fee to each title and recognize the allocated license fee as revenue when the title is made available to the customer. License fees in excess of the allocated by-title minimum guarantee are deferred until the aggregate contractual minimum guarantee has been exceeded and thereafter recognized as earned based on the licensee's underlying sales. Under current guidance, an upfront allocation of the minimum guarantee is not required as license fees are recognized as earned based on the licensee's underlying sales with any shortfalls recognized at the end of the contract period.
- For renewals or extensions of license agreements for television and film content, we will recognize revenue when the licensed content becomes available under the renewal or extension, instead of when the agreement is renewed or extended.

We are developing processes to capture the information necessary for the expanded disclosures required under the new guidance, and continuing to identify updates needed to our internal controls to support our new revenue recognition policies and disclosure requirements.

The guidance may be adopted either by restating fiscal 2017 and 2018 to reflect the impact of the new guidance (full retrospective method) or by recording the impact of adoption as an adjustment to retained earnings at the beginning of

fiscal 2019 (modified retrospective method). The Company currently expects to adopt the standard using the modified retrospective method.

The Company's equity method investees are considered private companies for purposes of applying the new guidance and are not required to adopt the new standard until fiscal years beginning after December 15, 2018. Our significant equity method investees continue to assess the potential impact of adopting the new standard on their financial statements. We currently do not

expect any material impacts to the Company's consolidated financial statements upon the investees' adoption of the new guidance.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS
Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations

ORGANIZATION OF INFORMATION
Management's Discussion and Analysis provides a narrative of the Company's financial performance and condition that should be read in conjunction with the accompanying financial statements. It includes the following sections:
Consolidated Results and Non-segment Items
Seasonality
Business Segment Results
Impact of U.S. tax reform
Financial Condition
Commitments and Contingencies
Other Matters
Market Risk
CONSOLIDATED RESULTS AND NON-SEGMENT ITEMS
Our summary consolidated results are presented below:

	Quarter Ended		% Change	Nine Months Ended		% Change
(in millions, except per share data)	June 30, 2018	July 1, 2017	Better/ (Worse)	June 30, 2018	July 1, 2017	Better/ (Worse)
Revenues:						
Services	$13,142	$12,097	9 %	$38,646	$35,990	7 %
Products	2,086	2,141	(3) %	6,481	6,368	2 %
Total revenues	15,228	14,238	7 %	45,127	42,358	7 %
Costs and expenses:						
Cost of services (exclusive of depreciation and amortization)	(7,124)	(6,469)	(10) %	(20,762)	(19,328)	(7) %
Cost of products (exclusive of depreciation and amortization)	(1,224)	(1,248)	2 %	(3,856)	(3,764)	(2) %
Selling, general, administrative and other	(2,212)	(2,022)	(9) %	(6,538)	(5,948)	(10) %
Depreciation and amortization	(744)	(711)	(5) %	(2,217)	(2,074)	(7) %
Total costs and expenses	(11,304)	(10,450)	(8) %	(33,373)	(31,114)	(7) %
Restructuring and impairment charges	—	—	nm	(28)	—	nm
Other income/(expense), net	—	(177)	nm	94	(177)	nm
Interest expense, net	(143)	(117)	(22) %	(415)	(300)	(38) %
Equity in the income of investees	73	124	(41) %	122	327	(63) %
Income before income taxes	3,854	3,618	7 %	11,527	11,094	4 %
Income taxes	(795)	(1,144)	31 %	(880)	(3,593)	76 %
Net income	3,059	2,474	24 %	10,647	7,501	42 %
Less: Net income attributable to noncontrolling interests	(143)	(108)	(32) %	(371)	(268)	(38) %
Net income attributable to Disney	$2,916	$2,366	23 %	$10,276	$7,233	42 %
Diluted earnings per share attributable to Disney	$1.95	$1.51	29 %	$6.81	$4.55	50 %

Quarter Results
Revenues for the quarter increased 7%, or $1.0 billion, to $15.2 billion; net income attributable to Disney increased 23%, or $0.6 billion, to $2.9 billion; and diluted earnings per share attributable to Disney (EPS) increased 29% from $1.51 to $1.95. The EPS increase for the quarter was due to a benefit from new federal income tax legislation, the "Tax Cuts and Jobs Act" (Tax Act) (See Note 7 to the Condensed Consolidated Financial Statements), a decrease in weighted average shares outstanding as a result of our share repurchase program and higher segment operating income, partially offset by higher Corporate and unallocated shared expenses. The increase in segment operating income was due to growth at our Parks and Resorts and Studio Entertainment segments, partially offset by lower results at our Consumer Products & Interactive Media segment.
Revenues
Service revenues for the quarter increased 9%, or $1.0 billion, to $13.1 billion due to higher theatrical distribution revenue driven by the success of Avengers: Infinity War and Incredibles 2, growth in TV/subscription video on demand (SVOD) distribution revenue, higher fees from Multi-channel Video Distributors (MVPDs) (Affiliate Fees), growth in guest spending and higher volumes at our parks and resorts and the consolidation of BAMTech. The Company began consolidating BAMTech in the fourth quarter of the prior year. These increases were partially offset by lower advertising revenue.
Product revenues for the quarter decreased 3%, or $55 million to $2.1 billion primarily due to lower domestic home entertainment volumes and a decrease in retail store sales, partially offset by higher guest spending at our parks and resorts. Product revenues reflected an approximate 2 percentage point increase due to a favorable movement of the U.S. dollar against major currencies including the impact of our hedging program (FX Impact).
Costs and expenses
Cost of services for the quarter increased 10%, or $655 million, to $7.1 billion due to higher film cost amortization driven by increased theatrical distribution revenue and film cost impairments, higher television programming and production costs, the consolidation of BAMTech, and labor and other cost inflation at our parks and resorts. Cost of services reflected an approximate 1 percentage point increase due to an unfavorable FX Impact.
Cost of products for the quarter decreased 2%, or $24 million, to $1.2 billion primarily due to lower home entertainment volumes and a decrease in retail store sales, partially offset by higher guest spending and cost inflation at our parks and resorts. Cost of products reflected an approximate 1 percentage point increase due to an unfavorable FX Impact.
Selling, general, administrative and other costs increased 9%, or $190 million, to $2.2 billion primarily due to higher theatrical marketing spending, costs incurred in connection with our agreement to acquire Twenty-First Century Fox, Inc. and an increase in compensation costs.
Depreciation and amortization increased 5%, or $33 million, to $0.7 billion, due to the consolidation of BAMTech.
Other income/(expense), net
Other income/(expense), net of $177 million for the prior-year quarter consisted of a charge, net of committed insurance recoveries, incurred in connection with the settlement of litigation.
Interest expense, net
Interest expense, net is as follows:

(in millions)	Quarter Ended June 30, 2018	July 1, 2017	% Change Better/(Worse)	
Interest expense	$(175)	$(134)	(31)	%
Interest and investment income	32	17	88	%
Interest expense, net	$(143)	$(117)	(22)	%

The increase in interest expense was due to higher average interest rates and an increase in average debt balances. The increase in interest and investment income was driven by net investment income in the current quarter compared to net investment losses in the prior-year quarter.

Equity in the income of investees

Equity in the income of investees decreased $51 million to $73 million for the quarter due to higher losses from Hulu and lower income from A+E Television Networks (A+E). These decreases were partially offset by a favorable comparison to a loss

30

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS — (continued)

from BAMTech in the prior-year quarter. The decrease at Hulu was driven by higher programming and labor costs, partially offset by higher subscription and advertising revenue. The decrease at A+E was due to lower advertising revenue and higher programming costs, partially offset by higher program sales.

Effective Income Tax Rate

	Quarter Ended		
	June 30, 2018	July 1, 2017	Change Better/(Worse)
Effective income tax rate	20.6%	31.6%	11.0 ppt

The decrease in the effective income tax rate for the quarter was due to a net favorable impact of the Tax Act, which reflects the following:

- A reduction in the Company's fiscal 2018 U.S. statutory federal income tax rate to 24.5% from 35.0% in the prior year. Net of state tax and other related effects, the reduction in the statutory rate had an impact of approximately 8.6 percentage points on the effective income tax rate.
- A net benefit of approximately $110 million from updating our prior quarter estimates of the remeasurement of our net federal deferred tax liability to the new statutory rates and a one-time tax on certain accumulated foreign earnings (Deemed Repatriation Tax). This update includes the impact from finalizing our fiscal 2017 income tax return.This benefit had an impact of approximately 2.9 percentage points on the effective income tax rate.

Refer to Note 7 of the Condensed Consolidated Financial Statements for further information on the impact of the Tax Act on the Company.

Noncontrolling Interests

(in millions)	Quarter Ended June 30, 2018	July 1, 2017	% Change Better/(Worse)
Net income attributable to noncontrolling interests	$143	$108	(32) %

The increase in net income attributable to noncontrolling interests was due to higher results at ESPN and Shanghai Disney Resort. Results at ESPN included the benefit of lower tax expense, largely due to the Tax Act.

Net income attributable to noncontrolling interests is determined on income after royalties and management fees, financing costs and income taxes, as applicable.

Nine-Month Results

Revenues for the nine-month period increased 7%, or $2.8 billion, to $45.1 billion; net income attributable to Disney increased 42%, or $3.0 billion, to $10.3 billion; and EPS increased 50% from $4.55 to $6.81. The EPS increase for the nine-month period was due to the benefit from the Tax Act, a decrease in weighted average shares outstanding as a result of our share repurchase program and higher segment operating income. The increase in segment operating income was due to growth at our Parks and Resorts and Studio Entertainment segments, partially offset by lower results at our Media Networks and Consumer Products & Interactive Media segments.

Revenues

Service revenues for the nine-month period increased 7%, or $2.7 billion, to $38.6 billion due to higher theatrical distribution revenue, higher guest spending and volumes at our parks and resorts, an increase in affiliate fees, the consolidation of BAMTech and growth in TV/SVOD distribution revenue. These increases were partially offset by lower advertising revenue.

Product revenues for the nine-month period increased 2%, or $113 million to $6.5 billion, due to increases in guest spending and volumes at our parks and resorts, partially offset by lower domestic home entertainment volumes and a decrease in retail store sales. Product revenues reflected an approximate 1 percentage point increase due to a favorable FX Impact.

Costs and expenses

Cost of services for the nine-month period increased 7%, or $1.4 billion, to $20.8 billion, due to higher film cost amortization driven by an increase in theatrical revenue and film cost impairments, an increase in costs at our parks and resorts, the consolidation of BAMTech and higher television programming and production costs. The increase at parks and resorts was

driven by cost inflation, increased technology spending and higher volumes. Cost of services reflected an approximate 1 percentage point increase due to an unfavorable FX Impact.

Cost of products for the nine-month period increased 2%, or $92 million, to $3.9 billion, due to cost inflation and higher volumes at our parks and resorts, partially offset by lower home entertainment volumes. Cost of products reflected an approximate 2 percentage point increase due to an unfavorable FX Impact.

Selling, general, administrative and other costs for the nine-month period increased 10%, or $0.6 billion, to $6.5 billion, primarily due to higher marketing spend for theatrical distribution and at parks and resorts, the consolidation of BAMTech, costs incurred in connection with our agreement to acquire Twenty-First Century Fox, Inc. and an increase in compensation costs. Selling, general, administrative and other costs reflected an approximate 1 percentage point increase due to an unfavorable FX Impact.

Depreciation and amortization for the nine-month period increased 7%, or $143 million, to $2.2 billion due to depreciation of new attractions at our domestic parks and resorts and Hong Kong Disneyland Resort and the consolidation of BAMTech.

Restructuring and impairment charges

The Company recorded $28 million of restructuring and impairment charges in the current nine-month period primarily for severance costs.

Other income/(expense), net

Other income/(expense), net of $94 million for the current nine-month period reflects a gain from the sale of property rights and insurance proceeds related to a legal matter. Other income/(expense), net of $177 million for the prior-year period consisted of a charge, net of committed insurance recoveries, incurred in connection with the settlement of litigation.

Interest expense, net

Interest expense, net is as follows:

(in millions)	Nine Months Ended June 30, 2018	July 1, 2017	% Change Better/(Worse)
Interest expense	$(493)	$(370)	(33) %
Interest and investment income	78	70	11 %
Interest expense, net	$(415)	$(300)	(38) %

The increase in interest expense for the nine-month period was due to higher average debt balances and an increase in average interest rates.

Equity in the income of investees

Equity in the income of investees decreased $205 million to $122 million for the nine-month period due to higher losses from Hulu and lower income from A+E. These decreases were partially offset by a favorable comparison to a loss from BAMTech in the prior-year period. The decrease at Hulu was driven by higher programming, labor and marketing costs, partially offset by growth in subscription and advertising revenue. The decrease at A+E was due to lower advertising revenue.

Effective Income Tax Rate

	Nine Months Ended June 30, 2018	July 1, 2017	Change Better/(Worse)
Effective income tax rate	7.6%	32.4%	24.8 ppt

The decrease in the effective income tax rate was due to the impact of the Tax Act, which included:

- A net benefit of approximately $1.8 billion, which reflected an approximate $2.1 billion benefit from remeasuring our deferred tax balances to the new statutory rate, partially offset by a charge of approximately $0.3 billion from

accruing the Deemed Repatriation Tax. This net benefit had an impact of approximately 15.6 percentage points on the effective income tax rate.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS — (continued)

- A reduction in the Company's fiscal 2018 U.S. statutory federal income tax rate to 24.5% from 35.0% in the prior year. Net of state tax and other related effects, the reduction in the statutory rate had an impact of approximately 8.8 percentage points on the effective income tax rate.

Refer to Note 7 of the Condensed Consolidated Financial Statements for further information on the impact of the Tax Act on the Company.

Noncontrolling Interests

(in millions)	Nine Months Ended June 30, 2018	July 1, 2017	% Change Better/(Worse)
Net income attributable to noncontrolling interests	$371	$ 268	(38) %

The increase in net income attributable to noncontrolling interests for the nine-month period was due to lower tax expense at ESPN, largely due to the Tax Act, and the impact of the Company's acquisition of the noncontrolling interest in Disneyland Paris in the third quarter of the prior year.

SEASONALITY

The Company's businesses are subject to the effects of seasonality. Consequently, the operating results for the nine months ended June 30, 2018 for each business segment, and for the Company as a whole, are not necessarily indicative of results to be expected for the full year.

Media Networks revenues are subject to seasonal advertising patterns, changes in viewership levels and timing of program sales. In general, advertising revenues are somewhat higher during the fall and somewhat lower during the summer months.

Parks and Resorts revenues fluctuate with changes in theme park attendance and resort occupancy resulting from the seasonal nature of vacation travel and leisure activities. Peak attendance and resort occupancy generally occur during the summer months when school vacations occur and during early-winter and spring-holiday periods.

Studio Entertainment revenues fluctuate due to the timing and performance of releases in the theatrical, home entertainment and television markets. Release dates are determined by several factors, including competition and the timing of vacation and holiday periods.

Consumer Products & Interactive Media revenues are influenced by seasonal consumer purchasing behavior, which generally results in increased revenues during the Company's first and fourth fiscal quarter, and the timing and performance of theatrical and game releases and cable programming broadcasts.

BUSINESS SEGMENT RESULTS

The Company evaluates the performance of its operating segments based on segment operating income, which is shown below along with segment revenues:

(in millions)	Quarter Ended		% Change	Nine Months Ended		% Change
	June 30, 2018	July 1, 2017	Better/ (Worse)	June 30, 2018	July 1, 2017	Better/ (Worse)
Revenues:						
Media Networks	$6,156	$5,866	5 %	$18,537	$18,045	3 %
Parks and Resorts	5,193	4,894	6 %	15,226	13,748	11 %
Studio Entertainment	2,878	2,393	20 %	7,836	6,947	13 %
Consumer Products & Interactive Media	1,001	1,085	(8) %	3,528	3,618	(2) %
	$15,228	$14,238	7 %	$45,127	$42,358	7 %
Segment operating income:						
Media Networks	$1,822	$1,842	(1) %	$5,097	$5,427	(6) %
Parks and Resorts	1,339	1,168	15 %	3,640	3,028	20 %
Studio Entertainment	708	639	11 %	2,384	2,137	12 %
Consumer Products & Interactive Media	324	362	(10) %	1,295	1,371	(6) %
	$4,193	$4,011	5 %	$12,416	$11,963	4 %

The following table reconciles income before income taxes to segment operating income:

(in millions)	Quarter Ended		% Change	Nine Months Ended		% Change
	June 30, 2018	July 1, 2017	Better/ (Worse)	June 30, 2018	July 1, 2017	Better/ (Worse)
Income before income taxes	$3,854	$3,618	7 %	$11,527	$11,094	4 %
Add/(subtract):						
Corporate and unallocated shared expenses	196	99	(98) %	540	392	(38) %
Restructuring and impairment charges	—	—	nm	28	—	nm
Other income/(expense), net	—	177	nm	(94)	177	nm
Interest expense, net	143	117	(22) %	415	300	(38) %
Segment Operating Income	$4,193	$4,011	5 %	$12,416	$11,963	4 %

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS — (continued)

Depreciation expense is as follows:

(in millions)	Quarter Ended		% Change		Nine Months Ended		% Change	
	June 30, 2018	July 1, 2017	Better/ (Worse)		June 30, 2018	July 1, 2017	Better/ (Worse)	
Media Networks								
Cable Networks	$42	$ 34	(24)	%	$126	$105	(20)	%
Broadcasting	23	21	(10)	%	71	67	(6)	%
Total Media Networks	65	55	(18)	%	197	172	(15)	%
Parks and Resorts								
Domestic	340	333	(2)	%	1,053	983	(7)	%
International	189	187	(1)	%	546	500	(9)	%
Total Parks and Resorts	529	520	(2)	%	1,599	1,483	(8)	%
Studio Entertainment	15	13	(15)	%	41	36	(14)	%
Consumer Products & Interactive Media	14	15	7	%	41	46	11	%
Corporate	55	60	8	%	164	189	13	%
Total depreciation expense	$678	$ 663	(2)	%	$2,042	$1,926	(6)	%

Amortization of intangible assets is as follows:

(in millions)	Quarter Ended		% Change		Nine Months Ended		% Change	
	June 30, 2018	July 1, 2017	Better/ (Worse)		June 30, 2018	July 1, 2017	Better/ (Worse)	
Media Networks	$20	$ 3	>100 %		$40	$ 9	>(100)	%
Parks and Resorts	2	1	(100)	%	3	3	—	%
Studio Entertainment	16	16	—	%	48	48	—	%
Consumer Products & Interactive Media	28	28	—	%	84	88	5	%
Total amortization of intangible assets	$66	$ 48	(38)	%	$175	$ 148	(18)	%

Media Networks

Operating results for the Media Networks segment are as follows:

(in millions)	Quarter Ended		% Change	
	June 30, 2018	July 1, 2017	Better/ (Worse)	
Revenues				
Affiliate fees	$3,332	$3,176	5	%
Advertising	1,948	2,006	(3)	%
TV/SVOD distribution and other	876	684	28	%
Total revenues	6,156	5,866	5	%
Operating expenses	(3,725)	(3,500)	(6)	%
Selling, general, administrative and other	(602)	(593)	(2)	%
Depreciation and amortization	(85)	(58)	(47)	%
Equity in the income of investees	78	127	(39)	%
Operating Income	$1,822	$1,842	(1)	%

Revenues

The increase in affiliate fees was due to growth of 7% from higher contractual rates, partially offset by a 2% decrease from fewer subscribers.

The decrease in advertising revenues was due to a decrease of $67 million at Cable Networks, from $1,041 million to $974 million, partially offset by an increase of $9 million at Broadcasting, from $965 million to $974 million. Cable Networks advertising revenue reflected a decrease of 9% from lower impressions, partially offset by an increase of 4% from higher rates.

35

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS — (continued)

The decrease in impressions reflected lower average viewership at ESPN and Freeform. ESPN's advertising revenue was adversely impacted by one less NBA final game. Broadcasting advertising revenue reflected an increase of 7% from higher network rates, partially offset by decreases of 4% from lower network impressions and 1% from the owned television stations, which were both due to lower average viewership.

TV/SVOD distribution and other revenue increased $192 million due to higher program sales and the consolidation of BAMTech. On September 25, 2017 the Company increased its ownership in BAMTech and began consolidating its results. The Company's share of BAMTech's results was previously reported in equity in the income of investees. The increase in program sales was driven by higher sales of How to Get Away with Murder, Designated Survivor and Grey's Anatomy, partially offset by lower sales of Quantico. Additionally, the current quarter included the sale of Luke Cage compared to the prior-year quarter sale of The Defenders.

Costs and Expenses

Operating expenses include programming and production costs, which increased $147 million, from $3,203 million to $3,350 million. At Broadcasting, programming and production costs increased $102 million due to higher average cost network programming, including the impact of American Idol and Roseanne in the current quarter, and an increase in program sales. At Cable Networks, programming and production costs increased $45 million due to the consolidation of BAMTech and contractual rate increases for NBA programming, partially offset by the comparison to severance and contract termination costs in the prior-year quarter. Other operating costs, which include distribution and technology costs, increased primarily due to the consolidation of BAMTech.

Selling, general, administrative and other costs increased $9 million, from $593 million to $602 million as the impact from the consolidation of BAMTech was essentially offset by lower marketing and other costs.

Depreciation and amortization increased $27 million, from $58 million to $85 million due to the consolidation of BAMTech.

Equity in the Income of Investees

Income from equity investees decreased $49 million, from $127 million to $78 million due to higher losses from Hulu and lower income from A+E. These decreases were partially offset by a favorable comparison to a loss from BAMTech in the prior-year quarter. The decrease at Hulu was driven by higher programming and labor costs, partially offset by growth in subscription and advertising revenue. The decrease at A+E was due to lower advertising revenue and higher programming costs, partially offset by higher program sales.

Segment Operating Income

Segment operating income decreased 1%, or $20 million, to $1,822 million due to the consolidation of BAMTech, lower income from equity investees and a decrease at Freeform. These decreases were partially offset by higher income from program sales and increases at ESPN and the ABC Network.

The following table provides supplemental revenue and segment operating income detail for the Media Networks segment:

(in millions)	Quarter Ended June 30, 2018	Quarter Ended July 1, 2017	% Change Better/ (Worse)
Revenues			
Cable Networks[1]	$4,188	$4,086	2 %
Broadcasting	1,968	1,780	11 %
	$6,156	$5,866	5 %
Segment operating income			
Cable Networks[1]	$1,383	$1,462	(5) %
Broadcasting	361	253	43 %
Equity in the income of investees[1]	78	127	(39) %
	$1,822	$1,842	(1) %

(1)

Cable Networks results in the current quarter include the consolidated results of BAMTech, whereas in the prior-year quarter the Company’s share of BAMTech’s results was reported in equity in the income of investees.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS — (continued)

Parks and Resorts

Operating results for the Parks and Resorts segment are as follows:

(in millions)	Quarter Ended June 30, 2018	July 1, 2017	% Change Better/ (Worse)
Revenues			
Domestic	$4,089	$3,935	4 %
International	1,104	959	15 %
Total revenues	5,193	4,894	6 %
Operating expenses	(2,807)	(2,687)	(4) %
Selling, general, administrative and other	(511)	(515)	1 %
Depreciation and amortization	(531)	(521)	(2) %
Equity in the loss of investees	(5)	(3)	(67) %
Operating Income	$1,339	$1,168	15 %

Revenues

Parks and Resorts revenues increased 6%, or $299 million, to $5.2 billion due to increases of $154 million at our domestic operations and $145 million at our international operations. Results include an unfavorable impact due to the timing of the Easter holiday relative to our fiscal periods. One week of the Easter holiday fell in the third quarter of the current year whereas both holiday weeks fell in the third quarter of the prior year.

Revenue growth at our domestic operations reflected an increase of 4% from higher average guest spending. Guest spending growth was driven by higher average ticket prices for theme park admissions and for cruise line sailings, an increase in food, beverage and merchandise spending and higher average daily hotel room rates. Volumes were relatively flat as increased passenger cruise ship days were largely offset by lower occupied hotel room nights at Walt Disney World Resort. The increase in passenger cruise ship days included the impact of the Disney Fantasy dry-dock in the prior-year quarter. At Walt Disney World Resort, lower occupied hotel room nights were driven by room refurbishments and conversions to vacation club units.

Revenue growth at our international operations reflected increases of 7% from a favorable FX Impact, 3% from volume growth, 2% from higher real estate sales at Disneyland Paris and 2% from higher average guest spending. The increase in volumes was due to higher attendance at Shanghai Disney Resort and Hong Kong Disneyland Resort and an increase in occupied room nights at Hong Kong Disneyland Resort. Higher guest spending was driven by an increase in food, beverage and merchandise spending at Shanghai Disney Resort, Disneyland Paris and Hong Kong Disneyland Resort and higher average ticket prices. The increase in average ticket prices was due to increases at Disneyland Paris and Hong Kong Disneyland Resort, partially offset by a decrease at Shanghai Disney Resort.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS — (continued)

The following table presents supplemental park and hotel statistics:

	Domestic		International [2]		Total	
	Quarter Ended		Quarter Ended		Quarter Ended	
	June 30, 2018	July 1, 2017	June 30, 2018	July 1, 2017	June 30, 2018	July 1, 2017
Parks						
Increase/(decrease)						
Attendance	1 %	8 %	2 %	72 %	1 %	22 %
Per Capita Guest Spending	5 %	2 %	4 %	(1) %	4 %	(2) %
Hotels [1]						
Occupancy	86 %	88 %	87 %	84 %	86 %	87 %
Available Room Nights (in thousands)	2,517	2,533	793	772	3,310	3,305
Per Room Guest Spending	$357	$330	$301	$302	$344	$324

(1) Per room guest spending consists of the average daily hotel room rate, as well as food, beverage and merchandise sales at the hotels. Hotel statistics include rentals of Disney Vacation Club units.

(2) Per capita guest spending growth rate is stated on a constant currency basis. Per room guest spending is stated at the fiscal 2017 third quarter average foreign exchange rate.

Costs and Expenses

Operating expenses include operating labor, which increased $83 million, from $1,275 million to $1,358 million, infrastructure costs, which decreased $14 million, from $520 million to $506 million, and cost of sales, which increased $41 million, from $422 million to $463 million. The increase in operating labor was primarily due to inflation. The increase in cost of sales was due to higher volumes and increased real estate sales. Lower infrastructure costs reflected the comparison to costs that were incurred in the prior-year quarter for the dry-dock of the Disney Fantasy. Other operating expenses, which include costs for such items as supplies, commissions, and entertainment offerings, increased $10 million, from $470 million to $480 million. Operating expenses included an approximate 2% unfavorable FX Impact, which had similar impacts on operating labor, cost of sales, infrastructure costs and other operating expenses.

Depreciation and amortization increased $10 million, from $521 million to $531 million due to an unfavorable FX Impact.

Segment Operating Income

Segment operating income increased 15%, or $171 million, to $1,339 million due to growth at our domestic and international operations.

Studio Entertainment

Operating results for the Studio Entertainment segment are as follows:

(in millions)	Quarter Ended June 30, 2018	Quarter Ended July 1, 2017	% Change Better/ (Worse)
Revenues			
Theatrical distribution	$1,505	$1,044	44 %
Home entertainment	415	488	(15) %
TV/SVOD distribution and other	958	861	11 %
Total revenues	2,878	2,393	20 %
Operating expenses	(1,403)	(1,099)	(28) %
Selling, general, administrative and other	(736)	(626)	(18) %
Depreciation and amortization	(31)	(29)	(7) %

Operating Income	$708	$639	11 %

38

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS — (continued)

Revenues

The increase in theatrical distribution revenue was due to the success of Avengers: Infinity War and Incredibles 2, which were released in the current quarter compared to Guardians of the Galaxy Vol. 2 and Cars 3, which were released in the prior-year quarter. This increase was partially offset by the continued performance of Beauty and the Beast in the prior-year quarter. The prior-year quarter also included the release of Pirates of the Caribbean: Dead Men Tell No Tales while the current quarter included Solo: A Star Wars Story.

Lower home entertainment revenue was due to a decrease of 14% from lower domestic unit sales primarily due to the timing of the release of Star Wars titles. The DVD/Blu-ray release of Star Wars: The Last Jedi was in the second quarter of the current year whereas the DVD/Blu-Ray release of Rogue One: A Star Wars Story occurred in the prior-year third quarter. Other significant titles in the current quarter included Black Panther, whereas the prior-year quarter included Beauty and the Beast and Moana.

Growth in TV/SVOD distribution and other revenue was due to increases of 9% from TV/SVOD distribution and 3% from stage plays. Higher TV/SVOD distribution revenue was driven by increases from our domestic pay and free television businesses and international markets. Growth in domestic pay and free television was due to the timing of title availabilities. Domestic pay television sales also reflected an increase from higher rates. Higher stage play revenues were due to an additional production in the current quarter.

Costs and Expenses

Operating expenses include an increase of $288 million in film cost amortization, from $765 million to $1,053 million, due to the impact of higher theatrical distribution revenues and film cost impairments related to animated films that will not be released, partially offset by the impact of lower home entertainment revenue. Operating expenses also include cost of goods sold and distribution costs, which increased $16 million, from $334 million to $350 million due to an additional stage play production in the current quarter and an increase in international theatrical distribution costs, partially offset by lower home entertainment volumes.

Selling, general, administrative and other costs increased $110 million from $626 million to $736 million driven by higher theatrical marketing costs due to an increase in pre-release marketing costs and higher average spend on international theatrical releases in the current quarter.

Segment Operating Income

Segment operating income increased 11%, or $69 million, to $708 million due to increases in domestic theatrical and worldwide TV/SVOD distribution results, partially offset by higher film cost impairments and lower domestic home entertainment results.

Consumer Products & Interactive Media

Operating results for the Consumer Products & Interactive Media segment are as follows:

(in millions)	Quarter Ended June 30, 2018	Quarter Ended July 1, 2017	% Change Better/ (Worse)
Revenues			
Licensing, publishing and games	$674	$746	(10) %
Retail and other	327	339	(4) %
Total revenues	1,001	1,085	(8) %
Operating expenses	(413)	(431)	4 %
Selling, general, administrative and other	(222)	(249)	11 %
Depreciation and amortization	(42)	(43)	2 %
Operating Income	$324	$362	(10) %

Revenues

Lower licensing, publishing and games revenue was primarily due to decreased revenues from sales of licensed merchandise and an unfavorable FX Impact, partially offset by a benefit from a settlement. The decrease in sales of licensed merchandise was primarily due to lower revenue from products based on Spider-Man and Cars, partially offset by an increase from products based on Avengers.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS — (continued)

The decrease in retail and other revenue was due to lower comparable retail store sales, which reflected lower sales of Star Wars and Moana merchandise in the current quarter.

Costs and Expenses

Operating expenses include a $15 million decrease in cost of goods sold and distribution costs, from $234 million to $219 million and a $3 million decrease in product development expense, from $49 million to $46 million. Other operating expenses, which include occupancy costs, labor at our retail stores and other direct costs, were flat at $148 million. The decrease in cost of goods sold and distribution costs was primarily due to lower retail sales.

Selling, general, administrative and other costs decreased $27 million from $249 million to $222 million due to a favorable FX Impact and lower costs at our games business.

Segment Operating Income

Segment operating income decreased 10%, or $38 million, to $324 million due to lower income from licensing activities and decreased comparable retail store sales, partially offset by lower costs at our games business.

BUSINESS SEGMENT RESULTS - Nine Month Results

Media Networks

Operating results for the Media Networks segment are as follows:

	Nine Months Ended		% Change
(in millions)	June 30, 2018	July 1, 2017	Better/ (Worse)
Revenues			
Affiliate Fees	$9,934	$9,479	5 %
Advertising	6,185	6,466	(4) %
TV/SVOD distribution and other	2,418	2,100	15 %
Total revenues	18,537	18,045	3 %
Operating expenses	(11,393)	(10,899)	(5) %
Selling, general, administrative and other	(1,951)	(1,872)	(4) %
Depreciation and amortization	(237)	(181)	(31) %
Equity in the income of investees	141	334	(58) %
Operating Income	$5,097	$5,427	(6) %

Revenues

The increase in affiliate fees was due to an increase of 7% from higher contractual rates, partially offset by a 2% decrease from fewer subscribers.

The decrease in advertising revenues was due to decreases of $185 million at Cable Networks, from $3,379 million to $3,194 million, and $96 million at Broadcasting, from $3,087 million to $2,991 million. Cable Networks advertising revenue reflected a decrease of 6% from lower impressions, partially offset by a 2% increase from higher rates. Broadcasting advertising revenue reflected a decrease of 6% from lower network impressions and a decrease of 2% from the owned television stations due to lower political advertising, partially offset by an increase of 5% from higher network rates. Lower impressions at both Broadcasting and Cable Networks were due to lower average viewership.

TV/SVOD distribution and other revenue increased $318 million due to the consolidation of BAMTech and higher program sales reflecting increased revenue from Hulu and higher sales of Grey's Anatomy in the current period, partially offset by lower sales of Quantico. Additionally, the current period included the sales of Luke Cage and Jessica Jones compared to the prior-year period, which included the sales of Iron Fist and The Defenders.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS — (continued)

Costs and Expenses

Operating expenses include programming and production costs, which increased $339 million from $10,053 million to $10,392 million. At Cable Networks, programming and production costs increased $204 million due to contractual rate increases for college sports, NBA and NFL programming and the consolidation of BAMTech, partially offset by the comparison to severance and contract termination costs incurred in the prior-year period. At Broadcasting, programming and production costs increased $135 million due to higher average cost network programming, including the impact of American Idol and Roseanne in the current period, and an increase in program sales. Other operating costs, which include distribution and technology costs, increased driven by the consolidation of BAMTech.

Selling, general, administrative and other costs increased $79 million from $1,872 million to $1,951 million due to the consolidation of BAMTech.

Depreciation and amortization increased $56 million, from $181 million to $237 million due to the consolidation of BAMTech.

Equity in the Income of Investees

Income from equity investees decreased $193 million from $334 million to $141 million due to higher losses from Hulu and lower income from A+E. These decreases were partially offset by a favorable comparison to a loss from BAMTech in the prior-year period. The decrease at Hulu was driven by higher programming, labor and marketing costs, partially offset by growth in subscription and advertising revenue. The decrease at A+E was due to lower advertising revenue.

Segment Operating Income

Segment operating income decreased 6%, or $330 million, to $5,097 million due to the consolidation of BAMTech and lower income from equity investees.

The following table provides supplemental revenue and segment operating income detail for the Media Networks segment:

(in millions)	Nine Months Ended June 30, 2018	July 1, 2017	% Change Better/ (Worse)	
Revenues				
Cable Networks[1]	$12,933	$12,576	3	%
Broadcasting	5,604	5,469	2	%
	$18,537	$18,045	3	%
Segment operating income				
Cable Networks[1]	$3,967	$4,117	(4)	%
Broadcasting	989	976	1	%
Equity in the income of investees[1]	141	334	(58)	%
	$5,097	$5,427	(6)	%

(1) Cable Networks results in the current period include the consolidated results of BAMTech, whereas in the prior-year period the Company's share of BAMTech's results was reported in equity in the income of investees.

Parks and Resorts

Operating results for the Parks and Resorts segment are as follows:

(in millions)	Nine Months Ended June 30, 2018	Nine Months Ended July 1, 2017	% Change Better/ (Worse)
Revenues			
Domestic	$12,223	$11,231	9 %
International	3,003	2,517	19 %
Total revenues	15,226	13,748	11 %
Operating expenses	(8,461)	(7,817)	(8) %
Selling, general, administrative and other	(1,504)	(1,409)	(7) %
Depreciation and amortization	(1,602)	(1,486)	(8) %
Equity in the loss of investees	(19)	(8)	>(100) %
Operating Income	$3,640	$3,028	20 %

Revenues

Parks and Resorts revenues increased 11%, or $1,478 million, to $15.2 billion due to increases of $992 million at our domestic operations and $486 million at our international operations.

Revenue growth at our domestic operations reflected increases of 6% from higher average guest spending and 2% from volume growth. Guest spending growth was due to higher average ticket prices for theme park admissions and for cruise line sailings, increased food, beverage and merchandise spending and higher average daily hotel room rates. The increase in volumes was due to higher attendance and passenger cruise ship days, partially offset by lower occupied hotel room nights.

Revenue growth at our international operations reflected increases of 8% from a favorable FX Impact, 5% from an increase in volumes and 4% from higher average guest spending at Disneyland Paris. The increase in volumes was due to higher attendance and occupied room nights at Hong Kong Disneyland Resort and Disneyland Paris. Guest spending growth at Disneyland Paris was driven by higher average ticket prices, food, beverage and merchandise spending and average daily hotel room rates.

The following table presents supplemental park and hotel statistics:

	Domestic Nine Months Ended June 30, 2018	Domestic Nine Months Ended July 1, 2017	International [2] Nine Months Ended June 30, 2018	International [2] Nine Months Ended July 1, 2017	Total Nine Months Ended June 30, 2018	Total Nine Months Ended July 1, 2017
Parks						
Increase/(decrease)						
Attendance	4 %	2 %	4 %	64 %	4 %	15 %
Per Capita Guest Spending	6 %	3 %	7 %	(1) %	6 %	(1) %
Hotels [1]						
Occupancy	89 %	89 %	85 %	82 %	88 %	87 %
Available Room Nights (in thousands)	7,540	7,663	2,380	2,222	9,920	9,885
Per Room Guest Spending	$349	$321	$282	$271	$334	$311

(1) Per room guest spending consists of the average daily hotel room rate, as well as food, beverage and merchandise sales at the hotels. Hotel statistics include rentals of Disney Vacation Club units.

(2) Per capita guest spending growth rate is stated on a constant currency basis. Per room guest spending is stated at the fiscal 2017 nine-month average foreign exchange rate.

Costs and Expenses

Operating expenses include operating labor, which increased $342 million from $3,692 million to $4,034 million, infrastructure costs, which increased $94 million from $1,473 million to $1,567 million, and cost of sales, which increased $122 million from $1,226 million to $1,348 million. The increase in operating labor was due to inflation, higher volumes and a

42

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS — (continued)

special fiscal 2018 domestic employee bonus. The increase in cost of sales was due to higher volumes and inflation. Higher infrastructure costs were due to increased technology spending. Other operating expenses, which include costs for such items as supplies, commissions and entertainment offerings, increased $86 million, from $1,426 million to $1,512 million due to inflation. Operating expenses included an approximate 2% unfavorable FX Impact, which had similar impacts on operating labor, cost of sales, infrastructure costs and other operating expenses.

Selling, general, administrative and other costs increased $95 million, from $1,409 million to $1,504 million driven by inflation and an unfavorable FX Impact.

Depreciation and amortization increased $116 million, from $1,486 million to $1,602 million primarily due to new attractions at our domestic parks and resorts and Hong Kong Disneyland Resort and an unfavorable FX Impact.

Equity in the Loss of Investees

Loss from equity investees increased $11 million to $19 million due to a higher operating loss from Villages Nature, in which Disneyland Paris has a 50% interest.

Segment Operating Income

Segment operating income increased 20%, or $612 million, to $3,640 million due to growth at our domestic and international operations.

Studio Entertainment

Operating results for the Studio Entertainment segment are as follows:

(in millions)	Nine Months Ended June 30, 2018	July 1, 2017	% Change Better/ (Worse)
Revenues			
Theatrical distribution	$3,630	$2,715	34 %
Home entertainment	1,299	1,454	(11) %
TV/SVOD distribution and other	2,907	2,778	5 %
Total revenues	7,836	6,947	13 %
Operating expenses	(3,355)	(2,970)	(13) %
Selling, general, administrative and other	(2,008)	(1,756)	(14) %
Depreciation and amortization	(89)	(84)	(6) %
Operating Income	$2,384	$2,137	12 %

Revenues

The increase in theatrical distribution revenue was due to the comparison of three Marvel titles and two Star Wars titles in the current period compared to two Marvel titles and one Star Wars title in the prior-year period and the performance of Incredibles 2 in the current period compared to Cars 3 in the prior-year period. The Marvel titles in the current period were Avengers: Infinity War, Black Panther and Thor: Ragnarok, whereas the prior-year period included Guardians of the Galaxy Vol. 2 and Doctor Strange. The Star Wars titles in the current period were Star Wars: The Last Jedi and Solo: A Star Wars Story, whereas the prior-year period included Rogue One: A Star Wars Story. These increases were partially offset by the release of A Wrinkle in Time in the current period compared to the releases of Beauty and the Beast and Pirates of the Caribbean: Dead Men Tell No Tales in the prior-year period. Other significant releases in the current period included Coco, while the prior-year period included Moana.

Lower home entertainment revenue was due to a decrease of 9% from lower domestic unit sales due to one feature animation release in the current period compared to two feature animation releases in the prior-year period. This decrease was partially offset by the comparison of two Marvel titles in the current period compared to one Marvel title in the prior-year period. The feature animation release in the current period included Coco, whereas the prior-year period included Finding Dory and Moana. The Marvel releases in the current period were Thor: Ragnarok and Black Panther while the prior-year period included Doctor Strange. Other significant titles in the current period included Star

Wars: The Last Jedi, whereas the prior-year period included Rogue One: A Star Wars Story and Beauty and the Beast. Higher TV/SVOD distribution and other revenue was due to increases of 3% from stage plays and 2% from TV/SVOD distribution. Higher stage play revenues were due to additional productions in the current period. The increase in TV/SVOD distribution was driven by an increase in our free television business, partially offset by a decrease in our international pay

43

television business due to more titles available in the prior-year period. Growth in our free television business was primarily due to new international agreements, more title availabilities in the current period, the sale of Star Wars: The Force Awakens in the current period with no comparable title in the prior-year period and the timing of title availabilities.

Costs and Expenses

Operating expenses include an increase of $364 million in film cost amortization, from $2,021 million to $2,385 million due to the impact of higher theatrical distribution revenues and an increase in film cost impairments, partially offset by the impact of lower home entertainment revenues. Operating expenses also include cost of goods sold and distribution costs, which increased $21 million, from $949 million to $970 million due to the increase in stage play productions, partially offset by lower home entertainment volumes.

Selling, general, administrative and other costs increased $252 million from $1,756 million to $2,008 million primarily due to higher theatrical and stage play marketing costs. The increase in theatrical marketing costs was due to higher average spend on titles released in the current period and an increase in pre-release marketing costs. Higher stage play marketing costs reflected spending for additional productions in the current period.

Segment Operating Income

Segment operating income increased 12%, or $247 million, to $2,384 million due to increases in theatrical and TV/SVOD distribution results, partially offset by higher film cost impairments and lower domestic home entertainment distribution results.

Consumer Products & Interactive Media

Operating results for the Consumer Products & Interactive Media segment are as follows:

(in millions)	Nine Months Ended June 30, 2018	Nine Months Ended July 1, 2017	% Change Better/ (Worse)
Revenues			
Licensing, publishing and games	$2,310	$2,409	(4) %
Retail and other	1,218	1,209	1 %
Total revenues	3,528	3,618	(2) %
Operating expenses	(1,409)	(1,406)	— %
Selling, general, administrative and other	(699)	(708)	1 %
Depreciation and amortization	(125)	(134)	7 %
Equity in the income of investees	—	1	— %
Operating Income	$1,295	$1,371	(6) %

Revenues

The decrease in licensing, publishing and games revenue was due to lower revenues from sales of licensed merchandise, a decrease in licensee settlements and an unfavorable FX Impact. Lower revenues from sales of licensed merchandise were driven by decreased revenue from products based on Frozen, Spider-Man, Finding Nemo/Dory and Princess, partially offset by an increase from products based on Star Wars and Mickey and Minnie.

The increase in retail and other revenue includes higher sponsorship revenue and a favorable FX Impact, which were largely offset by lower retail sales. The decrease in retail sales was due to lower comparable store sales, partially offset by an increase in online retail revenue. Lower comparable retail store sales reflected decreased sales of Star Wars, Moana and Finding Nemo/Dory merchandise in the current period, partially offset by higher sales of Cars merchandise.

Costs and Expenses

Operating expenses included a $14 million decrease in cost of goods sold and distribution costs, from $808 million to $794 million, a $29 million increase in other operating expenses, from $438 million to $467 million, and a $12 million decrease in product development expense, from $160 million to $148 million. The decrease in cost of goods sold and distribution costs was driven by lower retail sales. The increase in other operating expenses, which include occupancy costs, labor at our retail stores and other direct costs, was driven by an unfavorable FX Impact. Lower product development expense was due to fewer games in development.

Segment Operating Income

Segment operating income decreased 6%, or $76 million, to $1,295 million due to decreases at our merchandise licensing and retail businesses.

Restructuring and Impairment Charges

The Company recorded restructuring and impairment charges of $14 million related to Consumer Products & Interactive Media in the current period primarily for severance costs.

CORPORATE AND UNALLOCATED SHARED EXPENSES

	Quarter Ended		% Change	Nine Months Ended		% Change
(in millions)	June 30, 2018	July 1, 2017	Better/ (Worse)	June 30, 2018	July 1, 2017	Better/ (Worse)
Corporate and unallocated shared expenses	$ (196)	$ (99)	(98) %	$ (540)	$ (392)	(38) %

Corporate and unallocated shared expenses increased $97 million to $196 million in the current quarter and increased $148 million to $540 million for the nine-month period, primarily due to costs incurred in connection with our agreement to acquire Twenty-First Century Fox, Inc. and higher compensation costs. The current quarter also included an unfavorable impact from the timing of allocations to operating segments.

IMPACT OF U.S. FEDERAL INCOME TAX REFORM

As discussed in Note 7 to the Condensed Consolidated Financial Statements, the Tax Act resulted in the following impacts to the Company (the amounts recorded in the nine-month period are provisional and will be refined during the remainder of calendar 2018):

- The Company's federal statutory income tax rate was reduced from 35.0% to 24.5% for fiscal 2018 and to 21.0% for following years.
- For the nine-month period ended June 30, 2018, the Company recognized a net benefit of approximately $1.8 billion, which reflected an approximate $2.1 billion benefit from remeasuring our deferred tax balances to the new statutory rate, partially offset by a charge of approximately $0.3 billion from accruing a Deemed Repatriation Tax.
- Generally, there will no longer be a U.S. federal income tax cost on the repatriation of foreign earnings.
- The Company will be eligible to claim an immediate deduction for investments in qualified fixed assets and film and television productions placed in service during fiscal 2018 through fiscal 2022. This provision phases out through fiscal 2027.
- Certain provisions of the Act are not effective for the Company until fiscal 2019 including:
- The elimination of the domestic production activities deduction.
- The taxation of certain foreign derived income in the U.S. at an effective rate of approximately 13% (which increases to approximately 16% in 2025) rather than the general statutory rate of 21%.
- A minimum effective tax on certain foreign earnings of approximately 13%.

We are continuing to assess the impacts of these provisions, but do not currently anticipate that the net impact will be material to our fiscal 2019 effective income tax rate.

- We expect a cash tax benefit similar to the reduction in the statutory rate, as well as a benefit from the immediate deduction for investments in qualified fixed assets and film and television productions.

45

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS — (continued)

FINANCIAL CONDITION

The change in cash and cash equivalents is as follows:

(in millions)	Nine Months Ended June 30, 2018	Nine Months Ended July 1, 2017	% Change Better/ (Worse)
Cash provided by operations	$10,442	$8,773	19 %
Cash used in investing activities	(5,143)	(3,290)	(56) %
Cash used in financing activities	(4,981)	(5,792)	14 %
Impact of exchange rates on cash, cash equivalents and restricted cash	(51)	(23)	>(100) %
Change in cash, cash equivalents and restricted cash	$267	$(332)	nm

Operating Activities

Cash provided by operating activities increased 19% to $10.4 billion for the current nine months compared to $8.8 billion in the prior-year nine months driven by a decrease in tax payments due to the Tax Act, a decrease in pension plan contributions and higher operating cash flow at Parks and Resorts, partially offset by lower operating cash flow at Media Networks. Parks and Resorts cash flow reflected higher operating cash receipts due to increased revenues, partially offset by higher spending on labor and other costs. Lower operating cash flow at Media Networks was primarily due to higher television production spending.

Film and Television Costs

The Company's Studio Entertainment and Media Networks segments incur costs to acquire and produce feature film and television programming. Film and television production costs include all internally produced content such as live-action and animated feature films, animated direct-to-video programming, television series, television specials, theatrical stage plays or other similar product. Programming costs include film or television product licensed for a specific period from third parties for airing on the Company's broadcast and cable networks and television stations. Programming assets are generally recorded when the programming becomes available to us with a corresponding increase in programming liabilities. Accordingly, we analyze our programming assets net of the related liability.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS — (continued)

The Company's film and television production and programming activity for the nine months ended June 30, 2018 and July 1, 2017 are as follows:

(in millions)	Nine Months Ended June 30, 2018	July 1, 2017
Beginning balances:		
Production and programming assets	$8,759	$7,547
Programming liabilities	(1,108)	(1,063)
	7,651	6,484
Spending:		
Television program licenses and rights	6,252	6,025
Film and television production	4,303	3,863
	10,555	9,888
Amortization:		
Television program licenses and rights	(6,280)	(5,986)
Film and television production	(3,674)	(3,157)
	(9,954)	(9,143)
Change in film and television production and programming costs	601	745
Other non-cash activity	(192)	19
Ending balances:		
Production and programming assets	8,925	8,012
Programming liabilities	(865)	(764)
	$8,060	$7,248

Investing Activities

Investing activities consist principally of investments in parks, resorts and other property and acquisition and divestiture activity. The Company's investments in parks, resorts and other property for the nine months ended June 30, 2018 and July 1, 2017 are as follows:

(in millions)	Nine Months Ended June 30, 2018	July 1, 2017
Media Networks		
Cable Networks	$161	$70
Broadcasting	54	44
Total Media Networks	215	114
Parks and Resorts		
Domestic	2,368	1,682
International	466	721
Total Parks and Resorts	2,834	2,403
Studio Entertainment	72	64
Consumer Products & Interactive Media	14	17
Corporate	129	130
	$3,264	$2,728

Capital expenditures for the Parks and Resorts segment are principally for theme park and resort expansion, new attractions, cruise ships, capital improvements and systems infrastructure. The increase at our domestic parks and resorts was due to higher spending on new attractions. The decrease at our international parks and resorts was due to lower spending at Hong Kong Disneyland Resort and Shanghai Disney Resort.

Capital expenditures at Media Networks primarily reflect investments in facilities and equipment for expanding and upgrading broadcast centers, production facilities and television station facilities. The increase at Cable Networks was primarily due to technology spending at BAMTech.
Capital expenditures at Corporate primarily reflect investments in corporate facilities, information technology infrastructure and equipment.
The Company currently expects its fiscal 2018 capital expenditures will be approximately $1 billion higher than fiscal 2017 capital expenditures of $3.6 billion primarily due to increased investments at our domestic parks and resorts.
Other Investing Activities
During the current nine-month period, the Company made a $1.6 billion payment for its incremental 42% interest in BAMTech and contributed $329 million to Hulu. During the prior-year nine-month period, the Company acquired an incremental 18% interest in BAMTech for $557 million.
The Company has entered into a definitive agreement to acquire 21CF, which, if completed, will require cash consideration of $35.7 billion and the issuance of stock (See Note 4 to the Condensed Consolidated Financial Statements).

Financing Activities
Cash used in financing activities was $5.0 billion in the current nine-month period, which reflected repurchases of common stock of $3.6 billion and dividends of $1.3 billion.
Cash used in financing activities of $5.0 billion in the current year nine-month period was $0.8 billion less than the $5.8 billion used in the prior-year nine-month period as a decrease in repurchases of common stock in the current nine-month period compared to the prior-year nine-month period ($3.6 billion vs $5.9 billion respectively) was partially offset by lower net borrowings in the current nine-month period compared to the prior-year nine-month period ($0.2 billion vs $2.2 billion respectively).
See Note 5 to the Condensed Consolidated Financial Statements for a summary of the Company's borrowing activities during the nine months ended June 30, 2018 and information regarding the Company's bank facilities. The Company may use commercial paper borrowings up to the amount of its unused bank facilities, in conjunction with term debt issuance and operating cash flow, to retire or refinance other borrowings before or as they come due.
See Note 10 to the Condensed Consolidated Financial Statements for a summary of the Company's dividends in fiscal 2018 and 2017 and share repurchases during the nine months ended June 30, 2018.
We believe that the Company's financial condition is strong and that its cash balances, other liquid assets, operating cash flows, access to debt and equity capital markets and borrowing capacity, taken together, provide adequate resources to fund the cash consideration in the pending acquisition of 21CF, ongoing operating requirements and future capital expenditures related to the expansion of existing businesses and development of new projects. However, the Company's operating cash flow and access to the capital markets can be impacted by macroeconomic factors outside of its control. In addition to macroeconomic factors, the Company's borrowing costs can be impacted by short- and long-term debt ratings assigned by nationally recognized rating agencies, which are based, in significant part, on the Company's performance as measured by certain credit metrics such as interest coverage and leverage ratios. As of June 30, 2018, Moody's Investors Service's long- and short-term debt ratings for the Company were A2 and P-1, respectively; Standard and Poor's long- and short-term debt ratings for the Company were A+ and A-1+; and Fitch's long- and short-term debt ratings for the Company were A and F1, respectively. Each of Moody's Investors Service, Standard and Poor's and Fitch has placed the Company's long- and short-term debt ratings on review for downgrade as a result of the pending acquisition of 21CF. The Company currently expects each rating agency to finalize its review of the Company's debt ratings upon closing of the acquisition and one or more of the agencies may downgrade our long- and short-term debt ratings. Should a downgrade occur, we do not anticipate that it would impact our ability to fund ongoing operating requirements and future capital expenditures. The Company's bank facilities contain only one financial covenant, relating to interest coverage, which the Company met on June 30, 2018 by a significant margin. The Company's bank facilities also specifically exclude certain entities, including the Asia Theme Parks, from any

representations, covenants or events of default.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS — (continued)

COMMITMENTS AND CONTINGENCIES

Legal Matters

As disclosed in Note 12 to the Condensed Consolidated Financial Statements, the Company has exposure for certain legal matters.

Guarantees

See Note 12 to the Condensed Consolidated Financial Statements for information regarding the Company's guarantees.

Tax Matters

As disclosed in Note 9 to the Consolidated Financial Statements in the 2017 Annual Report on Form 10-K, the Company has exposure for certain tax matters.

Contractual Commitments

See Note 14 to the Consolidated Financial Statements in the 2017 Annual Report on Form 10-K for information regarding the Company's contractual commitments.

OTHER MATTERS

Accounting Policies and Estimates

We believe that the application of the following accounting policies, which are important to our financial position and results of operations require significant judgments and estimates on the part of management. For a summary of our significant accounting policies, including the accounting policies discussed below, see Note 2 to the Consolidated Financial Statements in the 2017 Annual Report on Form 10-K.

Film and Television Revenues and Costs

We expense film and television production, participation and residual costs over the applicable product life cycle based upon the ratio of the current period's revenues to the estimated remaining total revenues (Ultimate Revenues) for each production. If our estimate of Ultimate Revenues decreases, amortization of film and television costs may be accelerated. Conversely, if our estimate of Ultimate Revenues increases, film and television cost amortization may be slowed. For film productions, Ultimate Revenues include revenues from all sources that will be earned within ten years from the date of the initial theatrical release. For television series, Ultimate Revenues include revenues that will be earned within ten years from delivery of the first episode, or if still in production, five years from delivery of the most recent episode, if later.

With respect to films intended for theatrical release, the most sensitive factor affecting our estimate of Ultimate Revenues (and therefore affecting future film cost amortization and/or impairment) is theatrical performance. Revenues derived from other markets subsequent to the theatrical release (e.g., the home entertainment or television markets) have historically been highly correlated with the theatrical performance. Theatrical performance varies primarily based upon the public interest and demand for a particular film, the popularity of competing films at the time of release and the level of marketing effort. Upon a film's release and determination of the theatrical performance, the Company's estimates of revenues from succeeding windows and markets are revised based on historical relationships and an analysis of current market trends. The most sensitive factor affecting our estimate of Ultimate Revenues for released films is the level of expected home entertainment sales. Home entertainment sales vary based on the number and quality of competing home entertainment products, as well as the manner in which retailers market and price our products.

With respect to television series or other television productions intended for broadcast, the most sensitive factors affecting estimates of Ultimate Revenues are program ratings and the strength of the advertising market. Program ratings, which are an indication of market acceptance, directly affect the Company's ability to generate advertising revenues during the airing of the program. In addition, television series with greater market acceptance are more likely to generate incremental revenues through the licensing of program rights worldwide to television distributors, SVOD services and in home entertainment formats. Alternatively, poor ratings may result in cancellation of the program, which would require an immediate write-down of any unamortized production costs. A significant decline in the advertising market would also negatively impact our estimates.

We expense the cost of television broadcast rights for acquired series, movies and other programs based on the number of times the program is expected to be aired or on a straight-line basis over the useful life, as appropriate. Amortization of those television programming assets being amortized on a number of airings basis may be accelerated if we reduce the estimated future airings and slowed if we increase the estimated future airings. The number of future airings of a particular program is impacted primarily by the program's ratings in previous airings, expected advertising rates and availability and quality of

alternative programming. Accordingly, planned usage is reviewed periodically and revised if necessary. We amortize rights costs for multi-year sports programming arrangements during the applicable seasons based on the estimated relative value of each year in the arrangement. The estimated value of each year is based on our projections of revenues over the contract period, which include advertising revenue and an allocation of affiliate revenue. If the annual contractual payments related to each season approximate each season's estimated relative value, we expense the related contractual payments during the applicable season. If planned usage patterns or estimated relative values by year were to change significantly, amortization of our sports rights costs may be accelerated or slowed.

Costs of film and television productions are subject to regular recoverability assessments, which compare the estimated fair values with the unamortized costs. The net realizable values of television broadcast program licenses and rights are reviewed using a daypart methodology. A daypart is defined as an aggregation of programs broadcast during a particular time of day or programs of a similar type. The Company's dayparts are: primetime, daytime, late night, news and sports (includes broadcast and cable networks). The net realizable values of other cable programming assets are reviewed on an aggregated basis for each cable network. Individual programs are written off when there are no plans to air or sublicense the program. Estimated values are based upon assumptions about future demand and market conditions. If actual demand or market conditions are less favorable than our projections, film, television and programming cost write-downs may be required.

Revenue Recognition

We reduce home entertainment revenues for estimated future returns of merchandise and for customer programs and sales incentives. These estimates are based upon historical return experience, current economic trends and projections of customer demand for and acceptance of our products. If we underestimate the level of returns or sales incentives in a particular period, we may record less revenue in later periods when returns or sales incentives exceed the estimated amount. Conversely, if we overestimate the level of returns or sales incentives for a period, we may have additional revenue in later periods when returns or sales incentives are less than estimated.

We recognize revenues from advance theme park ticket sales when the tickets are used. Revenues from annual pass sales are recognized ratably over the period for which the pass is available for use.

Pension and Postretirement Medical Plan Actuarial Assumptions

The Company's pension and postretirement medical benefit obligations and related costs are calculated using a number of actuarial assumptions. Two critical assumptions, the discount rate and the expected return on plan assets, are important elements of expense and/or liability measurement, which we evaluate annually. Refer to the 2017 Annual Report on Form 10-K for estimated impacts of changes in these assumptions. Other assumptions include the healthcare cost trend rate and employee demographic factors such as retirement patterns, mortality, turnover and rate of compensation increase.

The discount rate enables us to state expected future cash payments for benefits as a present value on the measurement date. A lower discount rate increases the present value of benefit obligations and increases pension expense. The guideline for setting this rate is a high-quality long-term corporate bond rate. The Company's discount rate was determined by considering yield curves constructed of a large population of high-quality corporate bonds and reflects the matching of the plans' liability cash flows to the yield curves.

To determine the expected long-term rate of return on the plan assets, we consider the current and expected asset allocation, as well as historical and expected returns on each plan asset class. A lower expected rate of return on pension plan assets will increase pension expense.

Goodwill, Other Intangible Assets, Long-Lived Assets and Investments

The Company is required to test goodwill and other indefinite-lived intangible assets for impairment on an annual basis and if current events or circumstances require, on an interim basis. Goodwill is allocated to various reporting units, which are an operating segment or one level below the operating segment. The Company compares the fair value of each reporting unit to its carrying amount, and to the extent the carrying amount exceeds the fair value, an impairment of goodwill is recognized for the excess up to the goodwill allocated to the reporting unit.

To determine the fair value of our reporting units, we generally use a present value technique (discounted cash flows) corroborated by market multiples when available and as appropriate. We apply what we believe to be the most appropriate valuation methodology for each of our reporting units. The discounted cash flow analyses are sensitive to our estimates of future revenue growth and margins for these businesses. We include in the projected cash flows an estimate of the revenue we believe the reporting unit would receive if the intellectual property developed by the reporting unit that is being used by other

reporting units was licensed to an unrelated third party at its fair market value. These amounts are not necessarily the same as those included in segment operating results. We believe our estimates of fair value are consistent with how a marketplace participant would value our reporting units.

In times of adverse economic conditions in the global economy, the Company's long-term cash flow projections are subject to a greater degree of uncertainty than usual. If we had established different reporting units or utilized different valuation methodologies or assumptions, the impairment test results could differ, and we could be required to record impairment charges.

The Company is required to compare the fair values of other indefinite-lived intangible assets to their carrying amounts. If the carrying amount of an indefinite-lived intangible asset exceeds its fair value, an impairment loss is recognized for the excess. Fair values of other indefinite-lived intangible assets are determined based on discounted cash flows or appraised values, as appropriate.

The Company tests long-lived assets, including amortizable intangible assets, for impairment whenever events or changes in circumstances (triggering events) indicate that the carrying amount may not be recoverable. Once a triggering event has occurred, the impairment test employed is based on whether the intent is to hold the asset for continued use or to hold the asset for sale. The impairment test for assets held for use requires a comparison of cash flows expected to be generated over the useful life of an asset group to the carrying value of the asset group. An asset group is established by identifying the lowest level of cash flows generated by a group of assets that are largely independent of the cash flows of other assets and could include assets used across multiple businesses or segments. If the carrying value of an asset group exceeds the estimated undiscounted future cash flows, an impairment would be measured as the difference between the fair value of the group's long-lived assets and the carrying value of the group's long-lived assets. The impairment is allocated to the long-lived assets of the group on a pro rata basis using the relative carrying amounts, but only to the extent the carrying value of each asset is above its fair value. For assets held for sale, to the extent the carrying value is greater than the asset's fair value less costs to sell, an impairment loss is recognized for the difference. Determining whether a long-lived asset is impaired requires various estimates and assumptions, including whether a triggering event has occurred, the identification of the asset groups, estimates of future cash flows and the discount rate used to determine fair values. If we had established different asset groups or utilized different valuation methodologies or assumptions, the impairment test results could differ, and we could be required to record impairment charges.

The Company has cost and equity investments. The fair value of these investments is dependent on the performance of the investee companies as well as volatility inherent in the external markets for these investments. In assessing the potential impairment of these investments, we consider these factors, as well as the forecasted financial performance of the investees and market values, where available. If these forecasts are not met or market values indicate an other-than-temporary decline in value, impairment charges may be required.

Allowance for Doubtful Accounts

We evaluate our allowance for doubtful accounts and estimate collectability of accounts receivable based on our analysis of historical bad debt experience in conjunction with our assessment of the financial condition of individual companies with which we do business. In times of domestic or global economic turmoil, our estimates and judgments with respect to the collectability of our receivables are subject to greater uncertainty than in more stable periods. If our estimate of uncollectible accounts is too low, costs and expenses may increase in future periods, and if it is too high, costs and expenses may decrease in future periods.

Contingencies and Litigation

We are currently involved in certain legal proceedings and, as required, have accrued estimates of the probable and estimable losses for the resolution of these proceedings. These estimates are based upon an analysis of potential results, assuming a combination of litigation and settlement strategies, and have been developed in consultation with outside counsel as appropriate. From time to time, we may also be involved in other contingent matters for which we have accrued estimates for a probable and estimable loss. It is possible, however, that future results of operations for

any particular quarterly or annual period could be materially affected by changes in our assumptions or the effectiveness of our strategies related to legal proceedings or our assumptions regarding other contingent matters. See Note 12 to the Condensed Consolidated Financial Statements for more detailed information on litigation exposure.

Income Tax Audits

As a matter of course, the Company is regularly audited by federal, state and foreign tax authorities. From time to time, these audits result in proposed assessments. Our determinations regarding the recognition of income tax benefits are made in consultation with outside tax and legal counsel, where appropriate, and are based upon the technical merits of our tax positions in consideration of applicable tax statutes and related interpretations and precedents and upon the expected outcome of proceedings (or negotiations) with taxing and legal authorities. The tax benefits ultimately realized by the Company may differ from those recognized in our future financial statements based on a number of factors, including the Company's decision to settle rather than litigate a matter, relevant legal precedent related to similar matters and the Company's success in supporting its filing positions with taxing authorities.

New Accounting Pronouncements

See Note 16 to the Condensed Consolidated Financial Statements for information regarding new accounting pronouncements.

MARKET RISK

The Company is exposed to the impact of interest rate changes, foreign currency fluctuations, commodity fluctuations and changes in the market values of its investments.

Policies and Procedures

In the normal course of business, we employ established policies and procedures to manage the Company's exposure to changes in interest rates, foreign currencies and commodities using a variety of financial instruments.

Our objectives in managing exposure to interest rate changes are to limit the impact of interest rate volatility on earnings and cash flows and to lower overall borrowing costs. To achieve these objectives, we primarily use interest rate swaps to manage net exposure to interest rate changes related to the Company's portfolio of borrowings. By policy, the Company targets fixed-rate debt as a percentage of its net debt between minimum and maximum percentages.

Our objective in managing exposure to foreign currency fluctuations is to reduce volatility of earnings and cash flow in order to allow management to focus on core business issues and challenges. Accordingly, the Company enters into various contracts that change in value as foreign exchange rates change to protect the U.S. dollar equivalent value of its existing foreign currency assets, liabilities, commitments and forecasted foreign currency revenues and expenses. The Company utilizes option strategies and forward contracts that provide for the purchase or sale of foreign currencies to hedge probable, but not firmly committed, transactions. The Company also uses forward and option contracts to hedge foreign currency assets and liabilities. The principal foreign currencies hedged are the euro, British pound, Japanese yen and Canadian dollar. Cross-currency swaps are used to effectively convert foreign currency denominated borrowings to U.S. dollar denominated borrowings. By policy, the Company maintains hedge coverage between minimum and maximum percentages of its forecasted foreign exchange exposures generally for periods not to exceed four years. The gains and losses on these contracts offset changes in the U.S. dollar equivalent value of the related exposures. The economic or political conditions in a country could reduce our ability to hedge exposure to currency fluctuations in the country or our ability to repatriate revenue from the country.

Our objectives in managing exposure to commodity fluctuations are to use commodity derivatives to reduce volatility of earnings and cash flows arising from commodity price changes. The amounts hedged using commodity swap contracts are based on forecasted levels of consumption of certain commodities, such as fuel oil and gasoline.

It is the Company's policy to enter into foreign currency and interest rate derivative transactions and other financial instruments only to the extent considered necessary to meet its objectives as stated above. The Company does not enter into these transactions or any other hedging transactions for speculative purposes.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.
See Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Item 4. Controls and Procedures
Evaluation of Disclosure Controls and Procedures – We have established disclosure controls and procedures to ensure that the information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms and that such information is accumulated and made known to the officers who certify the Company's financial reports and to other members of senior management and the Board of Directors as appropriate to allow timely decisions regarding required disclosure.
Based on their evaluation as of June 30, 2018, the principal executive officer and principal financial officer of the Company have concluded that the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) are effective.
There have been no changes in our internal controls over financial reporting during the third quarter of fiscal 2018 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION
ITEM 1. Legal Proceedings
As disclosed in Note 12 to the Condensed Consolidated Financial Statements, the Company is engaged in certain legal matters, and the disclosure set forth in Note 12 relating to certain legal matters is incorporated herein by reference.

ITEM 1A. Risk Factors
The Private Securities Litigation Reform Act of 1995 (the Act) provides a safe harbor for "forward-looking statements" made by or on behalf of the Company. We may from time to time make written or oral statements that are "forward-looking," including statements contained in this report and other filings with the Securities and Exchange Commission and in reports to our shareholders. All forward-looking statements are made on the basis of management's views and assumptions regarding future events and business performance as of the time the statements are made and the Company does not undertake any obligation to update its disclosure relating to forward-looking matters. Actual results may differ materially from those expressed or implied. Such differences may result from actions taken by the Company, including restructuring or strategic initiatives (including capital investments or asset acquisitions or dispositions), as well as from developments beyond the Company's control, including: changes in domestic and global economic conditions, competitive conditions and consumer preferences; adverse weather conditions or natural disasters; health concerns; international, political or military developments; and technological developments. Such developments may affect entertainment, travel and leisure businesses generally and may, among other things, affect the performance of the Company's theatrical and home entertainment releases, the advertising market for broadcast and cable television programming, demand for our products and services, expenses of providing medical and pension benefits, performance of some or all company businesses either directly or through their impact on those who distribute our products and the pending transaction with 21CF. Additional factors are discussed in the 2017 Annual Report on Form 10-K and in the Quarterly Report on 10-Q for the period ended December 30, 2017, in each case under the Item 1A, "Risk Factors."
Risk Factors Related to the Acquisition of Twenty-First Century Fox ("21CF")
Risks related to the acquisition of 21CF were discussed in the Quarterly Report on Form 10-Q for the period ended December 30, 2017, under Item 1A, "Risk Factors." In light of changes in the terms of the transaction, we are updating the risk relating to indebtedness of the Company following the transaction as follows.
Our consolidated indebtedness will increase substantially following completion of the 21CF Acquisition. This increased level of indebtedness and the incurrence of additional debt to pay a portion of the 21CF merger consideration will significantly increase our interest expense, financial leverage and debt service requirements, each of which could adversely affect the Company, including by decreasing its business flexibility.
Disney's consolidated indebtedness as of June 30, 2018 was approximately $23.7 billion. Upon completion of the 21CF Acquisition, Disney will assume an estimated fair value of approximately $17.1 billion of additional outstanding net debt of 21CF (approximately $23.9 billion of debt less approximately $6.8 billion in cash) if 21CF's all-cash offer for the approximately 61% interest in Sky not currently held by 21CF (the "Sky Acquisition") is not completed or an estimated fair value of $49.3 billion of additional outstanding net debt of 21CF (approximately $51.1 billion of debt less approximately $1.8 billion in cash) if the Sky Acquisition is completed at an offer price of £14.00 per share. We expect to fund the cash portion of the consideration in the 21CF Acquisition (approximately $35.7 billion) upon completion of the 21CF Acquisition through the issuance of senior unsecured notes and/or commercial paper. If such contemplated financing is unavailable prior to or upon completion, a 364-day unsecured bridge term loan facility will be provided by a five bank syndicate totaling $35.7 billion. Following the completion of this financing transaction, it is expected that the combined company will have approximately $109.6 billion of short and long-term debt and interest expense of approximately $3.3 billion per year.
The increased indebtedness could have the effect of, among other things, reducing our flexibility to respond to changing business and economic conditions. In addition, the amount of cash required to pay interest on the increased indebtedness levels will increase following completion of the 21CF Acquisition, and thus the demands on our cash resources will be greater than prior to completion of the 21CF Acquisition. The increased levels of indebtedness following completion of the 21CF Acquisition could also reduce funds available for capital expenditures, share repurchases and dividends, and other activities and may create competitive disadvantages relative to other companies

with lower debt levels. Our funds on hand will be further constrained by the issuance of shares of common stock in the 21CF Acquisition, because of dividend payments on common stock.

Following consummation of the 21CF Acquisition, our corporate or debt-specific credit rating could be downgraded, which may increase our borrowing costs or give rise to a need to refinance existing indebtedness. If a ratings downgrade occurs,

54

we may need to refinance existing debt or be subject to higher borrowing costs and more restrictive covenants when we incur new debt in the future, which could reduce profitability and diminish operational flexibility.

We may encounter difficulty or high costs associated with financing the cash portion of the consideration in the 21CF Acquisition.

We expect to fund the cash portion of the consideration in the 21CF Acquisition (approximately $35.7 billion) upon completion of the 21CF Acquisition through the issuance of senior unsecured notes and/or commercial paper. If such contemplated financing is unavailable prior to or upon completion, a 364-day unsecured bridge term loan facility will be provided by a five bank syndicate totaling $35.7 billion. Our ability to obtain additional debt financing will be subject to various factors, including market conditions, operating performance and our ability to incur additional debt. Depending on these factors, the terms upon which debt financing or debt offerings are available to us may be less favorable to us than we had anticipated.

We will be required to divest the 21CF regional sports networks (the “21CF RSNs”) and we may not be able to negotiate such divestitures expeditiously or on favorable terms.

On June 27, 2018, the U.S. Department of Justice (the “DOJ”) submitted a proposed final judgment resolving a complaint it filed the same day to remedy potential competitive concerns regarding our acquisition of the 21CF RSNs. Pursuant to the DOJ’s proposed final judgment, we are required to hold separate and divest the 21CF RSNs following the completion of the 21CF Acquisition. The proposed final judgment is subject to the approval of the United States District Court for the Southern District of New York. There can be no assurance that such court approval will be granted. Although we intend to fully comply with the proposed final judgment, there can be no assurance that we will be able to negotiate such divestitures expeditiously or on favorable terms, or that governmental authorities will approve the terms of such divestitures. In the event that we are unable to divest all of the 21CF RSNs within the agreed upon time periods, the DOJ may apply for a trustee to be appointed to give effect to the divestitures, and we will be unable to object to any sale of the 21CF RSNs by the trustee on any grounds other than the trustee’s malfeasance.

The Panel on Takeovers and Mergers of the United Kingdom (the “U.K. Takeover Panel”) has ruled that, unless the Sky Acquisition has completed or a third party has acquired more than 50% of the ordinary shares in Sky, in each case, prior to the completion of the 21CF Acquisition, we will be obliged to make a mandatory offer for all the ordinary shares in Sky not already owned by 21CF.

21CF currently has an approximately 39% interest in Sky. The U.K. Takeover Panel has ruled that, unless the Sky Acquisition has completed or a third party has acquired more than 50% of the ordinary shares in Sky, in each case prior to the completion of the 21CF Acquisition, we will be obliged to make a mandatory offer for all the ordinary shares in Sky not already owned by 21CF in accordance with Note 8 of Rule 9.1 of the Takeover Code as promulgated by the U.K. Takeover Panel (the “U.K. Takeover Code”) at an offer price of £14.00 for each ordinary share in Sky. The Hearings Committee of the U.K. Takeover Panel (the “Hearings Committee”) reviewed the ruling made by the U.K. Takeover Panel that set the mandatory offer price at £14.00 per share at a hearing held on July 27, 2018, and upheld such ruling. It is expected that there will be an appeal to the U.K. Takeover Appeal Board, which could agree or disagree with the offer price set by the U.K. Takeover Panel. In the event that there is a further appeal and the U.K. Takeover Appeal Board does not agree with such offer price, the price at which we may be required to make such mandatory offer may be increased or decreased. An increase in the mandatory offer price could adversely affect our financial position.

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds
(a)The following table provides information about Company purchases of equity securities that are registered by the Company pursuant to Section 12 of the Exchange Act during the quarter ended June 30, 2018:

Period	Total Number of Shares Purchased [1]	Weighted Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs [2]
April 1, 2018 - April 30, 2018	4,754,175	$ 100.47	4,726,100	162 million
May 1, 2018 - May 31, 2018	4,883,104	101.77	4,857,000	157 million
June 1, 2018 - June 30, 2018	23,964	105.63	—	157 million
Total	9,661,243	101.14	9,583,100	157 million

(1) 78,143 shares were purchased on the open market to provide shares to participants in the Walt Disney Investment Plan (WDIP). These purchases were not made pursuant to a publicly announced repurchase plan or program.

(2) Under a share repurchase program implemented effective June 10, 1998, the Company is authorized to repurchase shares of its common stock. On January 30, 2015, the Company's Board of Directors increased the share repurchase authorization to a total of 400 million shares as of that date. The repurchase program does not have an expiration date.

56

ITEM 6. Exhibits
See Index of Exhibits.

57

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

THE WALT DISNEY COMPANY
(Registrant)

By: /s/ CHRISTINE M. MCCARTHY
Christine M. McCarthy,
Senior Executive Vice President and Chief Financial Officer

August 7, 2018
Burbank, California

58

INDEX OF EXHIBITS

Number and Description of Exhibit (Numbers Coincide with Item 601 of Regulation S-K)		Document Incorporated by Reference from a Previous Filing or Filed Herewith, as Indicated below
2.1	Amended and Restated Agreement and Plan of Merger, dated as of June 20, 2018, among Twenty-First Century Fox Inc., The Walt Disney Company, TWDC Holdco 613 Corp., WDC Merger Enterprises I, Inc. and WDC Merger Enterprises II, Inc.*	Exhibit 2.1 to the Current Report on Form 8-K of the Company filed June 20, 2018
10.1	Amended and Restated Voting Agreement dated as of June 20, 2018, among The Walt Disney Company, Murdoch Family Trust, and Cruden Financial Services, LLC	Exhibit 10.1 to the Current Report on Form 8-K of the Company filed June 20, 2018
10.2	Description of Directors Compensation	Filed herewith
12.1	Ratio of Earnings to Fixed Charges	Filed herewith
31(a)	Rule 13a-14(a) Certification of Chief Executive Officer of the Company in accordance with Section 302 of the Sarbanes-Oxley Act of 2002	Filed herewith
31(b)	Rule 13a-14(a) Certification of Chief Financial Officer of the Company in accordance with Section 302 of the Sarbanes-Oxley Act of 2002	Filed herewith
32(a)	Section 1350 Certification of Chief Executive Officer of the Company in accordance with Section 906 of the Sarbanes-Oxley Act of 2002**	Furnished
32(b)	Section 1350 Certification of Chief Financial Officer of the Company in accordance with Section 906 of the Sarbanes-Oxley Act of 2002**	Furnished
101	The following materials from the Company’s Quarterly Report on Form 10-Q for the quarter ended June 30, 2018 formatted in Extensible Business Reporting Language (XBRL): (i) the Condensed Consolidated Statements of Income, (ii) the Condensed Consolidated Statements of Comprehensive Income, (iii) the Condensed Consolidated Balance Sheets, (iv) the Condensed Consolidated Statements of Cash Flows, (v) the Condensed Consolidated Statements of Equity and (vi) related notes	Filed

* Certain schedules and exhibits have been omitted pursuant to 601(b)(2) of Regulation S-K. A copy of any omitted schedule or exhibit will be furnished supplementally to the SEC upon request.

** A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

59