DEVON ENERGY CORP/DE
Form 10-Q
May 03, 2007

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

(Mark One)

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

For the Quarterly Period Ended March 31, 2007

or

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

Commission File No. 001-32318
Devon Energy Corporation
(Exact Name of Registrant as Specified in its Charter)

Delaware	**73-1567067**
(State or Other Jurisdiction of Incorporation or Organization)	*(I.R.S. Employer Identification Number)*
20 North Broadway Oklahoma City, Oklahoma	**73102-8260**
(Address of Principal Executive Offices)	*(Zip Code)*

Registrant s telephone number, including area code:
(405) 235-3611
Former name, former address and former fiscal year, if changed from last report.
Not applicable

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

Large accelerated filer 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 number of shares outstanding of Registrant s common stock, par value $0.10, as of March 31, 2007, was 444,814,000.

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to the Securities and Exchange Commission

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DEFINITIONS

As used in this document:

Bbl or Bbls means barrel or barrels.

Bcf means billion cubic feet.

Boe means barrel of oil equivalent, determined by using the ratio of one Bbl of oil or NGLs to six Mcf of gas.

MMBbls means million barrels.

MMBoe means million Boe.

Mcf means thousand cubic feet.

NGL or NGLs means natural gas liquids.

Oil includes crude oil and condensate.

SEC means United States Securities and Exchange Commission.

Domestic means the properties of Devon in the onshore continental United States and the offshore Gulf of Mexico.

United States Onshore means the properties of Devon in the continental United States.

United States Offshore means the properties of Devon in the Gulf of Mexico.

Canada means the division of Devon encompassing oil and gas properties located in Canada.

International means the division of Devon encompassing oil and gas properties that lie outside the United States and Canada.

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PART I. Financial Information

Item 1. ***Financial Statements***

DEVON ENERGY CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	March 31, 2007 (Unaudited)	December 31, 2006
	(In millions, except share data)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 615	692
Short-term investments, at fair value	275	574
Accounts receivable	1,361	1,324
Deferred income taxes	66	102
Current assets held for sale	252	232
Other current assets	167	288
Total current assets	2,736	3,212
Property and equipment, at cost, based on the full cost method of accounting for oil and gas properties ($3,276 and $3,293 excluded from amortization in 2007 and 2006, respectively)	41,536	39,585
Less accumulated depreciation, depletion and amortization	17,128	16,429
	24,408	23,156
Investment in Chevron Corporation common stock, at fair value	1,049	1,043
Goodwill	5,741	5,706
Assets held for sale	1,680	1,619
Other assets	364	327
Total assets	$ 35,978	35,063
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable trade	$ 1,236	1,154
Revenues and royalties due to others	476	522
Income taxes payable	192	82
Short-term debt	1,857	2,205
Accrued interest payable	81	114
Current portion of asset retirement obligation, at fair value	55	53
Current liabilities associated with assets held for sale	222	173
Accrued expenses and other current liabilities	321	342
Total current liabilities	4,440	4,645
Debentures exchangeable into shares of Chevron Corporation common stock	732	727

Other long-term debt	4,839	4,841
Financial instruments, at fair value	309	302
Asset retirement obligation, at fair value	1,152	804
Liabilities associated with assets held for sale	450	429
Other liabilities	630	583
Deferred income taxes	5,270	5,290
Stockholders equity:		
Preferred stock of $1.00 par value. Authorized 4,500,000 shares; issued 1,500,000 ($150 million aggregate liquidation value)	1	1
Common stock of $0.10 par value. Authorized 800,000,000 shares; issued 444,814,000 in 2007 and 444,040,000 in 2006	44	44
Additional paid-in capital	6,897	6,840
Retained earnings	10,055	9,114
Accumulated other comprehensive income	1,159	1,444
Treasury stock, at cost: 11,000 shares in 2006		(1)
Total stockholders equity	18,156	17,442
Commitments and contingencies (Note 6)		
Total liabilities and stockholders equity	$ 35,978	35,063

See accompanying notes to consolidated financial statements.

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DEVON ENERGY CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended March 31,	
	2007	2006
	(Unaudited) (In millions, except per share amounts)	
Revenues:		
Oil sales	$ 691	508
Gas sales	1,226	1,358
NGL sales	177	176
Marketing and midstream revenues	379	458
Total revenues	2,473	2,500
Expenses and other income, net:		
Lease operating expenses	430	331
Production taxes	80	83
Marketing and midstream operating costs and expenses	270	338
Depreciation, depletion and amortization of oil and gas properties	587	443
Depreciation and amortization of non-oil and gas properties	46	41
Accretion of asset retirement obligation	18	10
General and administrative expenses	119	90
Interest expense	110	101
Change in fair value of financial instruments	1	12
Other income, net	(26)	(29)
Total expenses and other income, net	1,635	1,420
Earnings from continuing operations before income tax expense	838	1,080
Income tax expense:		
Current	189	224
Deferred	75	140
Total income tax expense	264	364
Earnings from continuing operations	574	716
Discontinued operations:		
Earnings from discontinued operations before income tax expense	137	47
Income tax expense	60	63
Earnings (loss) from discontinued operations	77	(16)
Net earnings	651	700
Preferred stock dividends	2	2
Net earnings applicable to common stockholders	$ 649	698

Basic net earnings per share:			
Earnings from continuing operations	$	1.29	1.61
Earnings (loss) from discontinued operations		0.17	(0.03)
Net earnings	$	1.46	1.58
Diluted net earnings per share:			
Earnings from continuing operations	$	1.27	1.59
Earnings (loss) from discontinued operations		0.17	(0.03)
Net earnings	$	1.44	1.56
Weighted average common shares outstanding:			
Basic		444	442
Diluted		450	449

See accompanying notes to consolidated financial statements.

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DEVON ENERGY CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	Three Months Ended March 31,	
	2007	2006
	(Unaudited) (In millions)	
Net earnings	$ 651	700
Foreign currency translation:		
Change in cumulative translation adjustment	83	(9)
Income taxes	(6)	1
Total	77	(8)
Derivative financial instruments reclassification adjustment for realized gains included in net earnings	(1)	(1)
Pension and postretirement benefit plans:		
Recognition of net actuarial loss in net earnings	4	
Income taxes	(1)	
Total	3	
Investment in Chevron Corporation common stock (Note 1):		
Unrealized holding gain		17
Income taxes		(6)
Total		11
Other comprehensive income, net of tax	79	2
Comprehensive income	$ 730	702

See accompanying notes to consolidated financial statements.

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DEVON ENERGY CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

	Preferred Stock	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock	Total Stockholders Equity
	(Unaudited) (In millions)							
Three Months Ended March 31, 2007								
Balance as of December 31, 2006	$ 1	444	$ 44	6,840	9,114	1,444	(1)	17,442
Adoption of FASB Statement No. 159 (Note 1)					364	(364)		
Adoption of FASB Interpretation No. 48 (Note 1)					(10)			(10)
Net earnings					651			651
Other comprehensive income						79		79
Stock option exercises		1		23				23
Common stock retired				(1)			1	
Common stock dividends					(62)			(62)
Preferred stock dividends					(2)			(2)
Share-based compensation				30				30
Excess tax benefits on share-based compensation				5				5
Balance as of March 31, 2007	$ 1	445	$ 44	6,897	10,055	1,159		18,156
Three Months Ended March 31, 2006								
Balance as of December 31, 2005	$ 1	443	$ 44	6,928	6,477	1,414	(2)	14,862
Net earnings					700			700
Other comprehensive income						2		2
Stock option exercises		1		19				19
Restricted stock grants, net of cancellations				1			(1)	
Common stock repurchased		(4)					(253)	(253)
Common stock retired				(238)			238	
Common stock dividends					(49)			(49)
Preferred stock dividends					(2)			(2)
Share-based compensation				19				19
Excess tax benefits on share-based compensation				4				4
Balance as of March 31, 2006	$ 1	440	$ 44	6,733	7,126	1,416	(18)	15,302

See accompanying notes to consolidated financial statements.

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DEVON ENERGY CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Three Months Ended March 31, 2007	Three Months Ended March 31, 2006
	(Unaudited) (In Millions)	
Cash flows from operating activities:		
Net earnings	$ 651	700
(Earnings) loss from discontinued operations, net of tax	(77)	16
Adjustments to reconcile net earnings from continuing operations to net cash provided by operating activities:		
Depreciation, depletion and amortization	633	484
Deferred income tax expense	75	140
Net gain on sales of non-oil and gas property and equipment		(5)
Other noncash charges	75	39
Changes in assets and liabilities:		
(Increase) decrease in:		
Accounts receivable	(29)	241
Other current assets	(10)	(10)
Long-term other assets	(25)	4
Increase (decrease) in:		
Accounts payable	20	(162)
Income taxes payable	207	80
Other current liabilities	(118)	(160)
Long-term other liabilities	(2)	(6)
Cash provided by operating activities continuing operations	1,400	1,361
Cash provided by operating activities discontinued operations	117	161
Net cash provided by operating activities	1,517	1,522
Cash flows from investing activities:		
Proceeds from sales of property and equipment	25	19
Capital expenditures	(1,484)	(1,249)
Purchases of short-term investments	(424)	(495)
Sales of short-term investments	723	441
Cash used in investing activities continuing operations	(1,160)	(1,284)
Cash used in investing activities discontinued operations	(53)	(68)
Net cash used in investing activities	(1,213)	(1,352)
Cash flows from financing activities:		
Net commercial paper repayments, net of issuance costs	(348)	
Debt repayments, including current maturities		(3)

Proceeds from stock option exercises	23	20
Repurchases of common stock		(253)
Excess tax benefits related to share-based compensation	5	4
Dividends paid on common stock	(62)	(49)
Dividends paid on preferred stock	(2)	(2)
Net cash used in financing activities	(384)	(283)
Effect of exchange rate changes on cash	2	1
Net decrease in cash and cash equivalents	(78)	(112)
Cash and cash equivalents at beginning of period (including cash related to assets held for sale)	756	1,606
Cash and cash equivalents at end of period (including cash related to assets held for sale)	$ 678	1,494
Supplementary cash flow data:		
Interest paid	$ 162	159
Income taxes (received) paid	$ (24)	160

See accompanying notes to consolidated financial statements.

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DEVON ENERGY CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Summary of Significant Accounting Policies

The accompanying consolidated financial statements and notes thereto of Devon Energy Corporation (Devon) have been prepared pursuant to the rules and regulations of the United States Securities and Exchange Commission. Accordingly, certain disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been omitted. The accompanying consolidated financial statements and notes thereto should be read in conjunction with the consolidated financial statements and notes thereto included in Devon s 2006 Annual Report on Form 10-K.

In the opinion of Devon s management, all adjustments (all of which are normal and recurring) that have been made are necessary to fairly state the consolidated financial position of Devon and its subsidiaries as of March 31, 2007, and the results of their operations and their cash flows for the three-month periods ended March 31, 2007 and 2006.

Certain prior period amounts have been reclassified to conform to the current period presentation.

Net Earnings Per Common Share

The following table reconciles earnings from continuing operations and common shares outstanding used in the calculations of basic and diluted earnings per share for the three-month periods ended March 31, 2007 and 2006.

	Net Earnings Applicable to Common Stockholders	Weighted Average Common Shares Outstanding	Net Earnings per Share
	(In millions, except per share amounts)		
Three Months Ended March 31, 2007:			
Earnings from continuing operations	$ 574		
Less preferred stock dividends	(2)		
Basic earnings per share	572	444	$ 1.29
Dilutive effect of potential common shares issuable upon the exercise of outstanding stock options		6	
Diluted earnings per share	$ 572	450	$ 1.27
Three Months Ended March 31, 2006:			
Earnings from continuing operations	$ 716		
Less preferred stock dividends	(2)		
Basic earnings per share	714	442	$ 1.61
Dilutive effect of potential common shares issuable upon the exercise of outstanding stock options		7	
Diluted earnings per share	$ 714	449	$ 1.59

Certain options to purchase shares of Devon s common stock were excluded from the dilution calculations because the options were antidilutive. During the first quarter of 2007 and 2006, 4.2 million shares and 2.6 million shares, respectively, were excluded from the diluted earnings per share calculations.

Short-term Investments and Other Marketable Securities Change in Accounting Principle

Devon owns approximately 14.2 million shares of Chevron Corporation (Chevron) common stock. These shares are held in connection with debt owed by Devon that contains an exchange option. This exchange option allows the debt holders, prior to the debt s maturity, to exchange the debt for the shares of Chevron common stock owned by Devon.

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The shares of Chevron common stock and the exchange option embedded in the debt have always been recorded on Devon s balance sheet at fair value. However, pursuant to accounting rules prior to January 1, 2007, only the change in fair value of the embedded option has historically been included in Devon s results of operations. Conversely, the change in fair value of the Chevron common stock has not been included in Devon s results of operations, but instead has been recorded directly to stockholders equity as part of accumulated other comprehensive income.

Effective January 1, 2007, Devon adopted Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115*. Statement No. 159 allows a company the option to value its financial assets and liabilities, on an instrument by instrument basis, at fair value, and include the change in fair value of such assets and liabilities in its results of operations. Devon chose to apply the provisions of Statement No. 159 to its shares of Chevron common stock. Accordingly, beginning with the first quarter of 2007, the change in fair value of the Chevron common stock owned by Devon, along with the change in fair value of the related exchange option, will both be included in Devon s results of operations.

In the first quarter of 2007, the change in fair value of financial instruments caption on Devon s statements of operations includes an unrealized gain of $6 million related to the Chevron common stock, and an unrealized loss of $8 million related to the embedded option. In the first quarter of 2006, prior to adopting Statement No. 159, an unrealized loss of $14 million related to the change in fair value of the embedded option was included in the change in fair value of financial instruments caption on Devon s statements of operations.

As of December 31, 2006, $364 million of after-tax unrealized gains related to Devon s investment in the Chevron common stock was included in accumulated other comprehensive income. This is the amount of unrealized gains that, prior to Devon s adoption of Statement No. 159, had not been recorded in Devon s historical results of operations. Upon the adoption of Statement No. 159 as of January 1, 2007, this $364 million of unrealized gains was reclassified on Devon s balance sheet from accumulated other comprehensive income to retained earnings.

In conjunction with the adoption of Statement No. 159, Devon also adopted on January 1, 2007 Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*. Statement No. 157 provides a common definition of fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements, but does not require any new fair value measurements. The adoption of Statement No. 157 had no impact on Devon s financial statements, but it did result in additional required disclosures as set forth in Note 7.

Income Taxes Change in Accounting Principle

Devon and its subsidiaries are subject to current income taxes assessed by the federal and various state jurisdictions in the United States and other foreign jurisdictions. In addition, Devon accounts for deferred income taxes related to these jurisdictions using the asset and liability method. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of assets and liabilities and their respective tax bases. Deferred tax assets are also recognized for the future tax benefits attributable to the expected utilization of existing tax net operating loss carryforwards and other types of carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences and carryforwards are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

At March 31, 2007, undistributed earnings of foreign subsidiaries included in continuing operations were determined to be permanently reinvested. Therefore, no U.S. deferred income taxes were provided on such amounts at March 31, 2007. If it becomes apparent that some or all of the undistributed earnings will be distributed, Devon would then record taxes on those earnings.

In June 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109.* Interpretation No. 48 prescribes a

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threshold for recognizing the financial statement effects of a tax position when it is more likely than not, based on the technical merits, that the position will be sustained upon examination by a taxing authority. Recognized tax positions are initially and subsequently measured as the largest amount of tax benefit that is more likely than not of being realized upon ultimate settlement with a taxing authority. Liabilities for unrecognized tax benefits related to such tax positions are included in other long-term liabilities unless the tax position is expected to be settled within the upcoming year, in which case the liabilities are included in accrued expenses and other current liabilities. Interest and penalties related to unrecognized tax benefits are included in income tax expense.

On January 1, 2007, Devon adopted Interpretation No. 48 and recorded a $10 million reduction to the January 1, 2007 balance of retained earnings related to unrecognized tax benefits. The $10 million includes $8 million for related interest and penalties. An additional $2 million of liabilities were recorded with a corresponding increase to goodwill.

As a result of the adoption of Interpretation No. 48, certain liabilities included in income taxes payable and deferred income taxes were reclassified to other current and long-term liabilities in the accompanying balance sheet. The total $12 million increase in liabilities included a $15 million increase to long-term liabilities, partially offset by a $3 million reduction to current liabilities.

As of January 1, 2007, Devon s unrecognized tax benefits were $114 million. This amount included $82 million that, if recognized, would affect Devon s effective income tax rate.

Included below is a summary of the tax years, by jurisdiction, that remain subject to examination by taxing authorities.

Jurisdiction	Tax Years Open
U.S. federal	2002-2006
Various U.S. states	2001-2006
Canada federal	2000-2006
Various Canadian provinces	2000-2006
Various other foreign jurisdictions	1997-2006

Devon is currently in the final stages of the administrative review process for certain open tax years. In addition, certain statute of limitation expirations are scheduled to occur in the next twelve months. Due to these factors, Devon anticipates it is reasonably possible that liabilities for certain tax positions will decrease between $15 million and $25 million within the next twelve months.

Recently Issued Accounting Standards Not Yet Adopted

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R)*. Statement No. 158 requires the measurement of plan assets and benefit obligations as of the date of the employer s fiscal year-end, beginning with fiscal years ending after December 15, 2008. The Statement provides two alternatives to transition to a fiscal year-end measurement date. Devon has not yet adopted this requirement, but Devon does not expect such adoption to have a material effect on its results of operations, financial condition, liquidity or compliance with debt covenants.

2. Property and Equipment and Asset Retirement Obligations (ARO)

On November 14, 2006, Devon announced that it intends to divest its operations in Egypt. Also, on January 23, 2007, Devon announced that it intends to divest its operations in West Africa. See Note 10 for more discussion regarding these planned divestitures.

DEVON ENERGY CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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Asset Retirement Obligations

The following is a summary of the changes in Devon s ARO for the first three months of 2007 and 2006.

	Three Months Ended March 31, 2007	Three Months Ended March 31, 2006
	(In millions)	
Asset retirement obligation as of beginning of period	$ 857	636
Liabilities incurred	28	13
Liabilities settled	(12)	(9)
Revision of estimated obligation	311	
Accretion expense on discounted obligation	18	10
Foreign currency translation adjustment	5	
Asset retirement obligation as of end of period	1,207	650
Less current portion	55	51
Asset retirement obligation, long-term	$ 1,152	599

During the first quarter of 2007, Devon recognized a $311 million increase to its ARO. The primary factors causing the fair value increase were an overall increase in abandonment cost estimates, an overall decrease in estimated reserve lives and an increase in the assumed inflation rate. The effects of these factors were partially offset by the effect of an increase in the discount rate used to present value the obligations.

3. Debt

Credit Facility

In April 2007, Devon extended the maturity of its existing $2.5 billion five-year, syndicated, unsecured revolving line of credit (the Senior Credit Facility) from April 7, 2011 to April 7, 2012.

The Senior Credit Facility contains only one material financial covenant. This covenant requires Devon to maintain a ratio of total funded debt to total capitalization, as defined in the credit agreement, of no more than 65%. As of March 31, 2007, Devon was in compliance with this covenant. Devon s debt-to-capitalization ratio at March 31, 2007, as calculated pursuant to the terms of the agreement, was 25.6%.

As of March 31, 2007, there were no borrowings under the Senior Credit Facility. The available capacity under the Senior Credit Facility as of March 31, 2007, net of $1.46 billion of outstanding commercial paper and $285 million of outstanding letters of credit, was approximately $755 million.

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DEVON ENERGY CORPORATION AND SUBSIDIARIES
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4. Retirement Plans

Net Periodic Benefit Cost and Other Comprehensive Income

The following table presents the components of net periodic benefit cost and other comprehensive income for Devon s pension and other post retirement benefit plans for the quarters ended March 31, 2007 and 2006.

	Pension Benefits Three Months Ended March 31, 2007	Pension Benefits Three Months Ended March 31, 2006	Other Postretirement Benefits Three Months Ended March 31, 2007	Other Postretirement Benefits Three Months Ended March 31, 2006
	(In millions)			
Net periodic benefit cost:				
Service cost	$ 8	6		
Interest cost	11	10	1	1
Expected return on plan assets	(12)	(11)		
Net actuarial loss	4	3		
Net periodic benefit cost	11	8	1	1
Other comprehensive income:				
Recognition of net actuarial loss in net periodic benefit cost	(4)			
Total recognized	$ 7	8	1	1

5. Stockholders Equity

Stock Repurchases

On August 3, 2005, Devon announced a stock repurchase program to repurchase up to 50 million shares of its common stock. As of May 1, 2007, Devon has repurchased 6.5 million shares under this program for $387 million, or $59.80 per share. This program was suspended in 2006 as a result of the Chief acquisition. In conjunction with the sales of Egypt and West Africa (see Note 9), Devon expects to resume this repurchase program in late 2007 by using a portion of the sale proceeds to repurchase common stock. Although this program expires at the end of 2007, it could be extended if necessary.

Dividends

Dividends on Devon s common stock were paid in the first quarters of 2007 and 2006 at per share rates of $0.14 and $0.1125, respectively.

6. Commitments and Contingencies

Devon is party to various legal actions arising in the normal course of business. Matters that are probable of unfavorable outcome to Devon and which can be reasonably estimated are accrued. Such accruals are based on information known about the matters, Devon s estimates of the outcomes of such matters and its experience in contesting, litigating and settling similar matters. None of the actions are believed by management to involve future amounts that would be material to Devon s financial position or results of operations after consideration of recorded accruals although actual amounts could differ materially from management s estimate.

Environmental Matters

Devon is subject to certain laws and regulations relating to environmental remediation activities associated with past operations, such as the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) and similar state statutes. In response to liabilities associated with these activities, accruals have been

DEVON ENERGY CORPORATION AND SUBSIDIARIES
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(Unaudited)

established when reasonable estimates are possible. Such accruals primarily include estimated costs associated with remediation. Devon has not used discounting in determining its accrued liabilities for environmental remediation, and no material claims for possible recovery from third party insurers or other parties related to environmental costs have been recognized in Devon s consolidated financial statements. Devon adjusts the accruals when new remediation responsibilities are discovered and probable costs become estimable, or when current remediation estimates must be adjusted to reflect new information.

Certain of Devon s subsidiaries acquired in past mergers are involved in matters in which it has been alleged that such subsidiaries are potentially responsible parties (PRPs) under CERCLA or similar state legislation with respect to various waste disposal areas owned or operated by third parties. As of March 31, 2007, Devon s consolidated balance sheet included $5 million of non-current accrued liabilities, reflected in Other liabilities, related to these and other environmental remediation liabilities. Devon does not currently believe there is a reasonable possibility of incurring additional material costs in excess of the current accruals recognized for such environmental remediation activities. With respect to the sites in which Devon subsidiaries are PRPs, Devon s conclusion is based in large part on (i) Devon s participation in consent decrees with both other PRPs and the Environmental Protection Agency, which provide for performing the scope of work required for remediation and contain covenants not to sue as protection to the PRPs, (ii) participation in groups as a *de minimis PRP,* and (iii) the availability of other defenses to liability. As a result, Devon s monetary exposure is not expected to be material.

Royalty Matters

Numerous gas producers and related parties, including Devon, have been named in various lawsuits alleging violation of the federal False Claims Act. The suits allege that the producers and related parties used below-market prices, improper deductions, improper measurement techniques and transactions with affiliates which resulted in underpayment of royalties in connection with natural gas and natural gas liquids produced and sold from federal and Indian owned or controlled lands. The principal suit in which Devon is a defendant is United States ex rel. Wright v. Chevron USA, Inc. et al. (the Wright case). The suit was originally filed in August 1996 in the United States District Court for the Eastern District of Texas, but was consolidated in October 2000 with the other suits for pre-trial proceedings in the United States District Court for the District of Wyoming. On July 10, 2003, the District of Wyoming remanded the Wright case back to the Eastern District of Texas to resume proceedings. Trial is set for November 2007. Devon believes that it has acted reasonably, has legitimate and strong defenses to all allegations in the suit, and has paid royalties in good faith. Devon does not currently believe that it is subject to material exposure in association with this lawsuit and no liability has been recorded in connection therewith.

In 1995, the United States Congress passed the Deep Water Royalty Relief Act. The intent of this legislation was to encourage deep water exploration in the Gulf of Mexico by providing relief from the obligation to pay royalties on certain federal leases. Deep water leases issued in certain years by the Minerals Management Service (the MMS) have contained price thresholds, such that if the market prices for oil or natural gas exceeded the thresholds for a given year, royalty relief would not be granted for that year. Deep water leases issued in 1998 and 1999 did not include price thresholds. The MMS in 2006 informed Devon and other oil and gas companies that the omission of price thresholds from these leases was an error on its part and was not its intention. Accordingly, the MMS invited Devon and the other affected oil and gas producers to renegotiate the terms and conditions of the 1998 and 1999 leases to add price threshold provisions to the lease agreements for periods after October 1, 2006. Devon has since had several discussions with MMS representatives on this issue, but has not yet entered into renegotiated leases.

The U.S. House of Representatives in January 2007 passed legislation that would require companies to renegotiate the 1998 and 1999 leases as a condition of securing future federal leases. If this legislation were to become law, it would require price thresholds to be effective in the renegotiated 1998 and 1999 leases effective October 1, 2006. Although Devon has not yet signed renegotiated leases, it has accrued through March 31, 2007 approximately $11 million for royalties that would be due if price thresholds were added to its 1998 and 1999 leases effective October 1, 2006.

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Equatorial Guinea Investigation

The SEC has been conducting an inquiry into payments made to the government of Equatorial Guinea and to officials and persons affiliated with officials of the government of Equatorial Guinea. On August 9, 2005, Devon received a subpoena issued by the SEC pursuant to a formal order of investigation. Devon has cooperated fully with the SEC s requests for information in this inquiry. After responding in 2005 to such requests for information, Devon has not been contacted by the SEC. In the event that Devon receives any further inquiries, Devon will work with the SEC in connection with its investigation.

Hurricane Contingencies

Historically, Devon maintained a comprehensive insurance program that included coverage for physical damage to its offshore facilities caused by hurricanes. Devon s historical insurance program also included substantial business interruption coverage which Devon is utilizing to recover costs associated with the suspended production related to hurricanes that struck the Gulf of Mexico in the third quarter of 2005. Under the terms of this insurance program, Devon was entitled to be reimbursed for the portion of production suspended longer than forty-five days, subject to upper limits to oil and natural gas prices. Also, the terms of the insurance include a standard, per-event deductible of $1 million for offshore losses as well as a $15 million aggregate annual deductible.

Based on current estimates of physical damage and the anticipated length of time Devon will have production suspended, Devon expects its policy recoveries will exceed repair costs and deductible amounts. This expectation is based upon several variables, including the $467 million received in the third quarter of 2006 as a full settlement of the amount due from Devon s primary insurers. As of March 31, 2007, $171 million of these proceeds had been utilized as reimbursement of past repair costs and deductible amounts. The remaining proceeds of $296 million will be utilized as reimbursement of Devon s anticipated future repair costs. Devon has not yet received any settlements related to claims filed with its secondary insurers.

Should Devon s total policy recoveries, including the partial settlements already received from Devon s primary insurers, exceed all repair costs and deductible amounts, such excess will be recognized as other income in the statement of operations in the period in which such determination can be made.

The policy underlying the insurance program terms described above expired on August 31, 2006. During the third quarter of 2006, Devon was able to re-establish a comprehensive insurance program that includes business interruption and physical damage coverage for its business. However, due to significant changes in the marketplace, Devon was only able to obtain a *de minimis* amount of coverage for any damage that may be caused by named windstorms in the Gulf of Mexico. Devon has not experienced any losses covered by this new insurance arrangement through March 31, 2007.

Other Matters

Devon is involved in other various routine legal proceedings incidental to its business. However, to Devon s knowledge as of the date of this report, there were no other material pending legal proceedings to which Devon is a party or to which any of its property is subject.

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7. Fair Value Measurements

Certain of Devon s assets and liabilities are reported at fair value in the accompanying balance sheets. The following table provides fair value measurement information for such assets and liabilities as of March 31, 2007.

	Total Fair Value	Fair Value Measurements Using: Quoted Prices in Active Markets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
		(In millions)		
Assets:				
Short-term investments	$ 275	275		
Investment in Chevron common stock	$1,049	1,049		
Financial instruments	$ 6		6	
Liabilities:				
Financial instruments	$ 314		314	
Asset retirement obligation (ARO)	$1,207			1,207

Statement No. 157 (see Note 1) establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. As presented in the table above, this hierarchy consists of three broad levels. Level 1 inputs on the hierarchy consist of unadjusted quoted prices in active markets for identical assets and liabilities and have the highest priority. Level 3 inputs have the lowest priority.

Devon uses appropriate valuation techniques based on the available inputs to measure the fair values of its assets and liabilities. When available, Devon measures fair value using Level 1 inputs because they generally provide the most reliable evidence of fair value. Devon owes debt that has an embedded exchange option. Because the exchange option is not actively traded in an established market, its fair value is measured using Level 2 inputs. Devon also has certain commodity and interest-rate derivative financial instruments which are measured using Level 2 inputs, such as forward commodity price curves or interest-rate yield curves. Devon only uses Level 3 inputs to measure the fair value of its ARO. A reconciliation of the beginning and ending balances of Devon s ARO, including a revision of the fair value in the first quarter of 2007, is presented in Note 2.

8. Change in Fair Value of Financial Instruments

The components of change in fair value of financial instruments include the following:

	Three Months Ended March 31, 2007	2006
	(In millions)	
Option embedded in exchangeable debentures	$ 8	14
Investment in Chevron common stock (Note 1)	(6)	
Interest rate swaps	(1)	(2)
Total	$ 1	12

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9. Other Income

The components of other income include the following:

	Three Months Ended March 31,	
	2007	2006
	(In millions)	
Interest and dividend income	$ 21	28
Net gain on sales of non-oil and gas property and equipment		5
Other	5	(4)
Total	$ 26	29

10. Discontinued Operations

Egypt and West Africa

On November 14, 2006, Devon announced its plans to divest its operations in Egypt. On January 23, 2007, Devon announced its plans to divest its operations in West Africa. Pursuant to accounting rules for discontinued operations, Devon has classified all 2007 and prior period amounts related to its operations in Egypt and West Africa as discontinued operations. As of March 31, 2007, Devon has not recorded any gain or loss associated with these planned sales.

On April 18, 2007, Devon announced that it had agreed to sell its Egyptian operations for $375 million effective January 1, 2007. Devon estimates that after-tax proceeds will be approximately $300 million. The transaction is expected to close in the third quarter of 2007. Had the transaction closed on January 1, 2007, Devon would have recognized a gain, after taxes, of approximately $60 million. The gain ultimately recorded when the transaction closes will depend on the carrying values of Devon s Egyptian assets and liabilities at the closing date, as well as the effect of purchase price adjustments between the effective date of January 1, 2007 and the actual closing date.

Devon has recently opened data rooms for the West African assets and expects to receive bids on these properties in the third quarter of 2007.

Revenues related to Devon s operations in Egypt and West Africa totaled $175 million and $218 million in the first quarters of 2007 and 2006, respectively.

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The following table presents the main classes of assets and liabilities associated with Devon s operations in Egypt and West Africa as of March 31, 2007 and December 31, 2006.

	March 31, 2007	December 31, 2006
	(In millions)	
Assets:		
Cash	$ 63	64
Accounts receivable	117	101
Other current assets	72	67
Current assets	$ 252	232
Long-term assets property and equipment, net of accumulated depreciation, depletion and amortization	$ 1,680	1,619
Liabilities:		
Accounts payable trade	$ 60	48
Income taxes payable	152	115
Current portion of asset retirement obligation	8	8
Accrued expenses and other current liabilities	2	2
Current liabilities	$ 222	173
Asset retirement obligation, long-term	$ 44	38
Deferred income taxes	390	375
Other liabilities	16	16
Long-term liabilities	$ 450	429

Reduction of Carrying Value

Devon has commitments to drill four wells in Nigeria. The first two wells were unsuccessful. After drilling the second unsuccessful well in the first quarter of 2006, Devon determined that the capitalized costs related to these two wells should be impaired. Devon s first quarter 2006 earnings from discontinued operations include an $85 million impairment of its investment in Nigeria equal to the costs to drill the two dry holes and a proportionate share of block-related costs. There was no tax benefit related to this impairment.

11. Segment Information

Following is certain financial information regarding Devon s reporting segments. The revenues reported are all from external customers.

	U.S.	Canada	International	Total
		(In millions)		
As of March 31, 2007:				

Current assets	$ 1,187	564	985	2,736
Property and equipment, net of accumulated depreciation, depletion and amortization	15,975	7,395	1,038	24,408
Goodwill	3,053	2,620	68	5,741
Other assets	1,311	56	1,726	3,093
Total assets	$ 21,526	10,635	3,817	35,978
Current liabilities	$ 3,361	608	471	4,440
Long-term debt	2,597	2,974		5,571
Asset retirement obligation, long-term	602	480	70	1,152
Other liabilities	908	27	454	1,389
Deferred income taxes	3,361	1,839	70	5,270
Stockholders equity	10,697	4,707	2,752	18,156
Total liabilities and stockholders equity	$ 21,526	10,635	3,817	35,978

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	U.S.	Canada	International	Total
		(In millions)		
Three Months Ended March 31, 2007:				
Revenues:				
Oil sales	$ 234	153	304	691
Gas sales	869	356	1	1,226
NGL sales	136	41		177
Marketing and midstream revenues	371	8		379
Total revenues	1,610	558	305	2,473
Expenses and other income, net:				
Lease operating expenses	248	143	39	430
Production taxes	56	1	23	80
Marketing and midstream operating costs and expenses	266	4		270
Depreciation, depletion and amortization of oil and gas properties	371	160	56	587
Depreciation and amortization of non-oil and gas properties	41	5		46
Accretion of asset retirement obligation	10	7	1	18
General and administrative expenses	92	25	2	119
Interest expense	59	51		110
Change in fair value of financial instruments	2	(1)		1
Other income, net	(12)	(3)	(11)	(26)
Total expenses and other income, net	1,133	392	110	1,635
Earnings from continuing operations before income tax expense	477	166	195	838
Income tax expense (benefit):				
Current	67	62	60	189
Deferred	86	(1)	(10)	75
Total income tax expense	153	61	50	264
Earnings from continuing operations	324	105	145	574
Discontinued operations:				
Earnings from discontinued operations before income tax expense			137	137
Income tax expense			60	60
Earnings from discontinued operations			77	77
Net earnings	324	105	222	651
Preferred stock dividends	2			2

Net earnings applicable to common stockholders	$ 322	105	222	649
Capital expenditures, before revision of future ARO	$ 943	469	111	1,523
Revision of future ARO	210	99	2	311
Capital expenditures, continuing operations	$ 1,153	568	113	1,834

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	U.S.	Canada	International	Total
		(In millions)		
Three Months Ended March 31, 2006:				
Revenues:				