MARATHON OIL CORP
Form 10-Q
May 08, 2006

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

(Mark One)

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

For the Quarterly Period Ended March 31, 2006

OR

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

For the transition period from __________ to __________

Commission file number 1-5153
Marathon Oil Corporation
(Exact name of registrant as specified in its charter)

Delaware	**25-0996816**
(State of Incorporation)	(I.R.S. Employer Identification No.)

5555 San Felipe Road, Houston, TX 77056-2723
(Address of principal executive offices)
(713) 629-6600
(Registrant s telephone number)

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

Yes þ No o

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

There were 362,436,024 shares of Marathon Oil Corporation common stock outstanding as of April 30, 2006.

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Unless the context otherwise indicates, references in this Form 10-Q to Marathon, we, our, or us are references to Marathon Oil Corporation, including its wholly-owned and majority-owned subsidiaries, and its ownership interests in equity method investees (corporate entities, partnerships, limited liability companies and other ventures over which

Marathon exerts significant influence by virtue of its ownership interest, typically between 20 and 50 percent).
Effective September 1, 2005, Marathon Ashland Petroleum LLC changed its name to Marathon Petroleum Company LLC. In this Form 10-Q, references to Marathon Petroleum Company LLC (MPC) are references to the entity formerly known as Marathon Ashland Petroleum LLC.

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Part I Financial Information
Item 1. Financial Statements

MARATHON OIL CORPORATION
Consolidated Statements of Income (Unaudited)

(Dollars in millions, except per share data)	First Quarter Ended March 31, 2006	First Quarter Ended March 31, 2005
Revenues and other income:		
Sales and other operating revenues (including consumer excise taxes)	$ 12,998	$ 9,840
Revenues from matching buy/sell transactions	3,206	2,809
Sales to related parties	312	283
Income from equity method investments	92	40
Net gains on disposal of assets	11	11
Other income	19	27
Total revenues and other income	16,638	13,010
Costs and expenses:		
Cost of revenues (excludes items below)	9,769	7,692
Purchases related to matching buy/sell transactions	3,233	2,832
Purchases from related parties	51	56
Consumer excise taxes	1,165	1,084
Depreciation, depletion and amortization	415	323
Selling, general and administrative expenses	287	260
Other taxes	149	105
Exploration expenses	71	34
Total costs and expenses	15,140	12,386
Income from operations	1,498	624
Net interest and other financing costs	24	32
Minority interests in income (loss) of:		
Marathon Petroleum Company LLC		70
Equatorial Guinea LNG Holdings Limited	(3)	(1)
Income before income taxes	1,477	523
Provision for income taxes	693	199
Net income	$ 784	$ 324
Per share information:		

Net income per share basic	$ 2.15	$ 0.94
Net income per share diluted	$ 2.13	$ 0.93
Dividends paid per share	$ 0.33	$ 0.28

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

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MARATHON OIL CORPORATION
Consolidated Balance Sheets (Unaudited)

(Dollars in millions, except per share data)	March 31, 2006	December 31, 2005
Assets		
Current assets:		
Cash and cash equivalents	$ 1,269	$ 2,617
Receivables, less allowance for doubtful accounts of $3 and $3	3,614	3,476
Receivables from United States Steel	20	20
Receivables from related parties	55	38
Inventories	3,409	3,041
Other current assets	218	191
Total current assets	8,585	9,383
Investments and long-term receivables, less allowance for doubtful accounts of $9 and $10	1,841	1,864
Receivables from United States Steel	529	532
Property, plant and equipment, less accumulated depreciation, depletion and amortization of $12,746 and $12,384	15,186	15,011
Goodwill	1,307	1,307
Intangible assets, less accumulated amortization of $63 and $58	196	200
Other noncurrent assets	160	201
Total assets	$ 27,804	$ 28,498
Liabilities		
Current liabilities:		
Accounts payable	$ 5,194	$ 5,353
Consideration payable under Libya re-entry agreement	212	732
Payables to related parties	108	82
Payroll and benefits payable	286	344
Accrued taxes	846	782
Deferred income taxes	466	450
Accrued interest	49	96
Long-term debt due within one year	15	315
Total current liabilities	7,176	8,154
Long-term debt	3,687	3,698
Deferred income taxes	2,033	2,030
Employee benefits obligations	1,221	1,321
Asset retirement obligations	750	711

Payable to United States Steel	6	6
Deferred credits and other liabilities	295	438
Total liabilities	15,168	16,358
Minority interests in Equatorial Guinea LNG Holdings Limited	471	435
Commitments and contingencies		
Stockholders Equity		
Common stock issued 367,280,367 and 366,925,852 shares (par value $1 per share, 550,000,000 shares authorized)	367	367
Common stock held in treasury, at cost 3,457,472 and 179,977 shares	(245)	(8)
Additional paid-in capital	5,116	5,111
Retained earnings	7,068	6,406
Accumulated other comprehensive loss	(141)	(151)
Unearned compensation		(20)
Total stockholders equity	12,165	11,705
Total liabilities and stockholders equity	$ 27,804	$ 28,498

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

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MARATHON OIL CORPORATION
Consolidated Statements of Cash Flows (Unaudited)

(Dollars in millions)	First Quarter Ended March 31, 2006	2005
Increase (decrease) in cash and cash equivalents		
Operating activities:		
Net income	$ 784	$ 324
Adjustments to reconcile to net cash provided from operating activities:		
Deferred income taxes	41	3
Minority interests in income (loss) of subsidiaries	(3)	69
Depreciation, depletion and amortization	415	323
Pension and other postretirement benefits, net	(92)	47
Exploratory dry well costs and unproved property impairments	34	12
Net gains on disposal of assets	(11)	(11)
Changes in the fair value of long-term U.K. natural gas contracts	(78)	57
Equity method investments, net	(59)	(2)
Changes in:		
Current receivables	(192)	2
Inventories	(366)	(277)
Current accounts payable and accrued expenses	(173)	(137)
All other, net	(60)	(53)
Net cash provided from operating activities	240	357
Investing activities:		
Capital expenditures	(599)	(556)
Acquisitions	(527)	
Disposal of assets	38	36
Investments loans and advances		(30)
repayments of loans and advances	87	
All other, net	14	6
Net cash used in investing activities	(987)	(544)
Financing activities:		
Debt repayments	(302)	(2)
Issuance of common stock	8	39
Purchases of common stock	(229)	
Excess tax benefits from stock-based compensation arrangements	10	
Dividends paid	(121)	(97)

Contributions from minority shareholders of Equatorial Guinea LNG Holdings Limited	30	73
Net cash provided from (used in) financing activities	(604)	13
Effect of exchange rate changes on cash	3	(4)
Net decrease in cash and cash equivalents	(1,348)	(178)
Cash and cash equivalents at beginning of period	2,617	3,369
Cash and cash equivalents at end of period	$ 1,269	$ 3,191

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

MARATHON OIL CORPORATION

Notes to Consolidated Financial Statements (Unaudited)

1. Basis of Presentation

These consolidated financial statements are unaudited but, in the opinion of management, reflect all adjustments necessary for a fair presentation of the results for the periods reported. All such adjustments are of a normal recurring nature unless disclosed otherwise. These consolidated financial statements, including selected notes, have been prepared in accordance with the applicable rules of the Securities and Exchange Commission and do not include all of the information and disclosures required by accounting principles generally accepted in the United States of America for complete financial statements. Certain reclassifications of prior year data have been made to conform to 2006 classifications. These interim financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Marathon Oil Corporation (Marathon or the Company) 2005 Annual Report on Form 10-K.

2. New Accounting Standards

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123 (Revised 2004), Share-Based Payment, (SFAS No. 123(R)) as a revision of SFAS No. 123, Accounting for Stock-Based Compensation. This statement requires entities to measure the cost of employee services received in exchange for an award of equity instruments based on the fair value of the award on the grant date. That cost is recognized over the period during which an employee is required to provide service in exchange for the award, usually the vesting period. In addition, awards classified as liabilities are remeasured at fair value each reporting period. Marathon had previously adopted the fair value method under SFAS No. 123 for grants made, modified or settled on or after January 1, 2003.

Marathon adopted SFAS No. 123(R) as of January 1, 2006, for all awards granted, modified or cancelled after adoption, and for the unvested portion of awards outstanding at January 1, 2006. At the date of adoption, SFAS No. 123(R) requires that an assumed forfeiture rate be applied to any unvested awards and that awards classified as liabilities be measured at fair value. Prior to adopting SFAS No. 123(R), Marathon recognized forfeitures as they occurred and applied the intrinsic value method to awards classified as liabilities. The adoption did not have a significant impact on Marathon s consolidated results of operations, financial position or cash flows.

SFAS No. 123(R) also requires a company to calculate the pool of excess tax benefits (the APIC Pool) available to absorb tax deficiencies recognized subsequent to adopting the statement. In November 2005, the FASB issued FASB Staff Position No. 123R-3, Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards, to provide an alternative transition election (the short cut method) to account for the tax effects of share-based payment awards to employees. Marathon has elected the long-form method to determine its APIC Pool as of January 1, 2006. See Note 3 for the disclosures regarding share-based payments required by SFAS No. 123(R).

Effective January 1, 2006, Marathon adopted SFAS No. 151, Inventory Costs an amendment of ARB No. 43, Chapter 4. This statement requires that items such as idle facility expense, excessive spoilage, double freight and re-handling costs be recognized as a current-period charge. The adoption did not have a significant effect on Marathon s consolidated results of operations, financial position or cash flows.

Effective January 1, 2006, Marathon adopted SFAS No. 154, Accounting Changes and Error Corrections A Replacement of APB Opinion No. 20 and FASB Statement No. 3. SFAS No. 154 requires companies to recognize (1) voluntary changes in accounting principle and (2) changes required by a new accounting pronouncement, when the pronouncement does not include specific transition provisions, retrospectively to prior periods financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change.

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3. Stock-Based Compensation Arrangements

Description of the Plans

The Marathon Oil Corporation 2003 Incentive Compensation Plan (the Plan) authorizes the Compensation Committee of the Board of Directors of Marathon to grant stock options, stock appreciation rights, stock awards, cash awards and performance awards to employees. The Plan also allows Marathon to provide equity compensation to its non-employee directors. No more than 20,000,000 shares of common stock may be issued under the Plan, and no more than 8,500,000 of those shares may be used for awards other than stock options or stock appreciation rights. Shares subject to awards that are forfeited, terminated, expire unexercised, settled in cash, exchanged for other awards, tendered to satisfy the purchase price of an award, withheld to satisfy tax obligations or otherwise lapse become available for future grants. Shares issued as a result of stock option exercises and restricted stock grants are generally funded out of common stock held in treasury, except to the extent there are insufficient treasury shares, in which case new common shares are issued.

The Plan replaced the 1990 Stock Plan, the Non-Officer Restricted Stock Plan, the Non-Employee Director Stock Plan, the deferred stock benefit provision of the Deferred Compensation Plan for Non-Employee Directors, the Senior Executive Officer Annual Incentive Compensation Plan and the Annual Incentive Compensation Plan (collectively, the Prior Plans). No new grants will be made from the Prior Plans. Any awards previously granted under the Prior Plans shall continue to vest and/or be exercisable in accordance with their original terms and conditions.

Stock-Based Awards Under the Plans

Marathon s stock options represent the right to purchase shares of common stock at the fair market value of the common stock on the date of grant. Through 2004, certain options were granted with a tandem stock appreciation right, which allows the recipient to instead elect to receive cash and/or common stock equal to the excess of the fair market value of shares of common stock, as determined in accordance with the Plan, over the option price of the shares. Most stock options granted under the Plan vest ratably over a three-year period and all expire ten years from the date they are granted.

Similar to stock options, stock appreciation rights (SARs) represent the right to receive a payment equal to the excess of the fair market value of shares of common stock on the date the right is exercised over the exercise price. In general, SARs that have been granted under the Plan are settled in shares of stock, vest ratably over a three-year period and have a maximum term of ten years from the date they are granted.

In 2003 and 2004, the Compensation Committee granted stock-based performance awards to Marathon s and MPC s officers under the Plan. The stock-based performance awards represent shares of common stock that are subject to forfeiture provisions and restrictions on transfer. Those restrictions may be removed if certain pre-established performance measures are met. The stock-based performance awards granted under the Plan generally vest at the end of a 36-month performance period if the performance targets are achieved and the recipient remains employed by Marathon at that date.

In 2005, the Compensation Committee granted time-based restricted stock to the officers under the Plan. The restricted stock awards vest three years from the date of grant, contingent on the recipient s continued employment. Prior to vesting, the restricted stock recipients have the right to vote such stock and receive dividends thereon. The nonvested shares are not transferable and are retained by Marathon until they vest.

Marathon also grants restricted stock to certain non-officer employees and phantom stock units to certain international employees under the Plan (restricted stock awards) based on their performance within certain guidelines and for retention purposes. The restricted stock awards generally vest in one-third increments over a three-year period, contingent on the recipient s continued employment. Prior to vesting, the restricted stock recipients have the right to vote such stock and receive dividends thereon. The nonvested shares are not transferable and are retained by Marathon until they vest.

Marathon maintains an equity compensation program for its non-employee directors under the Plan. Prior to January 1, 2006, pursuant to the program, non-employee directors were required to defer 50 percent of their annual retainers in the form of common stock units. In addition, each non-employee director receives an annual grant of non-retainer common stock units under the Plan. The program also provided each non-employee director with a matching grant of up to 1,000 shares of common stock on his or her initial election to the Board if he or she purchased an equivalent number of shares within 60 days of joining the Board. Effective January 1, 2006, non-employee directors are no longer required to defer 50 percent of their annual retainers in the form of common stock units and the matching grant program was discontinued.

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Stock-Based Compensation Expense

The fair values of stock options, stock options with tandem SARs and stock-settled SARs (stock option awards) are estimated on the date of grant using the Black-Scholes option pricing model. The model employs various assumptions, based on management s best estimates at the time of grant, which impact the fair value calculated and ultimately, the expense that is recognized over the life of the stock option award. Of the required assumptions, the expected life of the stock option award and the expected volatility of the Company s stock price have the most significant impact on the fair value calculation. Marathon has utilized historical data and analyzed current information which reasonably support these assumptions.

The fair value of Marathon s restricted stock awards is determined based on the fair market value of the Company s common stock on the date of grant. Prior to adoption of SFAS No. 123(R) on January 1, 2006, the fair values of Marathon s stock-based performance awards were determined in the same manner as restricted stock awards. Under SFAS No. 123(R), on a prospective basis, these awards are required to be valued utilizing an option pricing model. No stock-based performance awards have been granted since May 2004.

Effective January 1, 2006, Marathon s stock-based compensation expense is recognized based on management s best estimate of the awards that are expected to vest, using the straight-line attribution method for all service-based awards with a graded vesting feature. If actual forfeiture results are different than expected, adjustments to recognized compensation expense may be required in future periods. Unearned stock-based compensation is charged to stockholders equity when restricted stock awards and stock-based performance awards are granted. Compensation expense is recognized over the balance of the vesting period and is adjusted if conditions of the restricted stock award or stock-based performance award are not met. Options with tandem SARs are classified as a liability and are remeasured at fair value each reporting period until settlement.

Prior to January 1, 2006, Marathon recorded stock-based compensation expense over the stated vesting period for stock option awards that are subject to specific vesting conditions and specify (1) that an employee vests in the award upon becoming retirement eligible or (2) that the employee will continue to vest in the award after retirement without providing any additional service. Under SFAS No. 123(R), from the date of adoption, such compensation cost is recognized immediately for awards granted to retirement-eligible employees or over the period from the grant date to the retirement eligibility date if retirement eligibility will be reached during the stated vesting period. No stock option awards were granted during the quarter ended March 31, 2006, and therefore awards with such vesting terms did not impact stock-based compensation expense for the quarter. Marathon previously determined that the compensation expense determined under the current and previous approaches did not differ materially.

During the quarters ended March 31, 2006 and 2005, total employee stock-based compensation expense was $23 million and $42 million. The total related income tax benefits were $9 million and $16 million. During the first quarter 2006, cash received upon exercise of stock option awards was $8 million. Tax benefits realized for deductions during the first quarter 2006 that were in excess of the stock-based compensation expense recorded for options exercised and other stock-based awards vested during the quarter totaled $10 million. No stock option awards were settled in cash during the first quarter 2006.

Outstanding Stock-Based Awards

The following is a summary of stock option award activity for the quarter ended March 31, 2006:

	Shares	Price [(a)]

Outstanding at December 31, 2005	6,007,954	$36.51
Granted		
Exercised	(357,265)	$30.04
Canceled	(27,848)	$44.58
Outstanding at March 31, 2006 [b]	5,622,841	$36.88

[a] Weighted-average exercise price.

[b] Of the stock option awards outstanding as of March 31, 2006, 4,732,234 and 890,607 were outstanding under the 2003 Incentive Compensation Plan and 1990 Stock Plan, including 913,902 options with tandem SARs.

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The following table presents information on stock option awards at March 31, 2006:

		Outstanding		Exercisable	
Range of Exercise Prices	Number of Shares Under Option	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Number of Shares Under Option	Weighted-Average Exercise Price
$22.38 25.52	1,189,837	6.8	$ 25.50	670,209	$ 25.49
$26.91 30.88	510,538	5.7	$ 28.38	498,872	$ 28.37
$32.52 34.00	2,062,246	7.5	$ 33.49	759,603	$ 33.29
$47.65 51.67	1,860,220	9.2	$ 50.25	13,600	$ 47.65
Total	5,622,841	7.7	$ 36.88	1,942,284	$ 29.43

As of March 31, 2006 the aggregate intrinsic value of stock option awards outstanding was $221 million. The aggregate intrinisic value and weighted average remaining contractual life of stock option awards currently exercisable were $91 million and 6.4 years. As of March 31, 2006, the number of fully vested stock option awards and stock option awards expected to vest was 5,394,081. The weighted average exercise price and weighted average remaining contractual life of these stock option awards were $36.46 and 7.7 years and the aggregate intrinsic value was $214 million.

No stock option awards were granted during the quarters ended March 31, 2006 and 2005. The total intrinsic value of stock option awards exercised during each of these quarters was $16 million. Of these amounts, $7 million in the first quarter 2006 and $11 million in the first quarter 2005 was related to options with tandem SARs. As of March 31, 2006, unrecognized compensation cost related to stock option awards was $16 million, which is expected to be recognized over a weighted average period of 1.4 years.

The following is a summary of stock-based performance award and restricted stock award activity for the quarter ended March 31, 2006:

	Stock-Based Performance Awards	Weighted Average Grant Date Fair Value	Restricted Stock and Units	Weighted Average Grant Date Fair Value
Unvested at December 31, 2005	448,600	$ 29.93	985,556	$ 47.94
Granted	67,848	$ 76.82	35,020	$ 76.68
Vested	(273,448)	$ 38.30	(123,626)	$ 37.96
Forfeited			(11,950)	$ 52.20
Unvested at March 31, 2006	243,000	$ 33.61	885,000	$ 50.61

During the quarters ended March 31, 2006 and 2005, the weighted average grant date fair value of restricted stock awards was $76.68 and $46.86. The total vesting date fair value of restricted stock awards that vested during the quarters ended March 31, 2006 and 2005 was $32 million and $6 million. Of these amounts, $21 million related to the vesting of the officer stock-based performance awards during the first quarter of 2006. As of March 31, 2006, there was $33 million of unrecognized compensation cost related to restricted stock awards which is expected to be recognized over a weighted average period of 2 years.

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4. Computation of Income per Share

Basic net income per share is based on the weighted average number of common shares outstanding. Diluted net income per share assumes exercise of stock options, provided the effect is not antidilutive.

	First Quarter Ended March 31,			
	2006		2005	
(Dollars in millions, except per share data)	Basic	Diluted	Basic	Diluted
Net income	$ 784	$ 784	$ 324	$ 324
Shares of common stock outstanding (thousands):				
Average number of common shares outstanding	365,110	365,110	346,006	346,006
Effect of dilutive securities		3,270		2,639
Average common shares including dilutive effect	365,110	368,380	346,006	348,645
Per share:				
Net income per share	$ 2.15	$ 2.13	$ 0.94	$ 0.93

5. Segment Information

Marathon s operations consist of three reportable operating segments:
1)