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COP - Q2 2016 ConocoPhillips Earnings Call

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OVERVIEW:

COP reported 2Q16 adjusted net loss of roughly \$1b or \$0.79 per share.



CORPORATE PARTICIPANTS

Ellen DeSanctis *ConocoPhillips - VP, IR & Communications*

Ryan Lance *ConocoPhillips - Chairman and CEO*

Don Walette *ConocoPhillips - EVP Finance & Commercial, CFO*

Al Hirshberg *ConocoPhillips - EVP Production, Drilling & Projects*

CONFERENCE CALL PARTICIPANTS

Paul Cheng *Barclays Capital - Analyst*

Doug Leggate *BofA Merrill Lynch - Analyst*

Pavel Molchanov *Raymond James & Associates, Inc. - Analyst*

Ryan Todd *Deutsche Bank - Analyst*

Phil Gresh *JPMorgan - Analyst*

Guy Baber *Simmons & Company International - Analyst*

Roger Read *Wells Fargo Securities, LLC - Analyst*

Alastair Syme *Citigroup - Analyst*

Neil Mehta *Goldman Sachs - Analyst*

Blake Fernandez *Scotia Howard Weil, Inc. - Analyst*

Ed Westlake *Credit Suisse - Analyst*

Paul Sankey *Wolfe Research - Analyst*

James Sullivan *Alembic Global Advisors - Analyst*

PRESENTATION

Operator

Welcome to the second-quarter 2016 ConocoPhillips earnings conference call. My name is Christine, and I will be your operator for today's call. (Operator Instructions) Please note that this conference is being recorded.

I will now turn the call over to Ellen DeSanctis, VP, Investor Relations and Communications, ConocoPhillips. You may begin.

Ellen DeSanctis - *ConocoPhillips - VP, IR & Communications*

Thanks, Christine, and good morning to everyone. Welcome to the second-quarter earnings call.

With me today are Ryan Lance, our Chairman and CEO; Don Walette, our EVP of Finance, Commercial and our Chief Financial Officer; and Al Hirshberg, our EVP of Production, Drilling and Projects.

Our cautionary statement is shown on page 2 of our presentation. We'll make some forward-looking statements on today's call that refer to estimates and plans. Actual results could differ due to the factors noted on this slide and in our SEC filings.

We may also refer to some non-GAAP financial measures, which help facilitate comparisons across periods and with peers. For any non-GAAP measures we use, a reconciliation to the nearest corresponding GAAP measure can be found on our website.



So with those administrative details out of the way, it's my pleasure to turn the call over to Ryan.

Ryan Lance - ConocoPhillips - Chairman and CEO

Thanks, Ellen, and good morning. I'll begin on slide 4. This is a recap of our 2Q results, and Don and Al will provide more detail in a moment.

But the key messages are we delivered strong operational performance; our financial performance is improving; and we're making progress strategically to position ourselves for a world of lower and more volatile prices. Let me quickly go through this slide.

Production grew year-over-year by 3%. Our second-quarter performance exceeded guidance despite a busy season of turnarounds and over a month of downtime at Surmont due to the wildfires.

Based on our strong year-to-date performance, we're raising the midpoint of our 2016 production guidance by 2%. We're also lowering our 2016 capex from \$5.7 billion to \$5.5 billion based on efficiency improvements really across all business lines.

Our major projects across our portfolio are on track for startup as planned. And Al will talk about these projects in more detail.

Our financial performance was challenged, like the rest of industry, but did improve sequentially in line with prices. Three of five of our producing segments were profitable this quarter, and I think this highlights the benefits of having high-quality legacy assets in our portfolio.

Cash flows were in line with expectations, and we ended the quarter with over \$4 billion of cash and short-term investments on hand. We're continuing to make progress on our asset sale program and expect to achieve our goal of about \$1 billion of proceeds this year.

We reduced debt by \$800 million in the second quarter, so we're making progress on improving our balance sheet.

On the strategic front, we continued our phased exit of deepwater exploration. We signed an agreement to sell our position in Senegal in July and expensed our remaining deepwater position in the Gibson and Tiber wells in the Gulf of Mexico, and we drilled a successful appraisal well at Shenandoah.

Our adjusted operating costs continue to improve across the business, and we are lowering our full-year guidance there as well. This will create additional cash flow momentum as prices improve.

And finally, we continue to spend a lot of time analyzing the macro outlook and the choices we have for allocating cash flows through the business cycles. This is an important aspect of our value proposition and very much on the minds of investors.

We have set priorities and targets that will guide our allocation decisions. By following these priorities, we can create value as prices recover and through future price cycles. So before I turn it over to Don and Al, I want to step through our allocation priorities and targets on the next slide.

The way to create value in this business is through disciplined capital allocation. On last quarter's call, I had outlined the principles of our capital allocation approach, which are shown on the left side of this slide.

As a reminder, they were that the dividend will remain a core part of our offering and we're targeting real annual growth in that dividend. Another principle is to maintain a strong balance sheet; the recent downturn has emphasized the importance of this principle. For us, that means having debt of less than \$25 billion.

And finally, we'll focus on disciplined growth, where per-share growth will compete with absolute growth. We have positioned the company to compete on returns; so while we have a large, low cost of supply portfolio, we'll be disciplined about allocating cash to volume growth.



Now, establishing these principles was an important first step in articulating our value proposition, especially coming out of the downturn. But we also wanted to set priorities and targets that will guide our incremental allocation decision, and these are shown on the right-hand side of this slide. Let me step through them.

The first use of cash is to pay our existing dividend and invest capital to maintain our production base. Now, let me be clear that flat production is not our goal; but at a minimum we want to sustain our existing production.

Because of our low decline base production, we can keep production flat for over a decade with capex of \$5 billion to \$6 billion. We believe our capital intensity is now one of the lowest among our competitors, and that's a real advantage.

After our cash from operations exceeds the level required to cover our dividend and capex for flat volumes, the next use of cash will be to grow our quarterly dividend -- our dividend annually at a real rate. We think this is a prudent and sustainable target.

Our next priority is to reduce our debt to below \$25 billion. Our target is to reduce debt as it matures, but we might accelerate some of that reduction with asset sales. Our target is to have an A-rated balance sheet, which we think is a competitive advantage.

Next we have a target to achieve 20% to 30% total shareholder payout of cash flow from operations through a combination of our ordinary dividend and flexible share repurchases. We don't believe our ordinary dividend represents enough return of capital to shareholders through the cycles for a company our size and maturity; so when we have available cash flows we expect to return additional capital through share buybacks.

We believe this will be a differential aspect of our offering. It will also force discipline on the system while giving us a more flexible means of returning capital to our owners.

And our final priority of cash flows will be to invest in our large, low cost of supply captured resource base. We'll allocate capital to the lowest cost of supply opportunities while maintaining an appropriate balance between short- and medium-cycle programs; and we have that inventory to grow.

So what I've laid out should give you a clear sense of how we plan to create value through disciplined capital allocation. You should not think of our priorities and targets as a precise formula, but rather as a relative ranking of the choices we can exercise through the cycles.

In some parts of the cycles we can envision pulling on all these levers; at other times, we may be hunkered down. But in all parts of the cycle we'll be disciplined.

So let me stop here. We'll have some more time for your questions on this call. We'll also provide a lot more detail on our strategy at our Analyst and Investor Meeting in November. But what you should take away from my comments is that we know where we're headed and we have a strategy that is distinctive and will differentiate ConocoPhillips from our competitors.

So let me turn it over to Don for a few comments on our financial results.

Don Wallete - *ConocoPhillips - EVP Finance & Commercial, CFO*

Thanks, Ryan. I'll provide a quick overview of the second-quarter financials, starting with adjusted earnings on slide 7. The business is performing well operationally, and we grew production 3%; but the low commodity price environment continues to impact financial results.

For the second quarter, with an average realized price of around \$28 per BOE, we reported an adjusted net loss of roughly \$1 billion or \$0.79 per share. A couple of items to note that negatively impacted earnings in the quarter.

We expensed our remaining position in the Keathley Canyon area of the deepwater Gulf of Mexico and, with respect to adjusted earnings, recognized the Gibson and Tiber wells as dry holes. We also saw higher DD&A in the quarter, and we are increasing our guidance for the year from \$8.5 billion

to \$9.2 billion. This increase is due in part to stronger production performance, but it's also related to an increase in the DD&A rate, primarily a result of price-related reserve revisions.

We continue to reduce costs across the business and achieved an 18% reduction in adjusted operating costs compared to the year-ago quarter.

Second-quarter adjusted earnings by segment are shown in the lower right side of the slide. While Lower 48 was impacted sequentially by higher DD&A and dry hole expenses, the remaining segments are roughly in line with expectations. As a reminder, the supplemental data on our website provides additional financial detail.

Turning to slide 8, I'll cover production. Our second-quarter production averaged 1.546 million BOE per day, which exceeded our guidance despite the wildfires in Canada. Last year's second-quarter volumes were 1.595 million BOE per day, or 1.523 million when adjusted for dispositions.

Adjusting for the impact of incremental downtime, production increased by 46,000 BOE a day, representing 3% growth year-over-year. Increases in LNG and liquids volumes were partially offset by lower natural gas volumes, mostly in North America. This gets you to our 1.546 million BOE per day production for the quarter.

If you turn now to slide 9 I'll cover the cash flow waterfall for the first half of the year. We started the year with \$2.4 billion in cash and have generated \$1.9 billion from operating activities, excluding operating working capital changes.

Total working capital was a use of cash of \$600 million in the first half of the year. This was largely driven by reduced capital spending and lower decommissioning activity in Europe. Since we don't expect a significant reversal of our spending trends for the remainder of 2016, we believe working capital will be a use of cash for the full year.

Proceeds from asset sales, mostly North America gas properties, were \$400 million in the first half.

Through the first six months, debt increased by \$3.8 billion. This reflects the \$4.6 billion of debt raised in the first quarter, offset by \$800 million of commercial paper retired in the second quarter.

Capital spending for the first half of the year was \$3 billion. After dividend payments of \$600 million and some other small items, we ended June with \$4.2 billion in cash and short-term investments.

Now I'll turn it over to AI to run through our operational performance.

AI Hirshberg - *ConocoPhillips - EVP Production, Drilling & Projects*

Thanks, Don. I'll go through our operations by segment and then provide a brief overview of what's left to watch for in the second half of the year, and then we can take your questions. If you turn to slide 11, I'll start with the Lower 48 and Canada segments.

In the Lower 48 our production in the second quarter was 503 thousand barrels per day. Once you adjust for asset sales, that's an underlying decrease of 17 thousand barrels a day compared to this time last year.

The unconventional produced 262 thousand barrels per day, or down 4% from second quarter of 2015. That's better performance than we had expected, driven primarily by better well performance in the Eagle Ford and the Bakken, but also by the lag effects from our ramp down in rig activity. Now that we're running with three rigs, we expect decline in the unconventional to steepen somewhat in the second half of the year.

In the Gulf of Mexico, we saw successful results at the latest Shenandoah 5 appraisal well, which encountered over 1,000 feet of net pay.

Moving to Canada, our production was 279 thousand barrels per day. Adjusted for dispositions, we saw growth compared to the second quarter of last year, even including the wildfire impacts at Surmont. That's the result of ongoing ramp-up of our oil sands projects which provided a 16%



increase in bitumen production compared to this time last year. We expect growth to continue as Surmont 2 ramps up to full capacity through 2017 and we bring additional phases online at FCCL. We also achieved first production with the commissioning of the Foster Creek Phase G during the second quarter, and we're progressing toward first production at Christina Lake Phase F.

Moving to slide 12 I'll cover the Alaska and Europe & North Africa segments. In Alaska we saw growth compared to the same time last year, with second-quarter production of 179 thousand barrels per day. This came from ongoing strong production at CD5 and Drill Site 2S.

In the quarter, we also approved an expansion phase of CD5, which will add an additional 16 wells and bring CD5 to its full design capacity. We have significant turnaround activity planned in Alaska for the third quarter at both Kugaruk and Alpine. And finally, we completed the sale of our Beluga River asset in the Cook Inlet during the quarter.

In Europe & North Africa, production of 187 thousand barrels per day was down 20,000 barrels per day compared to the same period last year. That decrease is primarily the result of increased turnaround activity in this year's second quarter.

In the UK, at Clair Ridge the drilling and production modules were successfully installed, and progress is also continuing at Alder where we expect to achieve first production in the fourth quarter.

Moving to slide 13, I'll cover the Asia Pacific & Middle East and Other International segments. In APME, production was 398 thousand barrels per day, up 14% year-over-year.

The increase was primarily due to the ongoing ramp up at APLNG. Train 1 is continuing to run ahead of expectations, with 27 cargoes loaded in the first half of the year, including our first cargo to Kansai Electric in Japan. We're on track to deliver the first cargo from Train 2 in the fourth quarter of 2016.

In Malaysia, Gumusut is continuing to produce at a high level, and third-party pipeline commissioning is underway at KBB, so we're beginning to see increased production volumes there as well.

The sailaway of the Malikai TLP was completed this month with startup expected next year.

In the Other International segment the key milestone was signing the SPA for the sale of our exploration blocks in Senegal in July. This sale is expected to generate proceeds of \$400 million to \$450 million.

If you turn to slide 14, I'll provide a few comments about our outlook for the rest of the year. As Ryan and Don mentioned, the business has performed well through the first half of the year. We're updating our full-year production guidance to 1.54 million to 1.57 million barrels per day; that's an increase of 35 thousand barrels per day or about 2% over prior guidance, while at the same time we're lowering both our capital and our operating cost guidance.

For the third quarter, we expect production to be between 1.51 million and 1.55 million barrels per day, which reflects ongoing turnaround activity in Europe and Alaska.

Our project activity is on track. We're continuing to ramp up at our Surmont and FCCL projects and are progressing several other projects in Alaska, Europe and Asia Pacific.

We expect to complete our Senegal sale before the end of the year, and we're continuing to market our remaining deepwater exploration positions in Eastern Canada and the Gulf of Mexico.

Then finally, just a reminder that we will host our 2016 Analyst and Investor Meeting in New York on November 10. At that meeting we'll provide more details on our cash flow priorities, our low cost of supply portfolio, and our future investment plans. So we look forward to seeing all of you at that update.



And now I'll turn it over for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Paul Cheng, Barclays.

Paul Cheng - Barclays Capital - Analyst

Hey, guys. Good morning -- actually, good afternoon. Well, anyway, Ryan, just curious. Your partner in Canada was saying that they are ready to restart Christina Lake. Given that your portfolio is different than theirs, is there any maybe scheduling differences in opinion between you and your partner?

Ryan Lance - ConocoPhillips - Chairman and CEO

Scheduling what? Scheduling differences, Paul?

Paul Cheng - Barclays Capital - Analyst

Yes, in terms of the expectation, given that I think the first set of assets that you're going to go back and reinvest, I don't believe is going to be oil sands; I presume that is going to be in Eagle Ford and Bakken and Permian. So how is that we reconcile there?

Ryan Lance - ConocoPhillips - Chairman and CEO

Yes. No, well, we spend quite a bit of time with our partner up in Canada talking about our plans. We've been fairly well aligned in terms of what the performance and the opportunity set looks like.

I'm aware they've -- some of their comments are wanting to ramp up some of their spending, get back to work on some of the projects with increased oil prices. But we've got that accommodated in our plans as well, and we work really close with them to make sure that we're doing the right things and that the projects make sense economically and have a competitive cost of supply.

Paul Cheng - Barclays Capital - Analyst

Okay. Just a real quick one for me. Maybe do you have a production number for Eagle Ford, Bakken, and Permian in the second quarter?

Al Hirshberg - ConocoPhillips - EVP Production, Drilling & Projects

Yes, I can quote you those numbers. It's actually -- production is actually up in the Eagle Ford versus -- from the first quarter to the second quarter.

Ellen DeSanctis - ConocoPhillips - VP, IR & Communications

I've got them here if you want.



Al Hirshberg - *ConocoPhillips - EVP Production, Drilling & Projects*

So you asked the same question in the first quarter about Eagle Ford, and we were at 168 thousand; we're up to 171 thousand in the second quarter. Bakken was 65 thousand in the first quarter; 64 thousand in the second quarter.

So, actually if you add Eagle Ford and Bakken together, we're up a few thousand barrels a day in the second quarter versus the first quarter.

Paul Cheng - *Barclays Capital - Analyst*

Okay. Very good. Thank you.

Operator

Doug Leggate, Bank of America Merrill Lynch.

Doug Leggate - *BofA Merrill Lynch - Analyst*

Thanks. Good morning, everybody. I think it's still morning, isn't it? So, Ryan, I think -- is it slide number 5? The 20% to 30% cash flow shareholder payout, I think that's a new number on the slide deck this quarter. I just wanted to get clarifications to make sure we're interpreting this properly. That includes the dividend, I assume?

Ryan Lance - *ConocoPhillips - Chairman and CEO*

Yes, it does.

Doug Leggate - *BofA Merrill Lynch - Analyst*

Okay, so basically can you just remind -- on that basis then, can you just give us some idea as to what kind of thresholds you are thinking about? Because I imagine \$70 oil, that would imply a much bigger number than obviously \$50 oil.

So can you give us some idea? Is it a limit to the level that you would put on that, or should we just take that as a blanket guidance going forward?

Ryan Lance - *ConocoPhillips - Chairman and CEO*

Well, Doug, I think the way to think about that is we recognize that, as prices recover, that the dividend payout that we have today doesn't represent probably enough return to shareholders in a recovered price scenario where we're starting to free cash flow above our requirements of the current dividend and to keep our production flat at a minimum. So we recognize that as prices recover that's not enough payout to the shareholders.

Even when we spun the company we were talking about these kinds of payout levels. We were doing that with just the ordinary dividend at the time.

So we set a pretty broad range, 20% to 30%, and clearly we'll take a look at that as the circumstances warrant. And then compare really -- as you get down to those fourth and fifth priorities, it's about what kind of investments do we have that the shareholders would want us to be making in the portfolio? What kind of returns do they have? What kind of cost of supply do they have?

And how does that compare to where our stock is trading at the time and the value that we see in the shares? And compare those two and make those decisions as we go down the road.



Doug Leggate - *BofA Merrill Lynch - Analyst*

Okay. Thanks for that. My follow-up is related, I guess. It's a clarification on your debt targets, because again number three on that list is pay down debt. You're already at a net debt number below \$25 billion and you're talking about paying debt as it matures.

So are you now at the debt level you're comfortable with? Or do you still want the absolute debt to be below \$25 billion? And I'll leave it there. Thanks.

Don Wallete - *ConocoPhillips - EVP Finance & Commercial, CFO*

Yes, Doug; no. This is Don. We wanted to be real clear.

We talk about balance sheet debt. We could be talking about net debt, too, but we didn't want there to be any ambiguity.

What we're looking at is balance sheet debt that at the end of the first quarter was approaching \$30 billion or so, and that's when we set our target and said we want to bring that down to a number less than \$25 billion.

Doug Leggate - *BofA Merrill Lynch - Analyst*

Okay. But Don, to be clear, if you are paying maturities as they come due, I assume that's from cash on the balance sheet. So isn't that essentially a net debt number?

Don Wallete - *ConocoPhillips - EVP Finance & Commercial, CFO*

Well, we'll see how the macro environment turns out, but we would hope that that would come not just from cash on the balance sheet but also from organic cash flow.

Operator

Pavel Molchanov, Raymond James.

Pavel Molchanov - *Raymond James & Associates, Inc. - Analyst*

Thanks for taking the question, guys. You've clearly had a lot of success ramping at APLNG. Is there a point with Train 1 or getting into Train 2 where the project in aggregate begins to be a net cash generator?

Al Hirshberg - *ConocoPhillips - EVP Production, Drilling & Projects*

Yes, this is Al; I'll take that one. As we -- we're still spending a lot of capital in on construction on Train 2, of course; but once both trains have ramped up the project, if you include even the financing, the cost of that, throws off cash when you get to around a \$45 barrel kind of number.

Pavel Molchanov - *Raymond James & Associates, Inc. - Analyst*

\$45 barrel at JCC?



Al Hirshberg - *ConocoPhillips - EVP Production, Drilling & Projects*

Yes.

Pavel Molchanov - *Raymond James & Associates, Inc. - Analyst*

Pricing? Okay. Just second quick one on the Senegal sale. Woodside threw out some numbers on the underlying resource. Were any of those included in your proved reserves at last year-end?

Al Hirshberg - *ConocoPhillips - EVP Production, Drilling & Projects*

No. That's a recent discovery that's a long way from any kind of proved reserves. Our proved reserves for Senegal on our books would be zero.

Pavel Molchanov - *Raymond James & Associates, Inc. - Analyst*

Okay. Appreciate it, guys.

Operator

Ryan Todd, Deutsche Bank.

Ryan Todd - *Deutsche Bank - Analyst*

Great, thanks. Good result, gentlemen. Maybe if I could talk about your free cash flow generation a little bit, we see you guys -- you were near free cash flow breakeven even at \$45 a barrel in the quarter here in 2016, which is probably a little ahead of what our anticipated pace was, in terms of you guys getting there in the medium term.

Are you ahead of pace on cost reduction and cost structure optimization? And could you talk about maybe continuing momentum that you have in that regard going forward and the potential to dip below your potential \$45 a barrel target in terms of covering capex and dividends?

Al Hirshberg - *ConocoPhillips - EVP Production, Drilling & Projects*

Yes, Ryan, I think we've really got -- in terms of the progress there we've got three things all working in our favor. We're higher on volumes; we're lower on capex; and we're lower on opex. So all those things are moving in the right direction to help drive down our breakeven cost of capital.

We've trimmed back our guidance on capex and opex to reflect that. But we continue to make a lot of progress there. I can go into the details more if you want, but really that's the big-picture answer, that all three of those things are driving us in the right direction.

Ryan Lance - *ConocoPhillips - Chairman and CEO*

And, Ryan, we're not satisfied with where the numbers are at today, and we've got a lot of effort to continue to drive them down to get the same scope done for less capital and less cost as well. Because we've got to continue to attack that breakeven and make sure we get the breakeven for the company down as low as we possibly can and be as competitive as we can.

Because we believe this world of low and a lot of volatility in prices is here to stay. So we've got to thrive in the down cycle.



Ryan Todd - *Deutsche Bank - Analyst*

Great, thanks. Maybe as a follow-up to that question, there seems to be a common concern amongst at least part of the market in terms of your confidence and your ability to deliver on the medium-term outlook, in terms of your ability to sustain volumes longer-term at the stated levels of capital spend or the capital intensity that you mentioned in your comments.

Can you maybe talk a little bit about how you think your portfolio has evolved over the years and how it's positioned to sustain that free cash flow generation? And is there maybe some additional granularity on the portfolio that you might be able to provide going forward that could help increase investor confidence in this?

Al Hirshberg - *ConocoPhillips - EVP Production, Drilling & Projects*

Yes. You've heard a lot from us over the last few years about the shift that we've had from mega-projects, longer cycle to shorter cycle, more flexible investment; that's really standing us in good stead now. But if you just look at our near-term performance on volumes, take -- start out with second-quarter volumes: we beat the midpoint of our guidance by 26,000 barrels a day and were even above the high end of our range. And that was despite being -- having about a negative 15,000 at Surmont due to the wildfires.

So you can see there that there are a lot of parts of our business that are really performing well. And the single biggest area that drove that outperformance on volumes was the Lower 48 unconventional, as you could see from some of the numbers we were quoting to Paul's question earlier.

The decline, even running just three rigs in the Lower 48, we're seeing better performance on the volume side and on the cost side in our Lower 48 unconventional. So that's a key driver.

Then as you look toward the end of the year at the strong momentum that we're going to have on volumes, we'll have Alder starting up, APLNG Train 2, Surmont 2 will be continuing to ramp, KBB volumes are moving up, FCCL. So we have a lot of different projects that will be adding volumes that give us a lot of confidence that we can continue to drive that volume performance of at least flat -- or even growth if we want to -- at these lower kind of capital levels that we've been talking about.

And of course, we're going to show you a lot more detail on that in November at our Analyst Day.

Ryan Todd - *Deutsche Bank - Analyst*

Great. Thanks.

Operator

Phil Gresh, JPMorgan.

Phil Gresh - *JPMorgan - Analyst*

Hi, there. Good afternoon. The first question is just a follow-up to Doug's question on the leverage level, the \$25 billion target. You have \$1.250 billion coming due in the third quarter, \$1 billion in 2017. You talked about maybe accelerating some paydowns if you have asset sales.

But I guess it would seem to imply that the \$25 billion target on a gross basis wouldn't be reached until maybe late 2017, perhaps. But I'm guessing you are probably thinking faster than that, based on the cash you might have coming in and the cash on the balance sheet.

So maybe you could just clarify that for us in terms of when you think you can reach that target.

Ryan Lance - *ConocoPhillips - Chairman and CEO*

Yes, Phil, we thought it was important to throw out an absolute gross target of debt, so Don talked about below \$25 billion. And then we've been -- I think some of the questions we've had since that time is saying: Well, you're not going to do anything else until you get to that point, so you're going to spend all those \$4 billion required to get from \$29 billion down to \$25 billion, will be at the expense of everything else.

What we wanted to try to tell folks is we feel comfortable with paying off the debt as it matures with the cash flow. So as we get some recovery in price and we're generating cash flow above what it takes to hold production flat and pay the dividend, we'll go ahead and put that to the balance sheet. But we're not going to spend \$4 billion before we do anything else, because we think we can get there over time, over the next couple of years, as you say, with the natural maturities that we have on the balance sheet.

And then -- and we know that we want to get back into the market with some asset sales when the market starts recovering. So we know that we'll be selling some more of our noncore assets, and we'll always have that to help us accelerate that debt repayment.

But the main message: it's manageable; we think we have a plan; we can get there with just through the natural maturities, and we can get to a point that we think is solidly investment grade in the A credit rated band.

Phil Gresh - *JPMorgan - Analyst*

Got it. Okay, so you're comfortable with the next couple years. Okay.

The question second question was just on the production beat. I believe maybe it was earlier this year you gave outlooks for each region from a production standpoint. I think Lower 48 at the time was down 3% or so, if I have my numbers right.

Maybe you could just give us your revised thoughts on the production outlook for different regions. It sounds like Lower 48 is the key driver of the beat and raise.

Al Hirshberg - *ConocoPhillips - EVP Production, Drilling & Projects*

I think the biggest change in our production outlook -- when we were -- when I was asked on the first-quarter call with coming down to three rigs and holding that three-rig level for the rest of the year, how much did we think our Lower 48 unconventional would decline on the year and my answer was 10%. At that time it looked -- our projection was we would drop about 10% in our Lower 48 unconventional.

With this update and with the performance we've had in the second quarter, that number has been cut roughly in half. About 6% now is what we think we'll be down in Lower 48 unconventional.

So that's a big change, holding that same flat three-rig rate. We've also got some improved production in Europe and in Malaysia.

So really if you think about it, those are all above-average margin barrels for us. So that's part of the other good news in our production beat, is that it's coming from places where we have higher-margin barrels.

Phil Gresh - *JPMorgan - Analyst*

Got it; that's helpful. Thanks.

Operator

Guy Baber, Simmons & Company.

Guy Baber - *Simmons & Company International - Analyst*

Thanks, everybody, for taking my question. Ryan, you mentioned you have one of the lowest capital intensity portfolios. I wanted to just explore that a little bit more and follow up on the earlier question. But at \$5 billion to \$6 billion you've noted you can keep your production profile flat. I believe that translates to capex on a per-barrel basis in the low teens.

Is that the type of F&D you believe you can achieve with your current portfolio? And can you talk about what gives you that confidence?

I'm really trying to understand if the \$5 billion to \$6 billion of spend cannot only hold production flat but also replace your reserves. Or if you're comfortable drawing down your proved reserve life to a certain extent, given the strength of your resource base.

Ryan Lance - *ConocoPhillips - Chairman and CEO*

Yes, there's quite a lot in that, Guy. Let me just start at your first question. Yes, we have a lot of confidence. As I said in my remarks, \$5 billion to \$6 billion of capital, at today's inflationary rates and what's going on in the market today, we can see with our portfolio a decade of flat production at that kind of level. So with the opportunities that we have to invest in the portfolio, even at the lower capital level, yes, we're pretty clear about what we can do over a long period of time at that level.

And a lot of that's driven by the fact that after we get APLNG up and running, second train, and we get Surmont 2 ramped up, we've got 500 thousand -- we've got a third of our production base that's virtually no decline for the next 20 years. I think that's what's unique about our company, and that's what helps us drive down this maintenance capital level or this capital to hold our production flat to the kind of level that we're seeing.

Now as that translates to F&D it's a little bit tougher question, because now you bring in the vagaries of reserves and bookings and all that kind of stuff. And that gets to be a little bit more tougher question.

But generally you're right: it has to drive F&D down from where we've been at over the last few years. But in our portfolio, we do have a pretty high R to P, so we are willing to let that moderate some, because the bookings will not necessarily exactly follow the capital as we go forward.

So reserve bookings end up being lumpy. But over time, over three- and five-year periods, yes, the F&D should follow. And as you are starting to book all the resources that you're developing, typically in the unconventional -- even in the Eagle Ford we're booked to a small percentage of what we think the total resource potential will ultimately be out of Eagle Ford.

So F&D is lumpy, but generally over time it should happen. But there is probably some drift in R to P.

Guy Baber - *Simmons & Company International - Analyst*

That's very helpful. Thank you. Then my follow-up is, as capex continues to be revised lower here, I just want to make sure that we stay on top of the latest view in terms of the level and the amount of longer-cycle committed capex that rolls off the books from 2016 to 2017. I think you previously talked about \$1.5 billion or so. Is that still the case?

Al Hirshberg - *ConocoPhillips - EVP Production, Drilling & Projects*

Yes, that story hasn't changed much from last quarter where, you're right, we were talking about \$1.5 billion. Remember that about \$1 billion of that was from APLNG and FCCL joint ventures and about \$0.5 billion from deepwater roll off.

The APLNG both because of a bit lower spending and a bit higher revenues, because the Train 1 is running above expectations, is using a little less. So that it may -- the \$1.5 billion may be down a tenth or so, but it's still in that same kind of range.

And that roll off does provide room for us should we choose to increase rigs in the Lower 48 next year. That roll off money is where some of that can come from and still keep us down at these same capital levels next year.

Some of that money will also be used with some of our medium-cycle-size projects that are in a phase of execution, where some of their capex is going up from 2016 to 2017.

Guy Baber - *Simmons & Company International - Analyst*

Thank you very much.

Operator

Roger Read, Wells Fargo.

Roger Read - *Wells Fargo Securities, LLC - Analyst*

Thank you. Good morning. I guess two questions I have. One is you described the decline in the opex; can you give us an idea what you see as sustainable there? Or are there further goals to reduce it?

Just trying to get an idea how much of that is internal and how much of that might be external as activity recovers, prices go up, and some of those costs have to go up.

Al Hirshberg - *ConocoPhillips - EVP Production, Drilling & Projects*

Yes, good question, Roger. I think you've seen us continue to drive our opex down. I think our organization has really continued to outperform versus the targets that we've set.

We just remind ourselves, we're down \$1.2 billion of opex with this new \$6.8 billion target versus where we were last year. That's 15% from last year.

And we're down \$2.9 billion from 2014, 30%. So we've driven our operating costs down about 30% from this year versus 2014.

But we're not done. We've got a lot of very firm plans and work that's been underway this year to continue driving those costs down next year substantially. So we'll do the reveal on that at the November Analyst Day, but there's more to come on our operating costs.

And of course, the second part of your question, we are very focused on trying to do this in a sustainable way with structural cost reductions and not just the cyclical deflation. Of course the deflation is a piece of this, and we're trying to hang on to that, get as much of that as we can along the way and hang onto it for as long as we can.



But we recognize that there will be reflation if prices ever come back one day and we'll give some of that back. But we're dominated here by the structural side and real significant changes we've made in the way we're running our business.

Roger Read - *Wells Fargo Securities, LLC - Analyst*

Okay, thanks. That's helpful. Then a cash flow question here. As we looked at the data that came through on the spreadsheet, saw a big hit on the deferred taxes side. I just was hoping to get maybe a little bit of a feel for what that is; and then maybe an idea of how to think about cash taxes when prices do recover and the company is generating profitability again.

Don Wallete - *ConocoPhillips - EVP Finance & Commercial, CFO*

Yes, Roger; this is Don. Yes, we continue to see deferred taxes as a use of cash, being in a non-taxpaying position in several of the key jurisdictions that we're in. I think that probably the way to think about it going forward is that we take a look at the price decks that the analyst community is using, and I think that on the basis of those it's really unlikely that we're going to be in a taxpaying position in North America and in the US and Canada for probably the next two or three years, at least, under those types of price environments.

So it's going to be a while before that deferred tax flips from a use to a source.

Roger Read - *Wells Fargo Securities, LLC - Analyst*

Okay, thank you.

Operator

Alastair Syme, Citi.

Alastair Syme - *Citigroup - Analyst*

Hi, thanks for taking the question. Really had the question back on Senegal, you look at the equity performance of some of the partners in the asset, and it did suggest the market, so the sales price, is fairly low. Can you maybe comment on that and why you think the deal was done?

Ryan Lance - *ConocoPhillips - Chairman and CEO*

We think we got fair value for the asset, based on our assessment of the resource and the cost to develop it.

Alastair Syme - *Citigroup - Analyst*

As a follow-up, can you maybe talk about where you're at regarding the rest of the asset sales and, again, what the environment is like for those sort of transactions? Specifically referring to the deepwater.

Ryan Lance - *ConocoPhillips - Chairman and CEO*

Yes. No -- so we've been told -- telegraphing that we think we're on track for \$1 billion of asset sales this year and we're on track to do that. So we'll deliver that.

We've said we've taken a number of producing oily assets off the market because we just don't think the market is there for a fair value with respect to that. So we're not going to sell assets into that kind of a headwind.

We have done some North American dry gas assets, and we continue to look at those in the portfolio and see if we can get what we believe is a fair value relative to how we view the assets.

That's certainly what we felt like with the Senegal transaction. And specifically on the deepwater, we've signaled to you what we think about Keathley Canyon is there's something there, but the development probably is smaller and it doesn't compete for capital in our portfolio. So we'll be looking at what we can do about that particular area going forward as well.

Senegal, we'll look at it -- I mean Shenandoah. We've had a successful appraisal well there, so we're really encouraged about what that looks like.

We'll think about putting that back on the market as well. But again if the market's not there for what we think is full value, we'll continue to be a part of that development.

Alastair Syme - Citigroup - Analyst

Okay. Thank you very much.

Operator

Neil Mehta, Goldman Sachs.

Neil Mehta - Goldman Sachs - Analyst

Good morning, good afternoon, guys. Want to ask a couple high-level questions and, Ryan, it goes back to your slide of the unique value proposition. I know one of the pushbacks that you often get from investors is that Conoco is kind of stuck in the middle; for some who look at you as a major, they'll say you have a low yield, and for some that are looking at you as an E&P, they'll be more focused on growth.

Is the message on that slide and going into the Analyst Day that the most powerful differentiating factor is the free cash flow? Is that what you see as that most powerful, unique value proposition point?

Ryan Lance - ConocoPhillips - Chairman and CEO

Well, I think that the leverage to the price has a point there where we can start to generate free cash flow with modest increases in the prices. And we've tried to tell you what we're going to do with that free cash flow.

And a big -- certainly a prevalent piece of that is a recognition that we need to return more to the shareholders as prices start to recover relative to where the ordinary dividend is. But I'd tell you, Neil, I think there's a lot of differentiating factors in the portfolio.

The maintenance capital to keep flat production, the quality of the investment cases that we have, the low cost of supply we have in the portfolio: we'll show you that in quite a lot of detail in November. But I think there's space in this E&P world for a company like ours that is focused on returns.

We know, given our size, that we can't compete against the growth of the pure-play smaller growth companies. But we're going into a world of lower and high volatile prices. And having some predictability -- which I think we've shown through the execution since we spun the company -- we've delivered on everything we've said.

We know how to run the company. We know how to run this business. We know what we're doing.

And as we think about that, there's space in the E&P space for a company that is differential on returns and that can be more predictable through the cycles, and do that both on the low and the upper end. Finally, ever since we spun the company we've been saying that we'll give returns back to our shareholders right off the top, and that's what we're trying to tell you here is an important part of our offering, the 20%- 30% we recognize needs to go to the shareholder with great discipline within the Company.

And that, combined with our flexible investments and what the portfolio looks like, we think will differentiate ourselves.

Neil Mehta - *Goldman Sachs - Analyst*

I appreciate that, Ryan. Just as a follow-up, I always appreciate your perspective on the oil macros. You operate in a lot of countries that we have less visibility on. You took, I think, a little bit more of a cautious view earlier this year, partly driving the dividend reduction.

Where do you see we are in the rebalancing process? And what do you think is the biggest upside and downside risk to the base case?

Ryan Lance - *ConocoPhillips - Chairman and CEO*

Yes, I think -- yes, we're concerned about it, Neil. I think the guys -- we've been talking and preaching for quite a bit of time we need to be prepared for lower prices and volatility. And I think we're in that, and we're seeing that in spades right now.

So in our outlook, our guys did predict that, yes, we would see refineries start to cut run rates, and we'd see gasoline inventories start to build. Because we were a little bit surprised to even see the crude oil inventory build in the last week like it did.

So we think we're in -- while the supply and demand are closely balanced, it doesn't take a lot of movement on either end to create the kind of volatility that we're seeing.

So as we think about it going forward, it's got to be really, really cautious as we go through 2016. It's going to take well into 2017 before we see any real increases in the price.

So we continue -- as Al said, we're battening down the hatches. We're focused on lowering the capital required to deliver the scope. And we're focused on reducing the cost and trying to get our breakeven down as low as it can possibly get, because we're going to be in this world for periods of time over the next year, year and a half.

Neil Mehta - *Goldman Sachs - Analyst*

Appreciate it, Ryan.

Operator

Blake Fernandez, Howard Weil.

Blake Fernandez - *Scotia Howard Weil, Inc. - Analyst*

Folks, good morning. Both of my questions are on slide 5, so maybe I can just ask them both. I'm really just trying to get a point of clarity here on number two, the annual dividend growth being a real dividend target, with inflation trending around, say, 1% or so. Is that to say that that's literally what you're trying to achieve is just maintaining pace with inflation? I don't mean to be pedantic with it, but I just wanted to clarify that.

And then the second piece is the 20% to 30% target on cash flow being paid out to shareholders. That's being put above growth capital. So is it fair to think that the buybacks are going to take priority over reinvesting? In other words, capex will remain at the \$5 billion to \$6 billion level until you've begun doing some buybacks? Thanks.

Ryan Lance - *ConocoPhillips - Chairman and CEO*

Yes, Blake, I guess a couple things on the dividend. We say targeting real annual returns; we're not trying to -- I'm not trying to put a percentage to it. I realize the inflation rate is quite low today, but what we're trying to say is we're not going to be trying to increase the dividend annually to get back to somewhere like we were before we cut the dividend.

So we're recognizing we went through the pain and the agony of the dividend decision to reset the fixed cost of the company at the lower end of the cycle. And we recognize as we go through the middle part of the trough into the upper end of the cycle, that's not enough return to the shareholders. So we're going to augment that with a variable distribution plan around share buyback.

And while we say a lot of the -- can you be counter-cyclic in that kind of world? We're going to look at that pretty judiciously. We'll have a view of commodity prices today and where we think they're going over the next few years. We'll look at how our shares are trading in the marketplace. And we'll make a decision on what the level of share buyback is.

Certainly at a minimum we'd like to offset the dilution that our stock programs to our employees provide. So that would set a floor on the share buyback.

But again I don't think there's bright lines between all of these. As I tried to say in my comments, as the prices start to recover, we can envision doing a little bit of everything.

We're going to be doing some share buyback, but we're also going to be investing in the portfolio as well. But certainly we view giving -- making sure that we hit the 20% to 30% return to our shareholders is an important hurdle for us to make before we start investing in the portfolio.

Blake Fernandez - *Scotia Howard Weil, Inc. - Analyst*

Got it. Thank you.

Operator

Ed Westlake, Credit Suisse.

Ed Westlake - *Credit Suisse - Analyst*

Yes. My first question is obviously congrats on the well recoveries driving the surprise in Lower 48 volumes. Obviously that's probably lowered the breakevens as well. So at the same time you've got global inventory positions still high.

Maybe talk a bit about where the breakevens are now in the core shale assets in North America and then what you'd need to see, maybe on the macro side or maybe just in terms of the well performance, to start to increase activity levels. Because it does feel as if you've got this following wind from your projects, so you don't necessarily have to rush.

Al Hirshberg - *ConocoPhillips - EVP Production, Drilling & Projects*

Yes, I think that's right. Our answer to that same question really hasn't changed from what we said on the first quarter, that we don't have some set price that's going to drive us out to add rigs in the Lower 48. We do have the volume momentum that I was talking about earlier and the better volume performance we're getting from just the rigs we're running.

But we're not going to get excited and rush out there and add rigs every time the price bumps up. The price since the last call, the last quarter's been up, it's been down. Did the same thing this time last year. So we're not on a hair trigger to go out and add rigs in that kind of situation, even though we do have a very high-quality opportunity set to invest in.

So I would say we're ready but we're patient. And when we do add rigs we're going to be very mindful about it. The macro situation will have to be solid, and we're going to have to have the right costs that we'll have to be able to make sure we get the right contracting to be able to go back at the cost level that we need to, to maintain that low cost of supply that we have from those assets.

Ed Westlake - *Credit Suisse - Analyst*

Some idea of where that breakeven has fallen, given the well performance improvements? Say Bakken and Eagle Ford.

Al Hirshberg - *ConocoPhillips - EVP Production, Drilling & Projects*

Those numbers are very low. That's really not what's driving us.

Those -- we could drill like crazy right now in both the Bakken and the Eagle Ford and make a lot of money at today's prices. Those have got cost of supplies down in the 30s.

But that's not really what's driving us. We don't want to go run out and add rigs too quickly before we get to a clear macro environment that's going to be supportive of that.

Ryan Lance - *ConocoPhillips - Chairman and CEO*

I would add, Ed, we all can show 40%, 50%, 70% internal rates of return on an incremental well. And we've all got that -- anybody that's got a large North American position has got that in their portfolio today. We've got it a-go-go; but as Al said, we're not going to drill into the face of \$40 headwinds.

It's not going anywhere. It just doesn't make any sense.

Ed Westlake - *Credit Suisse - Analyst*

My second question is maybe esoteric and maybe we'll have to leave it to the Analyst Day. But I don't know if you've done any work on just how large a noncore asset disposal program could be, if investors were still unhappy even with the \$25 billion debt target that you've laid out, if they felt that really the right gearing for a volatile oil market is actually lower than the gearing targets that you've laid out.

I presume there's lots of tax impacts on old assets and a whole load of things that you'd have to think about. But I'm just trying to get a sense of the size of the hopper that's available for disposals if you did want to reduce debt through that volatile period.



Ryan Lance - ConocoPhillips - Chairman and CEO

Yes, we'll probably speak to that more a little bit in November, Ed. We continue to watch the macro and continue to look at what competes for investment in the portfolio.

And then, as you say, there's other considerations. Can we get the value? Can we get the value we think we have with holding?

We know our assets really well. And we have a view on the macro, and we have a view what's full value being paid for the assets.

So we've demonstrated that we'll sell things that don't compete in the portfolio. We're going to continue to do that, and we'll provide you more in November.

Operator

Paul Sankey, Wolfe Research.

Paul Sankey - Wolfe Research - Analyst

Hi, everyone. You've got us in a little bit of a spin as to whether it's morning or afternoon here. But, hello.

Ryan Lance - ConocoPhillips - Chairman and CEO

Your option.

Paul Sankey - Wolfe Research - Analyst

Ryan, thinking of the November Analyst Meeting, it seems fairly clear to us that shareholders really want you to do what you're doing in terms of lowering costs and breakevens. But really commit to no growth and all buyback is an overriding strategy.

You're referencing it, but you're keeping the growth option open. Can you just talk a little bit about why you don't just go down the route that I believe -- and maybe I'm wrong -- most shareholders would prefer you to? Thank you.

Ryan Lance - ConocoPhillips - Chairman and CEO

Yes, thanks, Paul. We do get that question from you and maybe two others. It is -- that's a good way when we look at it. Again, we recognize that through an up cycle or through the -- as this commodity price recovers a little bit we'll start generating a fair amount of free cash flow. So what do we do with it? And how much of that should go to the shareholder and how much should go to the portfolio?

I'd say shareholders in the company -- and you know what our portfolio looks like; we'll show you more of that in November. And not only have we reduced the breakeven costs within the company, we've made some fairly substantial progress reducing the cost of supply in the portfolio within the company as well.

So when you look at those opportunities to invest in the portfolio that are going to move our returns, they're going to add margin and create more cash flow growth for the company, even at a flat, fairly low price deck, we think those are things that we ought to be investing at in the company.

And we've got to demonstrate that to you. We've got to show you, and that's our plan to go do that.



But I will say we're not trying to compete on growth. Investors have better -- they may have different places to go with their investment if that's what they want. We're going to show you why we can compete on returns; why that makes sense; yet we're not going to forget about the shareholder and make sure an appropriate amount is going to them off the top.

Paul Sankey - *Wolfe Research - Analyst*

Thank you, Ryan; that's reasonable. You guys are really helpful on the macro. Can you observe globally why decline rates haven't been as high, given your global portfolio? It would be just interesting to hear, given your own portfolio hasn't been declining as fast as we thought.

What's your perspective on what's going on, why we aren't seeing more declines than we anticipated? And I'll leave it there. Thank you.

Al Hirshberg - *ConocoPhillips - EVP Production, Drilling & Projects*

You know, I think that certainly if you look at US production we have seen a big decline. The US is off over 1 million barrels a day from the peak last year.

But I think that particularly in the unconventional, the surprise factor is that some people pronounced about a year ago that there was an asymptote coming and that technology had reached its end in the unconventional. And I think we're proving once again that that's not the case, that there's still more cost to be driven out and there's still more increased recoveries to be found through new ideas from new technologies.

So I think we've still got a long way to go there, and so you'll continue to see that.

In terms of the rest of the world, I think in our case there are some better reservoir performance that we've experienced in various places. We've had better facility performance in places like APLNG. We've had timing of a pipeline commission in KBB.

So it's been a variety of different things that have been -- driven the timing for us. But the main real performance surprise, the biggest single item for us is in the Lower 48 unconventional.

Ryan Lance - *ConocoPhillips - Chairman and CEO*

I would add, Paul, to that, internationally there's just a number of projects that have continued to come online that were funded in the last three to four years. And our experience is they are not lagging on schedule anymore. They're coming on, and they're coming on usually at better performance than what we were predicting.

We're seeing that in our portfolio, whether it's drilling in the UK or Norway, or projects in Malaysia. Or as Al said, Alaska; we're seeing better performance there.

And then APLNG, our train at APLNG and the rest of the trains, frankly, that are using our technology on Curtis Island are well outperforming their nameplate capacity and they are running really well. So we're seeing those pockets that are happening.

And it's a bit more of a lag in the international space. But the capital investment I think will catch up internationally. We're just seeing some of those projects come online.

Paul Sankey - *Wolfe Research - Analyst*

Thanks.



Ellen DeSanctis - *ConocoPhillips - VP, IR & Communications*

Thanks, Paul. Folks, we're at the top of the hour. We'll take one more question and then, by all means, feel free to follow up with IR after the fact. Christine, one more.

Operator

James Sullivan, Alembic Global Advisors.

James Sullivan - *Alembic Global Advisors - Analyst*

Hey. Good afternoon now decisively, guys. Just wanted to ask a question melding your view on the macro. And it's not another cut at the same question about growth and share buybacks, but do you guys have a threshold to materiality, given that we're not necessarily going to be looking at oodles of free cash flow necessarily, but maybe smaller tranches of free cash flow if we're at \$50 or \$55 in a year or two? Do you guys have a threshold of materiality for a shareholder buyback, or how do you think about that?

Ryan Lance - *ConocoPhillips - Chairman and CEO*

Well, yes. I mean as I tried to say, I think as we generate free cash flow we'd like to at least at a minimum do some anti-dilutionary share buybacks to offset the cost of our employee-based stock ownership plans. So that sets a bit of a floor.

Then depending on where -- what level of free cash flow we have available, we'll start delivering that to the shareholder. And then we'd like to be in that range of 20% to 30% of our cash flow going to the shareholders, so we'll target that range and look at where we're trading in the marketplace to make sure it makes sense relative to the other options we have.

James Sullivan - *Alembic Global Advisors - Analyst*

Okay, great. So first, that anti-dilution, but really you don't necessarily have -- I mean it's got to be a billion? in or anything like that in terms of --?

Ryan Lance - *ConocoPhillips - Chairman and CEO*

No, we're at the 20% to 30%, so that's what we've tried to tell everybody and signal that that's the range we'd like to be in, in terms of total returns to the shareholder including our ordinary dividend.

James Sullivan - *Alembic Global Advisors - Analyst*

Great. All right. Thanks, guys.

Operator

Thank you. And we'll now turn the call back over to Ellen DeSanctis, VP, Investor Relations and Communications, for final remarks.



Ellen DeSanctis - ConocoPhillips - VP, IR & Communications

Great. Thank you, Christine. Thanks to our listeners. Appreciate your time and attention and look forward to seeing you in November. And by all means, if you have questions at all during the rest of the day, feel free to ring IR. Thanks a ton and talk to you soon.

Operator

Thank you. And thank you, ladies and gentlemen. This concludes today's conference. Thank you for participating. You may now disconnect.

Editor

CAUTIONARY STATEMENT FOR THE PURPOSES OF THE "SAFE HARBOR" PROVISIONS OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

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