PIONEER NATURAL RESOURCES CO
Form 10-Q
August 09, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2007

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: **1-13245**

PIONEER NATURAL RESOURCES COMPANY

(Exact name of Registrant as specified in its charter)

Delaware	**75-2702753**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
5205 N. O'Connor Blvd., Suite 200, Irving, Texas	**75039**
(Address of principal executive offices)	(Zip Code)

(972) 444-9001
(Registrant's telephone number, including area code)

Not applicable
(Former name, former address and former fiscal year, if changed since last report)

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

Yes x 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	**x**	**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 x

Number of shares of Common Stock outstanding as of August 7, 2007	**123,161,645**

PIONEER NATURAL RESOURCES COMPANY

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Cautionary Statement Concerning Forward-Looking Statements

The information in this Quarterly Report on Form 10-Q (the "Report") contains forward-looking statements that involve risks and uncertainties. When used in this document, the words "believes," "plans," "expects," "anticipates," "intends," "continue," "may," "will," "could," "should," "future," "potential," "estimate," or the negative of such terms and similar expressions as they relate to Pioneer Natural Resources Company ("Pioneer" or the "Company") are intended to identify forward-looking statements. The forward-looking statements are based on the Company's current expectations, assumptions, estimates and projections about the Company and the industry in which the Company operates. Although the Company believes that the expectations and assumptions reflected in the forward-looking statements are reasonable, they involve risks and uncertainties that are difficult to predict and, in many cases, beyond the Company's control. Accordingly, no assurances can be given that the actual events and results will not be materially different than the anticipated results described in the forward-looking statements. See "Part I, Item 3. Quantitative and Qualitative Disclosures About Market Risk" and "Part II, Item 1A. Risk Factors" in this Report and "Item 1. Business — Competition, Markets and Regulations", "Item 1A. Risk Factors" and "Item 7A. Quantitative and Qualitative Disclosures About Market Risk" in the Company's Annual Report on Form 10-K for the year ended December 31, 2006 for a description of various factors that could materially affect the ability of Pioneer to achieve the anticipated results described in the forward-looking statements. The Company undertakes no duty to publicly update these statements except as required by law.

Definitions of Certain Terms and Conventions Used Herein

Within this Report, the following terms and conventions have specific meanings:

- **"Bbl"** means a standard barrel containing 42 United States gallons.
- **"Bcf"** means one billion cubic feet and is a measure of natural gas volume.
- **"BOE"** means a barrel of oil equivalent and is a standard convention used to express oil and gas volumes on a comparable oil equivalent basis. Gas equivalents are determined under the relative energy content method by using the ratio of 6.0 Mcf of gas to 1.0 Bbl of oil or natural gas liquid.
- **"BOEPD"** means BOE per day.
- **"Btu"** means British thermal unit, which is a measure of the amount of energy required to raise the temperature of one pound of water one degree Fahrenheit.
- **"CBM"** means coal bed methane.
- **"IPO"** means initial public offering.
- **"LIBOR"** means London Interbank Offered Rate, which is a market rate of interest.
- **"MBbl"** means one thousand Bbls.
- **"MBOE"** means one thousand BOEs.
- **"Mcf"** means one thousand cubic feet and is a measure of natural gas volume.
- **"MMBbl"** means one million Bbls.
- **"MMBOE"** means one million BOEs.
- **"MMBtu"** means one million Btus.
- **"MMcfpd"** means one million cubic feet per day.
- **"NGL"** means natural gas liquid.
- **"NYMEX"** means the New York Mercantile Exchange.
- **"Pioneer"** or **"the Company"** means Pioneer Natural Resources Company and its subsidiaries.
- **"proved reserves"** mean the estimated quantities of crude oil, natural gas and natural gas liquids which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economic and operating conditions, *i.e.,* prices and costs as of the date the estimate is made. Prices include consideration of changes in existing prices provided only by contractual arrangements, but not on escalations based upon future conditions.

(i) Reservoirs are considered proved if economic producibility is supported by either actual production or conclusive formation test. The area of a reservoir considered proved includes (A) that portion delineated by drilling and defined by gas-oil and/or oil-water contacts, if any; and (B) the immediately adjoining portions not yet drilled, but which can be reasonably judged as economically productive on the basis of available geological and engineering data. In the absence of information on fluid contacts, the lowest known structural occurrence of hydrocarbons controls the lower proved limit of the reservoir.

(ii)Reserves which can be produced economically through application of improved recovery techniques (such as fluid injection) are included in the "proved" classification when successful testing by a pilot project, or the operation of an installed program in the reservoir, provides support for the engineering analysis on which the project or program was based.

(iii)Estimates of proved reserves do not include the following: (A) oil that may become available from known reservoirs but is classified separately as "indicated additional reserves"; (B) crude oil, natural gas and natural gas liquids, the recovery of which is subject to reasonable doubt because of uncertainty as to geology, reservoir characteristics or economic factors; (C) crude oil, natural gas and natural gas liquids, that may occur in undrilled prospects; and (D) crude oil, natural gas and natural gas liquids, that may be recovered from oil shales, coal, gilsonite and other such sources.

- **"SEC"** means the United States Securities and Exchange Commission.

- **"VPP"** means volumetric production payment.
- **"U.S."** means United States.
- With respect to information on the working interest in wells, drilling locations and acreage, **"net"** wells, drilling locations and acres are determined by multiplying **"gross"** wells, drilling locations and acres by the Company's working interest in such wells, drilling locations or acres. Unless otherwise specified, wells, drilling locations and acreage statistics quoted herein represent gross wells, drilling locations or acres.
- Unless otherwise indicated, all currency amounts are expressed in U.S. dollars.

PART I. FINANCIAL INFORMATION

Item 1. **Financial Statements**

PIONEER NATURAL RESOURCES COMPANY

CONSOLIDATED BALANCE SHEETS

(in thousands)

	June 30, 2007 (Unaudited)	December 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 25,318	$ 7,033
Accounts receivable:		
Trade, net of allowance for doubtful accounts of $7,119 and $6,999 as of June 30, 2007 and December 31, 2006, respectively	198,725	195,534
Due from affiliates	653	3,837
Income taxes receivable	61,291	24,693
Inventories	108,483	95,131
Prepaid expenses	5,999	11,509
Deferred income taxes	90,549	82,927
Other current assets:		
Derivatives	56,812	63,665
Other	49,392	52,229
Total current assets	597,222	536,558
Property, plant and equipment, at cost:		
Oil and gas properties, using the successful efforts method of accounting:		
Proved properties	8,894,449	7,967,708
Unproved properties	215,196	210,344
Accumulated depletion, depreciation and amortization	(2,099,722)	(1,895,408)
Total property, plant and equipment	7,009,923	6,282,644
Deferred income taxes	478	345
Goodwill	309,830	309,908
Other property and equipment, net	131,381	131,840
Other assets:		
Derivatives	4,703	4,333
Other, net of allowance for doubtful accounts of $4,039 and $4,045 as of June 30, 2007 and December 31, 2006, respectively	84,326	89,771
	$ 8,137,863	$ 7,355,399

The financial information included as of June 30, 2007 has been prepared by management

without audit by independent registered public accountants.

The accompanying notes are an integral part of these consolidated financial statements.

PIONEER NATURAL RESOURCES COMPANY

CONSOLIDATED BALANCE SHEETS (Continued)

(in thousands, except share data)

	June 30, 2007 (Unaudited)	December 31, 2006
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable:		
Trade	$ 312,825	$ 332,795
Due to affiliates	10,777	17,025
Interest payable	41,274	31,008
Income taxes payable	15,765	12,865
Other current liabilities:		
Derivatives	137,343	141,898
Deferred revenue	169,812	181,232
Other	192,395	170,156
Total current liabilities	880,191	886,979
Long-term debt	2,229,988	1,497,162
Derivatives	71,468	125,459
Deferred income taxes	1,264,590	1,172,507
Deferred revenue	404,343	483,279
Other liabilities and minority interests	197,061	205,342
Stockholders' equity:		
Common stock, $.01 par value: 500,000,000 shares authorized; 123,228,975 and 122,686,073 shares issued at June 30, 2007 and December 31, 2006, respectively	1,232	1,227
Additional paid-in capital	2,674,749	2,654,047
Treasury stock, at cost: 2,093,392 and 1,183,090 shares at June 30, 2007 and December 31, 2006, respectively	(91,454)	(53,274)
Retained earnings	538,542	497,488
Accumulated other comprehensive income (loss):		
Net deferred hedge losses, net of tax	(126,142)	(167,220)
Cumulative translation adjustment	93,295	52,403
Total stockholders' equity	3,090,222	2,984,671
Commitments and contingencies		
	$ 8,137,863	$ 7,355,399

The financial information included as of June 30, 2007 has been prepared by management

without audit by independent registered public accountants.

The accompanying notes are an integral part of these consolidated financial statements.

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PIONEER NATURAL RESOURCES COMPANY

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Revenues and other income:				
Oil and gas	$ 458,032	$ 407,570	$ 849,950	$ 787,038
Interest and other	27,690	9,741	41,606	22,852
Loss on disposition of assets, net	(1,802)	(3,403)	(1,542)	(3,476)
	483,920	413,908	890,014	806,414
Costs and expenses:				
Oil and gas production	120,417	103,066	224,830	197,749
Depletion, depreciation and amortization	103,979	87,984	196,117	170,390
Impairment of long-lived assets	17,891	—	17,891	—
Exploration and abandonments	69,790	41,618	146,162	124,260
General and administrative	30,811	29,468	65,255	61,715
Accretion of discount on asset retirement obligations	2,146	1,154	4,204	2,302
Interest	30,502	22,766	58,996	59,342
Hurricane activity, net	47,000	—	60,548	38,000
Other	10,195	11,759	18,608	16,813
	432,731	297,815	792,611	670,571
Income from continuing operations before income taxes	51,189	116,093	97,403	135,843
Income tax provision	(16,284)	(50,207)	(32,203)	(70,924)
Income from continuing operations	34,905	65,886	65,200	64,919
Income from discontinued operations, net of tax	1,575	22,153	873	566,327
Net income	$ 36,480	$ 88,039	$ 66,073	$ 631,246
Basic earnings per share:				
Income from continuing operations	$ 0.29	$ 0.52	$ 0.53	$ 0.52
Income from discontinued operations, net of tax	0.01	0.18	0.01	4.48
Net income	$ 0.30	$ 0.70	$ 0.54	$ 5.00
Diluted earnings per share:				
Income from continuing operations	$ 0.29	$ 0.52	$ 0.53	$ 0.52
Income from discontinued operations, net of tax	0.01	0.17	0.01	4.34
Net income	$ 0.30	$ 0.69	$ 0.54	$ 4.86
Weighted average shares outstanding:				
Basic	121,226	125,629	121,374	126,282
Diluted	122,776	129,624	122,847	130,346

Dividends declared per share	$ —	$ —	$ 0.13	$ 0.12

The financial information included herein has been prepared by management

without audit by independent registered public accountants.

The accompanying notes are an integral part of these consolidated financial statements.

PIONEER NATURAL RESOURCES COMPANY

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

(in thousands, except dividends per share)

(Unaudited)

	Shares Outstanding	Common Stock	Additional Paid-in Capital	Treasury Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss) Net Deferred Hedge Losses, Net of Tax	Cumulative Translation Adjustment	Total Stockholders' Equity
Balance as of January 1, 2007	121,502	$ 1,227	$ 2,654,047	$ (53,274)	$ 497,488	$ (167,220)	$ 52,403	$ 2,984,671
Dividends declared ($.13 per share)	—	—	—	—	(16,035)	—	—	(16,035)
Exercise of long-term incentive plan stock options	372	—	—	16,069	(8,984)	—	—	7,085
Purchase of treasury stock	(1,281)	—	—	(54,249)	—	—	—	(54,249)
Tax benefits related to stock-based compensation	—	—	4,352	—	—	—	—	4,352
Compensation costs:								
Compensation awards	543	5	(5)	—	—	—	—	—
Compensation costs included in net income	—	—	16,355	—	—	—	—	16,355
Net income	—	—	—	—	66,073	—	—	66,073
Other comprehensive income (loss):								
Net hedging activity, net of tax:								
Net deferred hedge gains	—	—	—	—	—	17,292	—	17,292
Net hedge losses included in continuing operations	—	—	—	—	—	23,786	—	23,786
Translation adjustment	—	—	—	—	—	—	40,892	40,892
	121,136	$ 1,232	$ 2,674,749	$ (91,454)	$ 538,542	$ (126,142)	$ 93,295	$ 3,090,222

Balance as of June
30, 2007

The financial information included herein has been prepared by management without audit by independent registered public accountants.

The accompanying notes are an integral part of these consolidated financial statements.

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PIONEER NATURAL RESOURCES COMPANY

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	Three months ended June 30, 2007	Three months ended June 30, 2006	Six months ended June 30, 2007	Six months ended June 30, 2006
Cash flows from operating activities:				
Net income	$ 36,480	$ 88,039	$ 66,073	$ 631,246
Adjustments to reconcile net income to net cash provided by operating activities:				
Depletion, depreciation and amortization	103,979	87,984	196,117	170,390
Impairment of long-lived assets	17,891	—	17,891	—
Exploration expenses, including dry holes	42,921	17,354	89,886	69,936
Hurricane activity	47,000	—	66,000	42,000
Deferred income taxes	52,628	50,223	63,394	67,184
Loss on disposition of assets, net	1,802	3,403	1,542	3,476
Loss on extinguishment of debt	—	8,076	—	8,076
Accretion of discount on asset retirement obligations	2,146	1,154	4,204	2,302
Discontinued operations	(61)	(1,002)	(2,167)	(540,655)
Interest expense	4,487	2,118	9,213	5,165
Commodity hedge related activity	4,734	(6,061)	10,633	(5,553)
Amortization of stock-based compensation	8,617	10,824	16,355	18,310
Amortization of deferred revenue	(45,322)	(47,886)	(90,356)	(95,835)
Other noncash items	3,125	4,892	(3,152)	7,591
Change in operating assets and liabilities, net of effects from acquisitions and dispositions:				
Accounts receivable, net	15,789	37,137	562	163,165
Income taxes receivable	(49,156)	104	(36,598)	(15)
Inventories	(11,393)	(18,994)	(9,404)	(39,125)
Prepaid expenses	4,064	14,228	5,219	1,964
Other current assets, net	(399)	(341)	(187)	9,207
Accounts payable	(7,996)	(18,758)	(32,586)	(96,413)
Interest payable	13,736	8,826	10,266	(10,274)
Income taxes payable	(3,915)	(78,236)	2,900	55,815
Other current liabilities	(23,795)	(4,438)	(38,446)	8,927
Net cash provided by operating activities	217,362	158,646	347,359	476,884
Cash flows from investing activities:				
Proceeds from disposition of assets, net of cash sold	13,272	679,371	18,037	1,642,562
Additions to oil and gas properties	(536,152)	(309,544)	(974,799)	(644,432)
Additions to other assets and other property and equipment, net	(16,102)	(26,291)	(29,675)	(32,839)
Net cash provided by (used in) investing activities	(538,982)	343,536	(986,437)	965,291

Cash flows from financing activities:				
Borrowings under long-term debt	369,000	534,219	1,091,000	898,490
Principal payments on long-term debt	—	(438,571)	(361,555)	(1,702,842)
Payments of other liabilities	(3,805)	(1,428)	(9,560)	(17,858)
Exercise of long-term incentive plan stock options	4,716	2,744	7,085	4,666
Purchase of treasury stock	(22,812)	(170,464)	(54,249)	(172,445)
Excess tax benefits from share-based payment arrangements	2,781	918	4,321	1,933
Payment of financing fees	(776)	(2,169)	(4,295)	(2,169)
Dividends paid	(16,035)	(15,510)	(16,035)	(15,510)
Net cash provided by (used in) financing activities	333,069	(90,261)	656,712	(1,005,735)
Net increase in cash and cash equivalents	11,449	411,921	17,634	436,440
Effect of exchange rate changes on cash and cash equivalents	519	2,139	651	1,800
Cash and cash equivalents, beginning of period	13,350	42,982	7,033	18,802
Cash and cash equivalents, end of period	$ 25,318	$ 457,042	$ 25,318	$ 457,042

The financial information included herein has been prepared by management

without audit by independent registered public accountants.

The accompanying notes are an integral part of these consolidated financial statements.

PIONEER NATURAL RESOURCES COMPANY

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands)

(Unaudited)

	Three Months Ended June 30, 2007	Three Months Ended June 30, 2006	Six months Ended June 30, 2007	Six months Ended June 30, 2006
Net income	$ 36,480	$ 88,039	$ 66,073	$ 631,246
Other comprehensive income:				
Net hedge activity, net of tax:				
Net deferred hedge gains (losses)	28,367	(1,806)	17,292	36,948
Net hedge gains included in continuing operations	11,441	15,185	23,786	54,917
Net hedge losses included in discontinued operations	—	—	—	126,272
Translation adjustment	37,731	13,018	40,892	10,783
Other comprehensive income	77,539	26,397	81,970	228,920
Comprehensive income	$ 114,019	$ 114,436	$ 148,043	$ 860,166

The financial information included herein has been prepared by management

without audit by independent registered public accountants.

The accompanying notes are an integral part of these consolidated financial statements.

PIONEER NATURAL RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2007

(Unaudited)

NOTE A. Organization and Nature of Operations

Pioneer is a Delaware corporation whose common stock is listed and traded on the New York Stock Exchange. The Company is a large independent oil and gas exploration and production company with operations in the United States, Canada, Equatorial Guinea, Nigeria, South Africa and Tunisia.

NOTE B. Basis of Presentation

Presentation. In the opinion of management, the unaudited consolidated financial statements of the Company as of June 30, 2007 and for the three and six months ended June 30, 2007 and 2006 include all adjustments and accruals, consisting only of normal recurring accrual adjustments, which are necessary for a fair presentation of the results for the interim periods. These interim results are not necessarily indicative of results for a full year.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States ("GAAP") have been condensed or omitted in this Form 10-Q pursuant to the rules and regulations of the SEC. These consolidated financial statements should be read in connection with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

Discontinued operations. During 2006, the Company sold its interests in the following oil and gas asset groups:

Country	Description of Assets	Date Divested
United States	Deepwater Gulf of Mexico fields	March 2006
Argentina	Argentine assets	April 2006

In accordance with Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS 144"), the Company has reflected the results of operations of the above divestitures as discontinued operations, rather than as a component of continuing operations. See Note P for additional information regarding discontinued operations.

Inventories. Inventories consisted of $107.1 million and $93.7 million of materials and supplies and $1.4 million of commodities as of June 30, 2007 and December 31, 2006, respectively. The Company's materials and supplies inventory primarily comprises oil and gas drilling or repair items such as tubing, casing, chemicals, operating supplies and ordinary maintenance materials and parts. The materials and supplies inventory is primarily acquired for use in future drilling operations or repair operations and is carried at the lower of cost or market, on a weighted average cost basis. Commodities inventory is carried at the lower of weighted average cost or market, on a first-in, first-out basis. Any valuation reductions to inventory are reflected as a loss on disposition of assets in the Consolidated Statements of Operations. As of June 30, 2007 and December 31, 2006, the Company's materials and supplies inventory was net of $2.6 million and $4.2 million, respectively, of valuation reserve allowances.

Goodwill. In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets", goodwill is not amortized to earnings, but is assessed for impairment whenever events or circumstances indicate that impairment of the carrying value of goodwill is likely, but no less often than annually. If the carrying value of goodwill is determined to be impaired, it is reduced for the impaired value with a corresponding charge to pretax earnings in the period in which it is determined to be impaired. During the third quarter of 2006, the Company performed its annual assessment of goodwill impairment and determined that there was no impairment. In accordance with GAAP, certain qualifying income tax benefits derived from stock-based compensation are recorded as reductions in the carrying value of goodwill.

PIONEER NATURAL RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2007

(Unaudited)

Minority interests in consolidated subsidiaries. The Company owns the majority interests in certain subsidiaries with operations in the United States and Nigeria. Associated therewith, the Company has recognized minority interests in consolidated subsidiaries of $10.9 million and $14.4 million in other liabilities and minority interests in the Consolidated Balance Sheets as of June 30, 2007 and December 31, 2006, respectively.

Minority interests in the net losses of the Company's consolidated Nigerian subsidiary amounting to $.4 million and $2.5 million for the three and six months ended June 30, 2007, respectively, as compared to $.7 million and $3.6 million for the same respective periods of 2006, are included in interest and other income in the Consolidated Statements of Operations. Minority interests in the net income of the Company's consolidated United States subsidiaries amounting to $.6 million and $1.3 million for the three and six months ended June 30, 2007, respectively, as compared to $.6 million and $1.5 million for the same respective periods in 2006, are included in other expense in the Consolidated Statements of Operations.

Stock-based compensation. On January 1, 2006, the Company adopted SFAS No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123(R)") to account for stock-based compensation. For equity-based compensation awards granted or modified subsequent to January 1, 2006, compensation expense, based on the fair value on the date of grant, is being recognized in the Company's financial statements over the vesting period. The Company utilizes (a) the Black-Scholes option pricing model to measure the fair value of stock options, (b) the stock price on the date of grant for the fair value of restricted stock awards and (c) the Monte Carlo simulation method for the fair value of performance unit awards. Prior to the adoption of SFAS 123(R), the Company followed the intrinsic value method in accordance with the Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") to account for stock options. Prior period financial statements have not been restated. The Company recorded no cumulative effect as a result of adopting SFAS 123(R).

For the three and six months ended June 30, 2007, the Company recorded $8.6 million and $16.4 million of stock-based compensation costs for all plans, respectively, as compared to $10.8 million and $18.3 million for the same respective periods of 2006.

Pursuant to the provisions of SFAS 123(R), the Company's issued shares, as reflected in the Consolidated Balance Sheets at June 30, 2007 and December 31, 2006, do not include 2,024,882 shares and 1,946,211 shares, respectively, related to unvested restricted stock awards. During the six months ended June 30, 2007, the Company issued 777,476 shares of restricted stock, net of associated forfeitures, for which restrictions will lapse in future periods.

As of June 30, 2007, there was approximately $54.2 million of unrecognized compensation expense related to unvested share-based compensation plan awards, primarily related to restricted stock and performance unit awards. This compensation will be recognized over the remaining vesting periods, which on a weighted average basis is approximately twenty-one months.

Reclassifications. Certain reclassifications have been made to the 2006 amounts in order to conform with the 2007 presentation. Specifically, (a) the Company reduced its exploration and abandonments expense by $42.0 million and interest and other income by $4.0 million for the six months ended June 30, 2006, which represents reclassification of abandonment costs and insurance recoveries for the Company's East Cameron facility destroyed by Hurricane Rita to hurricane activity, net expense in the Consolidated Statements of Operations, (b) the Company reclassified the aforementioned $42.0 million of East Cameron abandonment charge from exploration and abandonments to hurricane activity within net cash flows from operating activities in the Consolidated Statements of Cash Flows, (c) $1.3 million and $17.2 million for the three and six months ended June 30, 2006, respectively, of unfunded check issuances were reclassified from changes in accounts payable in net cash flows from operating activities to payment of other liabilities in net cash flows from financing activities within the Consolidated Statements of Cash Flows, (d) $0.9 million and $1.9 million for the three and six months ended June 30, 2006, respectively, of excess tax benefits from share-based payment arrangements were reclassified from other noncash items in net cash flows from operating activities to financing activities within the Consolidated Statements of Cash Flows and (e) $104 thousand and $(15) thousand for the three and six months ended June 30, 2006, respectively, of

PIONEER NATURAL RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2007

(Unaudited)

income taxes receivable were reclassified from changes in other current assets, net to changes in income taxes receivable in net cash flows from operating activities within the Consolidated Statements of Cash Flows.

New accounting pronouncements. In July 2006, the Financial Accounting Standards Board ("FASB") issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48"). The Interpretation clarifies the accounting for income taxes by prescribing a minimum recognition threshold that a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on measurement, classification, interim accounting and disclosure. FIN 48 is effective for fiscal years beginning after December 15, 2006. See Note D for additional information regarding the Company’s adoption of FIN 48.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measures" ("SFAS 157"). SFAS 157 defines fair value, establishes a framework for measuring fair value and enhances disclosures about fair value measures required under other accounting pronouncements, but does not change existing guidance as to whether or not an instrument is carried at fair value. SFAS 157 is effective for fiscal years beginning after November 15, 2007. The Company is continuing to assess the impact of SFAS 157.

In February 2007, the FASB issued SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities” (“SFAS 159”). SFAS 159 permits entities to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. SFAS 159 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The implementation of SFAS 159 is not expected to have a material effect on the financial condition or results of operations of the Company.

NOTE C. Exploratory Well Costs

The Company capitalizes exploratory well costs until a determination is made that the well has either found proved reserves or that it is impaired. The capitalized exploratory well costs are presented in proved properties in the Consolidated Balance Sheets. If the exploratory well is determined to be impaired, the well costs are charged to exploration and abandonments expense.

The following table reflects the Company's capitalized exploratory well activity during the three and six months ended June 30, 2007:

	Three months ended June 30, 2007	Six months ended June 30, 2007

	(in thousands)	
Beginning capitalized exploratory well costs	$ 294,877	$ 265,053
Additions to exploratory well costs pending the determination of proved reserves	106,058	218,898
Reclassification due to determination of proved reserves	(57,821)	(96,726)
Impairment of properties	(3,377)	(3,377)
Exploratory well costs charged to exploration expense	(24,138)	(68,249)
Ending capitalized exploratory well costs	$ 315,599	$ 315,599

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The following table provides an aging as of June 30, 2007 and December 31, 2006 of capitalized exploratory well costs based on the date the drilling was completed and the number of projects for which exploratory well costs have been capitalized for a period greater than one year since the date the drilling was completed:

	June 30, 2007	**December 31, 2006**
	(in thousands, except well counts)	
Capitalized exploratory well costs that have been capitalized:		
One year or less	$ 111,866	$ 126,749
Greater than one year	203,733	138,304
	$ 315,599	$ 265,053
Number of projects with exploratory well costs that have been capitalized for a period greater than one year	14	14

The following table provides an aging of capitalized costs of exploration projects that have been suspended for more than one year as of June 30, 2007:

	Total	**2007**	**2006**	**2005**	**2004**	**2003**	**2002**
	(in thousands)						
United States:							
Clipper	$ 75,910	$ 668	$ 37,027	$ 38,215	$ —	$ —	$ —
Lay Creek	44,815	13,555	31,260	—	—	—	—
Oooguruk	52,205	—	—	5,122	1,014	45,565	504
Other	14,368	2,364	9,031	2,973	—	—	—
Canada	15,809	112	13,655	2,042	—	—	—
Equatorial Guinea	626	178	183	265	—	—	—
Total	$ 203,733	$ 16,877	$ 91,156	$ 48,617	$ 1,014	$ 45,565	$ 504

The following discussion describes the history and status of each individually significant suspended exploratory project:

Clipper. During 2005, the Company drilled its first exploratory well on the Clipper prospect, which was a discovery. During 2006, the Company drilled additional wells to determine the magnitude of the discovery, which were successful. The Company is currently evaluating the plans for development of the discovery, including options for subsea tie-back to third-party production and handling facilities in the area.

Lay Creek. The Company’s Lay Creek project is a coal bed methane pilot program located in northwestern Colorado. The Company has drilled 17 wells in six separate pilot areas and completed workovers and recompletions on 14 wells drilled by a previous operator. The Company completed the water treatment facilities and plans to initiate sales of production in the second half of 2007. Determination of success of the pilot project is dependent on the ability to dewater the formation and determine if commercial quantities of gas can be produced. The pilot project is currently in the dewatering phase and if the pilot project is successful then full field development could begin in 2008.

Oooguruk. During 2003, the Company's Alaskan Oooguruk discovery wells found quantities of oil believed to be commercial. In 2003, the Company began farm-in discussions with the owner of undeveloped discoveries in adjacent acreage given its proximity and the potential cost benefits of a larger scale project. The farm-in was

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completed during 2004. Along with completing the farm-in agreement, Pioneer obtained access to exploration well and seismic data to improve the Company's understanding of the potential of the discoveries without having to drill additional wells. In late 2004, the Company completed an extensive technical and economic evaluation of the resource potential and a front-end engineering design study ("FEED study") for the area.

During 2006, the Company sanctioned the development of the discovery and obtained the necessary regulatory approvals. The Company completed the installation and armoring of the offshore gravel drilling and production site during 2006. During the first half of 2007, the flowline and facilities to carry produced liquids to existing onshore processing facilities at the Kuparuk River Unit were installed. Operations are underway to connect and commission the flowline and facilities. Pioneer is currently assembling the drilling rig on location and plans to commence drilling approximately 40 horizontal wells to develop the discovery in the second half of 2007. The Company estimates first production will occur during the first half of 2008.

NOTE D. Income Taxes

The Company accounts for income taxes in accordance with the provisions of SFAS No. 109, "Accounting for Income Taxes" ("SFAS 109"). SFAS 109 requires that the Company continually assess both positive and negative evidence to determine whether it is more likely than not that deferred tax assets can be realized prior to their expiration. Pioneer monitors Company-specific, oil and gas industry and worldwide economic factors to assess the likelihood that the Company's net operating loss carryforwards ("NOLs") and other deferred tax attributes in the United States and state, local and foreign tax jurisdictions will be utilized prior to their expiration. As of June 30, 2007 and December 31, 2006, the Company's valuation allowances (relating primarily to foreign tax jurisdictions) were $73.1 million and $94.7 million, respectively.

The Company adopted the provisions of FIN 48 on January 1, 2007. As a result of the implementation of FIN 48, the Company has analyzed its filing positions for open tax years in all of the foreign, federal and state jurisdictions where it has material tax attributes and is required to file income tax returns. The Company believes that its income tax filing positions and deductions will be substantially sustained on audit and does not anticipate any significant adjustments. Consequently, the Company did not record a cumulative effect adjustment related to the adoption of FIN 48.

The Company files income tax returns in the U.S. federal jurisdiction, and various states and foreign jurisdictions. With few exceptions, the Company believes that it is no longer subject to examinations by tax authorities for years before 2002. In the fourth quarter of 2006, the Internal Revenue Service commenced an examination of the Company’s 2004 U.S. income tax return that is anticipated to be completed by the end of 2007. In addition, the Company’s 2003 through 2005 state income tax returns in Colorado and Louisiana are currently under audit, the Tunisian government is concluding an audit of the Company’s 2002 through 2005 income tax returns for the Adam Concession, and the Canada Revenue Agency is currently auditing the Company’s 2003 and 2004 Canadian income tax returns. As of June 30, 2007, no significant adjustments have been proposed in any jurisdiction.

In February 2007, the Republic of South Africa passed legislation that included significant new tax benefits for oil and gas activities. Effective January 1, 2007, the Company is allowed a deduction from oil and gas income equal to 200 percent of exploration expenditures and 150 percent of development expenditures. Pursuant to the new tax legislation, the Company recorded a $5.2 million tax benefit for the six months ended June 30, 2007 associated with capital expenditures incurred after the effective date, primarily related to the South Coast Gas project.

Pursuant to Accounting Principles Board (“APB”) Opinion No. 23 “Accounting for Income Taxes – Special Areas”, the Company historically treated the undistributed earnings in South Africa as permanently reinvested and did not provide for a U.S. tax on such earnings. As of June 30, 2007, the Company made the determination that it no longer had identifiable plans to reinvest these earnings in South Africa and accordingly recorded $13.0 million of U.S. deferred tax expense in the second quarter of 2007. Prospectively, the Company will record U.S. taxes on the earnings of its South African subsidiaries.

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During the second quarter of 2007, the Company commenced plans to relinquish its interest in Block 256 and entered into an agreement to divest its interest in a subsidiary that held an interest in Block 320 in deepwater Nigeria. The agreement was terminated and the Company intends to withdraw from Block 320. Relinquishing of Block 256 is a result of unsuccessful drilling efforts while the withdrawal from Block 320 is a result of the terminated attempt to dispose of its interest and legal compliance matters, which are more fully discussed in Note O. With the plan to relinquish Block 256 and withdraw from Block 320, the Company plans to exit Nigeria. This exit allows the Company to deduct in the U.S. the cumulative expenditures associated with its past Nigerian activities and accordingly, during the second quarter of 2007, the Company recognized a $40.0 million tax benefit.

Income tax (provisions) benefits. The Company's income tax (provisions) benefits attributable to income from continuing operations consisted of the following for the three and six months ended June 30, 2007 and 2006:

	Three months ended June 30,		Six months ended June 30,	
	2007	2006	2007	2006
	(in thousands)			
Current:				
U.S. federal	$ 48,842	$ 10,460	$ 53,619	$ 12,973
U.S. state and local	—	(12)	—	(3)
Foreign	(12,498)	(10,432)	(22,428)	(16,710)
	36,344	16	31,191	(3,740)
Deferred:				
U.S. federal	(46,554)	(38,703)	(58,717)	(48,640)
U.S. state and local	(1,458)	(14,297)	(1,948)	(14,099)
Foreign	(4,616)	2,777	(2,729)	(4,445)
	(52,628)	(50,223)	(63,394)	(67,184)
	$ (16,284)	$ (50,207)	$ (32,203)	$ (70,924)

Discontinued operations. The Company's income tax (provisions) benefits attributable to income from discontinued operations consisted of the following for the three and six months ended June 30, 2007 and 2006:

	Three months ended June 30,		Six months ended June 30,	
	2007	2006	2007	2006

	(in thousands)			
Current:				
U.S. federal	$ —	$ (7,874)	$ —	$ (148,599)
U.S. state and local	—	290	—	(1,850)
Foreign	(202)	(961)	(4,698)	(2,126)
	(202)	(8,545)	(4,698)	(152,575)
Deferred:				
U.S. federal	(40)	1,374	(40)	(140,902)
U.S. state and local	—	(104)	—	(6,319)
Foreign	116	(881)	2,371	123
	76	389	2,331	(147,098)
	$ (126)	$ (8,156)	$ (2,367)	$ (299,673)

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NOTE E. Long-term Debt

Lines of credit. During April 2007, the Company entered into an Amended and Restated 5-Year Revolving Credit Agreement (the "Credit Facility") that matures in April 2012 unless extended in accordance with the terms of the Credit Facility. The Credit Facility also provides for initial aggregate loan commitments of $1.5 billion, which may be increased to a maximum aggregate amount of $2.0 billion if the lenders increase their loan commitments or if loan commitments of new financial institutions are added. As of June 30, 2007, the Company had $559.0 million of outstanding borrowings under the Credit Facility and had $119.0 million of undrawn letters of credit, of which $115.4 million were undrawn commitments under the Credit Facility, leaving the Company with $825.6 million of unused borrowing capacity under the Credit Facility.

Borrowings under the Credit Facility may be in the form of revolving loans or swing line loans. Aggregate outstanding swing line loans may not exceed $150 million. Revolving loans bear interest, at the option of the Company, based on (a) a rate per annum equal to the higher of the prime rate announced from time to time by JPMorgan Chase Bank or the weighted average of the rates on overnight Federal funds transactions with members of the Federal Reserve System during the last preceding business day plus .5 percent or (b) a base Eurodollar rate, substantially equal to LIBOR, plus a margin (the "Applicable Margin") that is determined by a reference grid based on the Company’s debt rating (currently .75 percent). Swing line loans bear interest at a rate per annum equal to the "ASK" rate for Federal funds periodically published by the Dow Jones Market Service plus the Applicable Margin. Letters of credit outstanding under the Credit Facility are subject to a per annum fee, representing the Applicable Margin plus .125 percent.

The Credit Facility contains certain financial covenants, which include the maintenance of a ratio of total debt to book capitalization less intangible assets, accumulated other comprehensive income and certain noncash asset impairments not to exceed .60 to 1.0. The covenants also include the maintenance of a ratio of the net present value of the Company’s oil and gas properties to total debt of at least 1.75 to 1.0 until the Company achieves an investment grade rating by Moody’s Investors Service, Inc. or Standard & Poors Ratings Group, Inc.

Senior notes. During March 2007, the Company issued $500 million of 6.65% senior notes due 2017 (the "6.65% Notes") and received proceeds, net of issuance discount and underwriting costs, of $494.9 million. The Company used the net proceeds from the issuance of the 6.65% Notes to reduce indebtedness under its Credit Facility.

On August 15, 2007, $32.1 million principal amount of the Company’s 8.25% senior notes mature and on January 15, 2008, $3.8 million principal amount of the Company’s 6.50% senior notes mature. The Company has both the intent and ability to fund the maturities of these senior notes with borrowings under the Credit Facility. Accordingly, the Company has classified these notes as noncurrent in its accompanying Consolidated Balance Sheets.

NOTE F. Derivative Financial Instruments

The Company uses financial derivative contracts to manage exposures to commodity price, interest rate and foreign currency fluctuations. The Company generally does not enter into derivative financial instruments for speculative or trading purposes. The Company also may enter into physical delivery contracts that effectively provide commodity price hedges. Because these contracts are not expected to be net cash settled, they are considered to be normal sales contracts and not derivatives. Therefore, these contracts are not recorded in the financial statements.

All derivatives are recorded in the balance sheet at estimated fair value. Fair value is generally determined based on the difference between the fixed contract price and the underlying market price at the determination date. Changes in the fair value of effective cash flow hedges are recorded as a component of accumulated other comprehensive income (loss), which is later transferred to earnings when the hedged transaction occurs. Changes in the fair value of derivatives that are not designated as hedges, as well as the ineffective portion of the hedge derivatives, are recorded in earnings. The ineffective portion is calculated as the difference between the change in fair value of the derivative and the estimated change in cash flows from the item hedged.

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Fair value hedges. The Company monitors the debt capital markets and interest rate trends to identify opportunities to enter into and terminate interest rate derivative contracts with the objective of reducing its costs of capital. As of June 30, 2007 and December 31, 2006, the Company was not a party to any open fair value hedges.

As of June 30, 2007, the carrying value of the Company's long-term debt in the Consolidated Balance Sheets included a $3.3 million reduction attributable to net deferred hedge losses on terminated fair value hedges that are being amortized as increases to interest expense over the original terms of the terminated agreements. During the three and six months ended June 30, 2007, the Company's amortization of deferred hedge losses and gains on terminated interest rate swaps increased the Company's reported interest expense by $123 thousand and $196 thousand, respectively. The Company’s amortization of deferred hedge losses and gains on terminated interest rate swaps decreased reported interest expense for the three and six months ended June 30, 2006 by $4 thousand and $109 thousand, respectively.

The following table sets forth, as of June 30, 2007, the scheduled amortization of net deferred hedge losses on terminated interest rate hedges (including terminated fair value and cash flow hedges) that will be recognized as increases to the Company's future interest expense:

	Net deferred interest rate hedge losses		
	Fair Value	**Cash Flow**	**Total**
	(in thousands)		
2007 (remaining six months)	$ 131	$ 105	$ 236
2008	$ 257	$ 231	$ 488
2009	$ 281	$ 260	$ 541
2010	$ 307	$ 293	$ 600
2011	$ 337	$ 328	$ 665
Thereafter	$ 1,978	$ 1,960	$ 3,938

Cash flow hedges. The Company utilizes commodity swap and collar contracts to (i) reduce the effect of price volatility on the commodities the Company produces and sells, (ii) support the Company's annual capital budgeting and expenditure plans and (iii) reduce commodity price risk associated with certain capital projects. As of June 30, 2007, all of the Company's open commodity hedges are designated as hedges of Canadian or United States forecasted sales. The Company also, from time to time, utilizes interest rate contracts to reduce the effect of interest rate volatility on the Company's indebtedness and forward currency exchange agreements to reduce the effect of U.S. dollar to Canadian dollar exchange rate volatility.

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Oil prices. All material physical sales contracts governing the Company's oil production have been tied directly or indirectly to NYMEX prices. The following table sets forth the volumes hedged in Bbls under outstanding oil hedge contracts and the weighted average NYMEX prices per Bbl for those contracts as of June 30, 2007:

	First Quarter	**Second Quarter**	**Third Quarter**	**Fourth Quarter**	**Outstanding Average**
Average daily oil production hedged (a):					
2007 – Collar Contracts					
Volume (Bbl)			5,000	5,000	5,000
Price per Bbl			$ 63.00 - $76.04	$ 63.00 - $76.04	$ 63.00 - $76.04
2007 – Swap Contracts					
Volume (Bbl)			5,000	5,000	5,000
Price per Bbl			$ 69.55	$ 69.55	$ 69.55
2008 – Swap Contracts					
Volume (Bbl)	13,500	13,500	13,500	13,500	13,500
Price per Bbl	$ 59.04	$ 59.04	$ 59.04	$ 59.04	$ 59.04
2009 – Collar Contracts					
Volume (Bbl)	2,000	2,000	2,000	2,000	2,000
Price per Bbl	$ 65.00 - $76.50	$ 65.00 - $76.50	$ 65.00 - $76.50	$ 65.00 - $76.50	$ 65.00 - $76.50
2009 – Swap Contracts					
Volume (Bbl)	6,000	6,000	6,000	6,000	6,000
Price per Bbl	$ 70.47	$ 70.47	$ 70.47	$ 70.47	$ 70.47
2010 – Swap Contracts					
Volume (Bbl)	4,000	4,000	4,000	4,000	4,000
Price per Bbl	$ 71.46	$ 71.46	$ 71.46	$ 71.46	$ 71.46

(a) Subsequent to June 30, 2007, the Company entered into additional oil swap contracts for 1,500 Bbls per day of the Company's August through December 2007 production at an average price of $73.00 per Bbl and 250 Bbls per day of the Company's 2008 production at an average price of $73.43 per Bbl. The Company also entered into oil collar contracts for 3,000 Bbls per day of the Company's 2008 production at an average floor price of $65.00 per Bbl and an average ceiling price of $80.80 per Bbl.

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The Company reports average oil prices per Bbl including the effects of oil quality adjustments, amortization of deferred volumetric production payment ("VPP") revenue and the net effect of oil hedges. The following table sets forth (i) the Company's oil prices from continuing operations, both reported (including hedge results and amortization of deferred VPP revenue) and realized (excluding hedge results and amortization of deferred VPP revenue), (ii) amortization of deferred VPP revenue to oil revenue from continuing operations and (iii) the net effect of settlements of oil price hedges on oil revenue from continuing operations for the three and six months ended June 30, 2007 and 2006:

	Three months ended June 30,		**Six months ended June 30,**	
	2007	**2006**	**2007**	**2006**
Average price reported per Bbl	$ 60.38	$ 69.71	$ 57.25	$ 64.86
Average price realized per Bbl	$ 62.48	$ 67.15	$ 59.55	$ 63.63
VPP increase to oil revenue (in millions)	$ 27.5	$ 29.1	$ 54.8	$ 58.0
Reduction to oil revenue from hedging activity (in millions) (a)	$ (32.4)	$ (23.4)	$ (65.5)	$ (52.5)

(a) Excludes hedge losses of $12.3 million attributable to discontinued operations for the three and six months ended June 30, 2006.

Natural gas liquids prices. During the three and six months ended June 30, 2007 and 2006, the Company did not enter into any NGL hedge contracts. There were no outstanding NGL hedge contracts at June 30, 2007. Subsequent to June 30, 2007, the Company entered into natural gas liquids swap contracts for 500 Bbls per day of the Company’s 2008 production at an average price of $44.33 per Bbl and 500 Bbls per day of the Company’s 2009 production at an average price of $41.75 per Bbl.

Gas prices. The Company employs a policy of hedging a portion of its gas production based on the index price upon which the gas is actually sold in order to mitigate the basis risk between NYMEX prices and actual index prices, or based on NYMEX prices if NYMEX prices are highly correlated with the index price. The following table sets forth the volumes hedged in MMBtus under outstanding gas hedge contracts and the weighted average index prices per MMBtu for those contracts as of June 30, 2007:

	First Quarter	**Second Quarter**	**Third Quarter**	**Fourth Quarter**	**Outstanding Average**

Average daily gas production hedged (a):					
2007 – Swap Contracts					
Volume (MMbtu)			225,000	225,000	225,000
Price per MMBtu			$ 7.71	$ 7.71	$ 7.71
2008 – Swap Contracts					
Volume (MMbtu)	60,000	40,000	40,000	40,000	44,973
Price per MMBtu	$ 9.00	$ 8.78	$ 8.78	$ 8.78	$ 8.85

(a) Subsequent to June 30, 2007, the Company entered into additional gas swap contracts for 2,500 MMBtu per day of the Company's 2008, 2009, and 2010 production at average prices of $7.35, $7.55 and $7.33 per MMBtu, respectively.

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The Company reports average gas prices per Mcf including the effects of Btu content, gas processing, shrinkage adjustments, amortization of deferred VPP revenue and the net effect of gas hedges. The following table sets forth (i) the Company's gas prices from continuing operations, both reported (including hedge results and amortization of deferred VPP revenue) and realized (excluding hedge results and amortization of deferred VPP revenue), (ii) amortization of deferred VPP revenue to gas revenue from continuing operations and (iii) the net effect of settlements of gas price hedges on gas revenue from continuing operations for the three and six months ended June 30, 2007 and 2006:

	Three months ended June 30,		**Six months ended June 30,**	
	2007	**2006**	**2007**	**2006**
Average price reported per Mcf	$ 7.45	$ 6.25	$ 7.39	$ 6.48
Average price realized per Mcf	$ 6.49	$ 5.75	$ 6.39	$ 6.37
VPP increase to gas revenue (in millions)	$ 17.8	$ 18.8	$ 35.6	$ 37.8
Increase (reduction) to gas revenue from hedging activity (in millions) (a)	$ 14.3	$ (3.3)	$ 27.3	$ (31.6)

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(a) Excludes hedge losses of $3.4 million attributable to discontinued operations for the three and six months ended June 30, 2006.

Interest rate. During March 2007, the Company entered into treasury lock contracts and designated the contracts as cash flow hedges of the forecasted interest rate risk associated with the coupon rate on the Company’s 6.65% Notes, which were issued in March 2007. The Company terminated these contracts for a loss of $1.5 million, which was recorded in accumulated other comprehensive income (loss) - net deferred hedge losses, net of tax ("AOCI - Hedging"). The Company did not realize any ineffectiveness in connection with the treasury lock contracts. See Note E for information regarding the 6.65% Notes.

Hedge ineffectiveness. During the six months ended June 30, 2007, the Company recorded net ineffectiveness charges of $.9 million, as compared to net ineffectiveness credits of $2.8 million and $11.0 million, respectively, during the three and six months ended June 30, 2006. Hedge ineffectiveness represents the ineffective portions of changes in fair values of the Company’s cash flow hedging instruments. The primary causes of changes in ineffectiveness are changes in correlations and derivative fair values associated with commodity price indexes of financial hedge derivatives and the commodity price indexes of the hedged forecasted production for certain fields.

AOCI - Hedging. As of June 30, 2007 and December 31, 2006, AOCI - Hedging represented net deferred losses of $126.1 million and $167.2 million, respectively. The AOCI - Hedging balance as of June 30, 2007 was comprised of $10.2 million of net deferred losses on the effective portions of open cash flow hedges, $189.5 million of net deferred losses on terminated cash flow hedges (including $3.2 million of net deferred losses on terminated cash flow interest rate hedges) and $73.6 million of associated net deferred tax benefits. The decrease in AOCI - Hedging during the six months ended June 30, 2007 was primarily attributable to the reclassification of net deferred hedge losses to net income as derivatives matured, partially offset by increases in future commodity prices relative to the commodity prices stipulated in the hedge contracts. The net deferred losses associated with open cash flow hedges remain subject to market price fluctuations until the positions are either settled under the terms of the hedge contracts or terminated prior to settlement. The net deferred losses on terminated cash flow hedges are fixed.

During the twelve months ending June 30, 2008, based on current estimates of future commodity prices and interest rates, the Company expects to reclassify $21.0 million of net deferred gains associated with open commodity hedges, $125.6 million of net deferred losses on terminated commodity and interest rate hedges from AOCI - Hedging to oil and gas revenues and interest expense. The Company also expects to reclassify approximately $39.4 million of net deferred income tax benefits associated with commodity and interest rate hedges during the twelve months ending June 30, 2008 from AOCI - Hedging to income tax benefit.

Terminated commodity hedges. At times, the Company terminates open commodity hedge positions when the underlying commodity prices reach a point that the Company believes will be the high or low price of the

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commodity prior to the scheduled settlement of the open commodity hedge position. This allows the Company to maximize gains or minimize losses associated with the open hedge positions. At the time of termination of the hedges, the amounts are recorded in AOCI – Hedging and amortized to earnings over the periods the production was scheduled to occur.

The following table sets forth, as of June 30, 2007, the scheduled amortization of net deferred losses on terminated commodity hedges that will be recognized as decreases to the Company's future oil and gas revenues:

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total
	(in thousands)				
2007 net deferred hedge losses			$ 37,986	$ 36,567	$ 74,553
2008 net deferred hedge losses	$ 26,899	$			