MILLENNIUM CHEMICALS INC
Form 10-K
February 28, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

x Annual Report Pursuant to Section 13 or 15(D) of the Securities Exchange Act of 1934 for the Fiscal Year Ended December 31, 2006

¨ Transition Report Pursuant to Section 13 or 15(D) of the Securities Exchange Act of 1934

Commission File No. 1-12091

MILLENNIUM CHEMICALS INC.

(Exact name of Registrant as specified in its charter)

Delaware	**22-3436215**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

Two Greenville Crossing, 4001 Kennett Pike

Suite 238, Greenville, Delaware	**19807**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (713) 652-7200

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

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

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

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes x No ¨

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 ¨ No x

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

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

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer x

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

There is no established public trading market for the Registrant s equity securities. As of June 30, 2006, the last business day of the Registrant s most recently completed second fiscal quarter, all of the Registrant s equity securities were held by affiliates.

The Registrant meets the conditions set forth in General Instructions I(1)(a) and (b) of Form 10-K and, therefore, is filing this form with a reduced disclosure format.

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PART I

Item 1. *Business*

MILLENNIUM

Overview of the Business

Millennium Chemicals Inc. (together with its consolidated subsidiaries, Millennium) is a global chemical company, with total 2006 revenues of $1.9 billion, and assets of $2.4 billion as of December 31, 2006. On November 30, 2004, Lyondell Chemical Company (Lyondell) acquired Millennium in a stock-for-stock business combination. As a result of the business combination, Millennium is now a wholly-owned subsidiary of Lyondell.

Millennium operates in two business segments: inorganic chemicals; and ethylene, co-products and derivatives.

Millennium s inorganic chemicals business segment primarily produces titanium dioxide (TiO_2). The inorganic chemicals business segment also produces titanium tetrachloride ($TiCl_4$), titanyl sulfate ($TiOSO_4$), ultra-fine TiO_2 and other inorganic chemicals. On February 23, 2007, Millennium and The National Titanium Dioxide Company Ltd. (Cristal) signed an agreement for a proposed sale of Millennium s worldwide inorganic chemicals business to Cristal for $1.05 billion, in cash, plus the assumption of specified liabilities. The amount will be adjusted up or down depending on the change in value of net working capital, cash and specified indebtedness as of the closing date. Closing is anticipated to occur in the first half of 2007.

Millennium s ethylene, co-products and derivatives business segment comprises its acetyls business and its equity investment in Equistar Chemicals, LP (together with its consolidated subsidiaries, Equistar). Millennium s acetyls business produces vinyl acetate monomer (VAM), acetic acid and methanol, which is a raw material for acetic acid. Equistar produces ethylene and its co-products, which primarily include propylene, butadiene and aromatics, which include benzene and toluene. Equistar s derivatives primarily include polyethylene, ethylene oxide (EO), ethylene glycol (EG) and other EO derivatives, as well as ethanol and polypropylene. Equistar also produces fuel products, such as methyl tertiary butyl ether (MTBE) and alkylate. Millennium owns 29.5% of Equistar, the balance of which is owned by Lyondell through other subsidiaries. Millennium accounts for its interest in Equistar using the equity method.

Millennium also produces fragrance and flavor chemicals. For additional segment information and for geographic information for each of the years in the three-year period ended December 31, 2006, see Note 21 to the Consolidated Financial Statements.

Additional Information Available

Millennium was incorporated under the laws of Delaware in 1996. Its principal executive offices are located at Two Greenville Crossing, 4001 Kennett Pike, Suite 238, Greenville, Delaware. Its telephone number is (713) 652-7200 and its website address is www.lyondell.com. Millennium s Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and all amendments to those reports are available free of charge through www.lyondell.com as soon as reasonably practicable after those reports are electronically filed with or furnished to the Securities and Exchange Commission.

In addition, Millennium has adopted a code of ethics, as defined in Item 406(b) of Regulation S-K. Millennium s code of ethics, known as its Business Ethics and Conduct Policy, is part of the overall Lyondell Business Ethics and Conduct Policy. It applies to all members of Millennium s Board of Directors and to all officers and employees of Millennium, including Millennium s principal executive officer, principal financial officer, principal accounting officer and controller. A copy of the Business Ethics and Conduct Policy is available at www.lyondell.com free of charge. In addition, Millennium intends to satisfy the disclosure requirements of Item 5.05 of Form 8-K regarding any amendment to, or waiver from, a provision of the Business Ethics and Conduct Policy that applies to Millennium s principal executive officer, principal financial officer, principal accounting officer or controller and relates to any element of the definition of code of ethics set forth in Item 406(b) of Regulation S-K by posting such information at www.lyondell.com.

Information contained on Millennium s website (www.lyondell.com) or any other website is not incorporated into this Annual Report and does not constitute a part of this Annual Report.

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INORGANIC CHEMICALS SEGMENT

Overview

TiO_2 is the primary product of the inorganic chemicals business, which accounted for approximately 64% of Millennium s total revenues in 2006, 65% in 2005 and 71% in 2004. TiO_2 is a white pigment used for imparting whiteness, brightness, opacity and durability in a wide range of products, including paint and coatings, plastics, paper and elastomers. On February 23, 2007, Millennium and Cristal signed an agreement for a proposed sale of Millennium s worldwide inorganic chemicals business to Cristal for $1.05 billion, in cash, plus the assumption of specified liabilities. Closing is anticipated to occur in the first half of 2007. The transaction would allow Millennium to accelerate debt repayment.

As of December 31, 2006, Millennium s annual TiO_2 production capacity, using the chloride process and the sulfate process discussed below, was approximately 670,000 metric tons. Unless otherwise specified, annual processing capacities were calculated by estimating the average number of days in a typical year that a production unit of a plant is expected to operate, after allowing downtime for regular maintenance, and multiplying that number by an amount equal to the unit s optimal daily output. Because the processing capacity of a production unit is an estimated amount, actual production volumes may be more or less than capacities set forth below.

TiO_2 Production Process	Annual Capacity	Percentage of Capacity
Chloride Process	515,000 metric tons	77%
Sulfate Process	155,000 metric tons	23%
Total	670,000 metric tons	100%

TiO_2 is produced in two crystalline forms: rutile and anatase. Rutile TiO_2 is primarily used in paint and coatings, ink and plastics. Anatase TiO_2 is primarily used in paper, ceramics, rubber and man-made fibers.

TiO_2 is manufactured using two different technologies. The newer chloride process is a high-temperature process in which chlorine is used to produce an intermediate TiO_2 rutile crystal pigment, with greater purity and better control over the size distribution of the pigment particles than the alternative sulfate process permits. In general, the chloride process is also less intensive than the sulfate process in terms of labor and energy. Because much of the chlorine can be recycled, the chloride process produces less waste than the sulfate process.

The sulfate process is a wet chemical process that uses concentrated sulfuric acid to produce either an intermediate TiO_2 anatase or rutile crystal pigment. The sulfate process generates higher volumes of waste, including iron sulfate and spent sulfuric acid.

Millennium s TiO_2 plants are located in the four major world markets for TiO_2: North America, South America, Western Europe and the Asia/Pacific region. The North American plants, consisting of one in Baltimore, Maryland and two in Ashtabula, Ohio, use the chloride process. The plant in Salvador, Bahia, Brazil uses the sulfate process. The Stallingborough, United Kingdom plant uses the chloride process. The plants in France at Le Havre, Normandy and Thann, Alsace use the sulfate process. The Kemerton plant in Western Australia uses the chloride process.

Millennium also owns a mineral sands mine located at Mataraca, Paraiba, Brazil, which supplies the Brazilian plant with most of its titanium ores. As of December 31, 2006, the mine had approximately 1.4 million metric tons of recoverable ilmenite reserves, approximately 233,000 metric tons of zircon reserves and approximately 21,000 metric tons of natural rutile reserves. The mine produced approximately 111,000 metric tons of ilmenite, a titanium-bearing ore, in 2006. Approximately 99,000 metric tons of ilmenite produced at the mine were processed by the Salvador TiO_2 plant in 2006, while approximately 22,000 metric tons were sold to the plant in Le Havre, France and approximately 1,000 metric tons were sold to unrelated parties. The mine also produced approximately 21,000 metric tons of zircon and approximately 2,000 metric tons of natural rutile titanium ore, all of which were sold to unrelated parties.

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Millennium s inorganic chemicals business also produces a number of specialty and performance products, some of which are manufactured at dedicated facilities and others of which are manufactured at facilities that also produce TiO_2 products. These products include titanium tetrachloride ($TiCl_4$), titanyl sulfate ($TiOSO_4$), ultra-fine TiO_2 and other inorganic chemicals.

Marketing and Sales

Of the TiO_2 sold by Millennium in 2006, approximately 65% was sold to customers in the paint and coatings industry, approximately 24% to customers in the plastics industry, approximately 10% to customers in the paper industry, and approximately 1% to other customers. Millennium experiences some seasonality in its TiO_2 sales because, in general, its customers production of paint and coatings are greatest in the spring and summer months. TiO_2 generally is sold by Millennium at prices determined by market-based negotiation under annual and multi-year contracts. TiO_2 is sold either directly to customers or, to a lesser extent, through agents or distributors, and is distributed by rail, truck and ocean carrier in either dry or slurry form.

No single inorganic chemicals customer accounted for 10% or more of Millennium s total revenues in 2006. For geographic data, see Note 21 to the Consolidated Financial Statements.

Raw Materials

Naturally occurring titanium-bearing ores such as ilmenite and natural rutile occur as sand or hard rock deposits in various parts of the world and are used as raw materials in the TiO_2 extraction process. Mining companies are increasingly treating ilmenite to extract iron and other minerals to produce slag or synthetic rutile with higher TiO_2 concentrations, resulting in lower amounts of wastes and by-products during processing by TiO_2 pigment plants. Generally, titanium-bearing ores are shipped by using bulk carriers from terminals in the country of origin to TiO_2 production plants, usually located near port facilities. Millennium obtains ores from a number of suppliers in South Africa, Australia, Canada, Brazil and Norway, generally pursuant to multi-year supply contracts. Rio Tinto Iron & Titanium Inc. (through its affiliates Richards Bay Iron & Titanium (Proprietary) Limited and QIT-Fer et Titane Inc.) and Iluka Resources Limited are the world s largest producers of titanium ores and they accounted for approximately 65% of the titanium ores purchased for Millennium s inorganic chemicals business in 2006.

Other major raw materials and supplies used in the production of TiO_2 are coke, chlorine, caustic soda, aluminum, sodium silicate, sodium aluminate, sulfuric acid, oxygen, nitrogen and natural gas. The number of sources for and availability of these materials is specific to the particular geographic region in which a facility is located. There are certain risks related to the acquisition of raw materials from less-developed or developing countries. See Item 1A. Risk Factors Risks Relating to the Businesses Millennium s international operations are subject to exchange rate fluctuations, exchange controls, political risks and other risks relating to non-U.S. operations.

A number of the raw materials used by Millennium s inorganic chemicals business are provided by only a few vendors and, accordingly, if one significant supplier or a number of significant suppliers were unable to meet their obligations under present supply arrangements, Millennium could suffer reduced supplies and/or be forced to incur increased costs for these raw materials. For example, for the Australian plant, chlorine and caustic soda are obtained exclusively from one supplier under a long-term supply agreement. See Item 1A. Risk Factors Risks Relating to the Businesses Costs of raw materials and energy, as well as reliability of supply, may result in increased operating expenses and reduced results of operations. However, at the present time, chloride- and sulfate-process raw materials are available in sufficient quantities.

Competition and Industry Conditions

The bases for competition in the inorganic chemicals businesses are price, product quality, product performance, product delivery, customer service and reliability of supply. The major competitors for sales of TiO_2 are E. I. du Pont de Nemours and Company (DuPont), Huntsman Tioxide (Huntsman Tioxide, a business unit of Huntsman Corporation), Kronos Worldwide, Inc. (Kronos) and Tronox Incorporated (Tronox, formerly a business unit of Kerr-McGee Corporation). Millennium estimates that collectively, as of December 31, 2006, DuPont, Millennium, Huntsman Tioxide, Kronos and Tronox accounted for approximately 64% of the world s TiO_2

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production capacity. Millennium is the second largest producer of TiO_2 in the world, based on published rated capacity.

In certain applications, TiO_2 competes with other whitening agents that are generally less effective but less expensive. These alternate products include kaolin clays, calcium carbonate pigments and synthetic polymers materials.

Sulfate-process plants can be less competitive than chloride-process plants, unless the sulfate-process plants (1) use lower cost raw materials and cost-effectively dispose of the waste, (2) have low labor costs, or (3) have higher selling prices through either tariff protection or specialty market position for some portion of the plant s output. When the TiO_2 industry is oversupplied, customers prefer the newer chloride-process products and, thus, sulfate-process plants would operate at lower utilization rates than chloride-process plants.

Generally, new plant capacity additions in the TiO_2 industry are slow to develop because of the substantial capital expenditure required and the significant lead time (three to five years typically for a new plant) needed for planning, obtaining environmental approvals and permits, construction of manufacturing facilities and arranging for raw material supplies. DuPont has announced plans to construct a 200,000 ton per year TiO_2 plant in Dongying, China with planned completion in 2010. Debottlenecking and other capacity expansions at existing plants require substantially less time and capital and can also increase overall industry capacity. For example, Huntsman Tioxide has announced plans to expand its TiO_2 facility in Greatham, U.K. by 50,000 tons.

ETHYLENE, CO-PRODUCTS AND DERIVATIVES SEGMENT

Millennium s ethylene, co-products and derivatives segment comprises its acetyls business and its equity investment in Equistar.

Acetyls Business

Overview

The acetyls business includes VAM, acetic acid and methanol, which is a raw material for acetic acid. VAM and acetic acid are manufactured by Millennium at facilities in La Porte, Texas. Millennium also owns an 85% interest in La Porte Methanol Company, which produces methanol at a plant in La Porte, Texas. The remaining 15% interest is owned by Linde AG (Linde).

The following table outlines:

- the acetyls business primary products;
- annual processing capacity at December 31, 2006; and
- the primary uses for those products.

Unless otherwise specified, annual processing capacity was calculated by estimating the average number of days in a typical year that a production unit of a plant is expected to operate, after allowing for downtime for regular maintenance, and multiplying that number by an amount equal to the unit s optimal daily output based on the design raw material mix. Because the processing capacity of a production unit is an estimated amount, actual production volumes may be more or less than the capacities set forth below. Capacities shown include 100% of the capacity of joint venture facilities.

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Product	Annual Capacity	Primary Uses
Vinyl Acetate Monomer (VAM)	820 million pounds	VAM is a petrochemical product used to produce a variety of polymers products used in adhesives, water-based paint, textile coatings and paper coatings.
Acetic Acid	1.2 billion pounds	Acetic acid is a raw material used to produce VAM, terephthalic acid (used to produce polyester for textiles and plastic bottles), industrial solvents and a variety of other chemicals.
Methanol	190 million gallons (a)	Methanol is a raw material used to produce acetic acid, MTBE, formaldehyde and several other products.

(a) Represents 100% of the methanol capacity at the La Porte, Texas facility, which is owned by La Porte Methanol Company, a partnership owned 85% by Millennium and 15% by Linde.

Marketing and Sales

Sales of VAM accounted for approximately 15% of Millennium s total revenues in 2006, and approximately 16% in 2005 and 2004. Sales of acetyls collectively accounted for approximately 25% of Millennium s total revenues in 2006, 26% in 2005 and 24% in 2004.

VAM is sold into domestic and export markets under multi-year contracts, and also on a spot basis. Acetic acid that is not consumed internally for the production of VAM is sold into domestic and export markets under multi-year contracts, and also on a spot basis. Contract pricing for sales of VAM and acetic acid generally is determined by market-based negotiation, market index or cost-based formulas. Millennium also sells VAM to Equistar and acetic acid to both Lyondell and Equistar at market-based pricing. Pursuant to an agreement that expired on December 31, 2006, a portion of the acetic acid produced at Millennium s La Porte, Texas plant previously was converted into VAM through DuPont s nearby VAM plant and Millennium acquired all of the VAM production at DuPont s plant that was not utilized internally by DuPont. As of January 1, 2007, Millennium produces those VAM volumes internally at its facilities. VAM and acetic acid are shipped by barge, ocean-going vessel, pipeline, tank car and tank truck. Millennium has bulk storage arrangements in Europe and South America to better serve its customers requirements in those regions. Sales are made through a direct sales force, agents and distributors.

The La Porte, Texas methanol facility is owned by La Porte Methanol Company, Millennium s 85%-owned joint venture with Linde. Each party to the joint venture receives its respective share of the methanol production. Millennium uses the methanol as a raw material for acetic acid and also sells the methanol under annual contracts and on a spot basis to large domestic customers. The product is shipped by barge and pipeline.

No single acetyls customer accounted for 10% or more of Millennium s total revenues in 2006. For geographic data, see Note 21 to the Consolidated Financial Statements.

Raw Materials

The primary raw materials for the production of VAM are acetic acid and ethylene. For VAM produced by Millennium, Millennium obtains its entire requirements for acetic acid from its internal production and buys all of its ethylene requirements from Equistar under a long-term supply contract based on market prices. In 2006, Millennium used a large percentage of its acetic acid production to produce VAM.

The primary raw materials required for the production of acetic acid are carbon monoxide and methanol. Millennium purchases its carbon monoxide from Linde pursuant to a long-term contract under which pricing is based primarily on cost of production. La Porte Methanol Company, Millennium s 85%-owned joint venture, supplies all of Millennium s requirements for methanol production. Natural gas is the primary raw material required for the production of methanol and carbon monoxide.

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Competition and Industry Conditions

The bases for competition in the acetyls businesses are price, product performance, product quality, product delivery, reliability of supply and customer service. The acetyls businesses compete globally with other large marketers and producers for sales of acetyls, including BP p.l.c., Celanese Corporation (Celanese), The Dow Chemical Company (Dow), Eastman Chemical Company, Methanex Corporation and Saudi Basic Industries Corp. Millennium is the second largest producer of VAM and acetic acid in North America, the third largest producer of acetic acid worldwide and the fourth largest producer of VAM worldwide, based on 2006 published rated production capacity.

Equity Investment in Equistar

Millennium owns a 29.5% interest in Equistar, a joint venture with Lyondell. Millennium accounts for its interest in Equistar as an equity investment. Equistar reports its results of operations in one segment: ethylene, co-products and derivatives.

Overview

Equistar produces ethylene, co-products and derivatives at fifteen facilities located in five states in the U.S. Ethylene co-products primarily include propylene, butadiene and aromatics, which include benzene and toluene. Derivatives primarily include polyethylene, EO, EG and other EO derivatives, as well as ethanol and polypropylene. Equistar also produces fuel products, such as MTBE and alkylate. Ethylene is the most significant petrochemical in terms of worldwide production volume and is the key building block for polyethylene and a large number of other chemicals, plastics and synthetics. Ethylene, co-products and derivatives are fundamental to many segments of the economy, including the production of consumer products, packaging, housing and automotive components and other durable and nondurable goods.

The following table outlines:

- Equistar s primary products;
- annual processing capacity as of December 31, 2006; and
- the primary uses for those products.

See Item 2. Properties for the locations where Equistar produces its products.

Unless otherwise specified, annual processing capacity was calculated by estimating the average number of days in a typical year that a production unit of a plant is expected to operate, after allowing for downtime for regular maintenance, and multiplying that number by an amount equal to the unit s optimal daily output based on the design raw material mix. Because the processing capacity of a production unit is an estimated amount, actual production volumes may be more or less than the capacities set forth below. Capacities shown include 100% of the capacity of joint venture facilities.

Product	Annual Capacity	Primary Uses
Ethylene	10.8 billion pounds (a)	Ethylene is used as a raw material to manufacture polyethylene, EO, ethanol, ethylene dichloride, styrene and VAM.
Co-Products:		
Propylene	4.8 billion pounds (a)(b)	Propylene is used to produce polypropylene, acrylonitrile and propylene oxide.
Butadiene	1.2 billion pounds	

Butadiene is used to manufacture styrene-butadiene rubber and polybutadiene rubber, which are used in the manufacture of tires, hoses, gaskets and other rubber products. Butadiene is also used in the production of paints, adhesives, nylon clothing, carpets, paper coatings and engineered plastics.

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Product	Annual Capacity	Primary Uses
Aromatics:		
Benzene	310 million gallons	Benzene is used to produce styrene, phenol and cyclohexane. These products are used in the production of nylon, plastics, synthetic rubber and polystyrene. Polystyrene is used in insulation, packaging and drink cups.
Toluene	66 million gallons	Toluene is used as an octane enhancer in gasoline, as a chemical raw material for benzene and/or paraxylene production, and a core ingredient in toluene diisocyanate, a compound used in urethane production.
Fuel Products:		
MTBE	284 million gallons (18,500 barrels/day) (c)	MTBE is a high octane gasoline blending component.
Alkylate	337 million gallons (d)	Alkylate is a high octane gasoline blending component.
Derivatives:		
High density polyethylene (HDPE)	3.2 billion pounds	HDPE is used to manufacture grocery, merchandise and trash bags; food containers for items from frozen desserts to margarine; plastic caps and closures; liners for boxes of cereal and crackers; plastic drink cups and toys; dairy crates; bread trays; pails for items from paint to fresh fruits and vegetables; safety equipment such as hard hats; house wrap for insulation; bottles for household and industrial chemicals and motor oil; milk, water, and juice bottles; large (rotomolded) tanks for storing liquids such as agricultural and lawn care chemicals; and pipe.
Low density polyethylene (LDPE)	1.4 billion pounds	LDPE is used to manufacture food packaging films; plastic bottles for packaging food and personal care items; dry cleaning bags; ice bags; pallet shrink wrap; heavy-duty bags for mulch and potting soil; boil-in-bag bags; coatings on flexible packaging products; and coatings on paper board such as milk cartons. Ethylene vinyl acetate is a specialized form of LDPE used in foamed sheets, bag-in-box bags, vacuum cleaner hoses, medical tubing, clear sheet protectors and flexible binders.
Linear low density polyethylene (LLDPE)	1.2 billion pounds	LLDPE is used to manufacture garbage and lawn-leaf bags; industrial can liners; housewares; lids for coffee cans and margarine tubs, dishpans, home plastic storage containers, kitchen trash containers; large (rotomolded) toys like outdoor gym sets; drip irrigation tubing; wire and cable insulating resins and compounds used to insulate copper and fiber optic wiring, and film; shrink wrap for multi-packaging canned food, bag-in-box bags, produce bags, and pallet stretch wrap.
Ethylene Oxide (EO)	1.5 billion pounds EO equivalents; 400 million pounds as pure EO (e)	EO is used to produce surfactants, industrial cleaners, cosmetics, emulsifiers, paint, heat transfer fluids and ethylene glycol.
Ethylene Glycol (EG)	1.4 billion pounds (e)	

		EG is used to produce polyester fibers and film, polyethylene terephthalate (PET) resin, heat transfer fluids and automobile antifreeze.
Other Ethylene Oxide Derivatives	225 million pounds	EO derivatives include ethylene glycol ethers and ethanolamines, and are used to produce paint and coatings, polishes, solvents and chemical intermediates.
Ethanol	50 million gallons	Ethanol is used in the production of solvents as well as household, medicinal and personal care products.
Polypropylene	280 million pounds	Polypropylene is used to manufacture fibers for carpets, rugs and upholstery; housewares; automotive battery cases; automotive fascia, running boards and bumpers; grid-type flooring for sports facilities; fishing tackle boxes; and bottle caps and closures.

(a) Excludes 850 million pounds/year of ethylene capacity and 200 million pounds/year of propylene capacity at Equistar s Lake Charles, Louisiana ethylene and co-products facility, which has been idled since the first quarter 2001. Although

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Equistar retains the physical ability to restart or sell that facility, in the third quarter of 2006 Equistar determined that it had no expectation of resuming production at that facility.

(b) Does not include refinery-grade material from Lyondell s refinery or production from the product flexibility unit at the Channelview facility, which can convert ethylene and other light petrochemicals into propylene. These facilities have an annual processing capacity of an additional one billion pounds/year of propylene.

(c) Includes up to 44 million gallons/year of capacity produced for and returned to Lyondell.

(d) Includes up to 172 million gallons/year of capacity produced for and returned to Lyondell.

(e) Includes 700 million pounds/year of EO equivalents capacity and 800 million pounds/year of EG capacity at the Beaumont, Texas facility, which represents 100% of the EO equivalents capacity and EG capacity, respectively, at the facility. The Beaumont, Texas facility is owned by PD Glycol, a partnership owned 50% by Equistar and 50% by DuPont.

Marketing and Sales

Equistar produces ethylene at six sites located in three states. Ethylene produced by Equistar generally is consumed internally as a raw material in the production of derivatives, or is shipped by pipeline to customers. For the year ended December 31, 2006, approximately 87% of Equistar s ethylene, based on sales dollars, was used by Equistar s derivatives facilities or sold to related parties at market-related prices. The sales to related parties during 2006 include significant ethylene sales to Occidental Chemical Corporation pursuant to a long-term ethylene supply agreement. Occidental Chemical Corporation is a subsidiary of Occidental Petroleum Corporation (together with its subsidiaries and affiliates, collectively, Occidental), which owned 8.5% of Lyondell s outstanding common stock as of December 31, 2006 and after giving effect to Occidental s January 26, 2007 exercise of its warrant to purchase Lyondell common stock. Sales of ethylene accounted for approximately 12% of Equistar s total revenues in 2006, 13% in 2005 and 12% in 2004.

Ethylene co-products are manufactured by Equistar primarily at four facilities in Texas. The Morris, Illinois and Clinton, Iowa facilities also can produce propylene.

Equistar consumes propylene in the production of polypropylene and also sells propylene to Lyondell at market-related prices. Equistar s propylene production that is not consumed internally or sold to related parties generally is sold under multi-year contracts. In addition, pursuant to a 15-year propylene supply arrangement entered into in 2003 with a subsidiary of Sunoco, Inc. (Sunoco), Equistar supplies 700 million pounds of propylene annually to Sunoco. Under the arrangement, a majority of the propylene is supplied under a cost-based formula and the balance is supplied on a market-related basis. Sales of propylene accounted for approximately 20% of Equistar s total revenues in 2006 and approximately 18% in 2005 and 2004.

Equistar generally sells its butadiene under multi-year contracts. Equistar sells benzene and toluene to Lyondell at market-related prices. Most of Equistar s benzene and toluene production that is not sold to related parties generally is sold under multi-year contracts. Equistar also sells benzene produced by Lyondell, which it purchases from Lyondell at market-related prices. Sales of benzene accounted for less than 10% of Equistar s total revenues in 2006 and 2005 and approximately 10% in 2004. Equistar serves as Lyondell s sole agent to market toluene, paraxylene and orthoxylene produced by Lyondell and receives a marketing fee for such services.

Equistar at times purchases ethylene, propylene, benzene and butadiene for resale, when necessary, to satisfy customer demand for these products above production levels. Volumes of ethylene, propylene, benzene and butadiene purchased for resale can vary significantly from period to period. However, purchased volumes generally do not have a significant impact on profitability.

MTBE produced at one of the two Channelview units and at the Chocolate Bayou plant is sold to Lyondell at market-related prices. MTBE is produced for Lyondell at the second Channelview unit for a processing fee. Equistar produces alkylate for and returns alkylate to Lyondell for a processing fee, and also sells alkylate both under short-term contracts and on a spot basis.

Most of the ethylene and propylene production of the Channelview, Chocolate Bayou, Corpus Christi and La Porte facilities is shipped via a pipeline system which has connections to numerous U.S. Gulf Coast consumers. This pipeline system, some of which is owned and some of which is leased, extends from Corpus Christi to Mont Belvieu to Port Arthur, Texas as well as around the Lake Charles, Louisiana area. In addition, exchange agreements

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with other ethylene and co-products producers allow access to customers who are not directly connected to Equistar s pipeline system. Some ethylene is shipped by railcar from Clinton, Iowa to Morris, Illinois and also to customers. A pipeline owned and operated by an unrelated party is used to transport ethylene from Morris, Illinois to Tuscola, Illinois. Some propylene is shipped by ocean-going vessel. Butadiene, benzene, toluene and other products are distributed by pipeline, railcar, truck, barge or ocean-going vessel.

Polyethylene is manufactured by Equistar using a variety of technologies at five facilities in Texas and at the Morris, Illinois and Clinton, Iowa facilities. Polyethylene includes high density polyethylene (HDPE), low density polyethylene (LDPE) and linear low density polyethylene (LLDPE). HDPE accounted for approximately 12% of Equistar s total revenues in 2006 and 2005 and 14% in 2004, and polyethylene (HDPE, LDPE and LLDPE collectively) accounted for approximately 21% of Equistar s total revenues in 2006 and 2005 and 26% in 2004.

Polyethylene products primarily are sold to an extensive base of established customers. Approximately two-thirds of Equistar s domestic polyethylene product volumes are sold to customers under annual or multi-year contracts. The remainder of the polyethylene volume generally is sold under customary terms and conditions without formal contracts. In either case, in most of the continuous supply relationships, prices are subject to change upon mutual agreement. Equistar also produces performance polymer products, which include enhanced grades of polyethylene and polypropylene. Equistar believes that, over a business cycle, average selling prices and profit margins for performance polymers tend to be higher than average selling prices and profit margins for higher-volume commodity polyethylenes.

EO or EO equivalents, and EO s primary derivative, EG, are produced at the Bayport facility located in Pasadena, Texas and through a 50/50 joint venture between Equistar and DuPont in Beaumont, Texas. The Bayport facility also produces other derivatives of EO, principally ethylene glycol ethers and ethanolamines. EO and EG typically are sold under multi-year contracts, with market-based pricing. Glycol ethers, ethanolamines and brake fluids are sold primarily into the solvent and distributor markets at market prices. Ethanol and ethers primarily are sold under contracts at market prices. EO is shipped by railcar, and its derivatives are shipped by railcar, truck, isotank or ocean-going vessel.

Other derivatives products are primarily distributed by railcar. The vast majority of the derivatives products are sold in North America, primarily through Equistar s sales organization. Sales agents are generally engaged to market the derivatives products in the rest of the world.

Other than Lyondell, which accounted for approximately 11% of Equistar s total revenues in 2006, no single customer accounted for 10% or more of Equistar s total revenues in 2006. For geographic data, see Note 21 to the Consolidated Financial Statements.

Raw Materials

Raw material cost is the largest component of the total cost for the production of ethylene and co-products. The primary raw materials used are heavy liquids and natural gas liquids (NGLs). Heavy liquids include crude oil-based naphtha and gas oil, as well as condensate, a very light crude oil resulting from natural gas production (collectively referred to as heavy liquids). NGLs include ethane, propane and butane. The use of heavy liquid raw materials results in the production of a significant amount of co-products such as propylene, butadiene, benzene and toluene, as well as gasoline blending components, while the use of NGLs results in the production of a smaller amount of co-products, such as propylene.

The flexibility to consume a wide range of raw materials, including heavy liquids, has historically provided plants with that flexibility with an advantage over plants that are restricted in their raw material processing capability to NGLs such as ethane and propane, assuming the co-products were recovered and sold. Facilities using heavy liquids historically have generated, on average, approximately four cents of additional variable margin per pound of ethylene produced compared to facilities restricted to using ethane. This margin advantage is based on an average of historical data over a period of years and is subject to short-term fluctuations, which can be significant. For example, the advantage during first quarter 2006 was well below the historical average. However, strengthening market conditions increased the advantage significantly for the remainder of the year. As a result, the advantage for

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the full year 2006 was above the historical average. Equistar has the capability to realize this margin advantage due to its ability to process heavy liquids at its Channelview, Corpus Christi and Chocolate Bayou ethylene and co-products facilities. Equistar s Channelview and Corpus Christi facilities have the greatest operational flexibility among Equistar s facilities to process significant quantities of either heavy liquids or NGLs, depending upon the relative economic advantage of the alternative raw materials.

As described above, management believes that this raw material flexibility is a key advantage in the production of ethylene and co-products. As a result, Equistar s heavy liquids requirements are sourced globally via a mix of contractual and spot arrangements. Spot market purchases are made in order to maintain raw material flexibility and to take advantage of raw material pricing opportunities. A large portion of Equistar s NGLs requirements are purchased via contractual arrangements from a variety of sources, but NGLs also are purchased on the spot market. Equistar also obtains a portion of its heavy liquids requirements from Lyondell s refinery at market-related prices. Heavy liquids generally are delivered by ship or barge, and NGLs generally are delivered via pipeline.

Equistar purchases all of its methanol requirements for ethylene and co-products from Lyondell at market-based prices. Also, Equistar purchases large amounts of natural gas to be used as energy for consumption in its business via market-based contractual arrangements with a variety of sources.

The primary raw material for the derivatives products is ethylene. Equistar s derivatives facilities generally can receive their ethylene directly from Equistar s ethylene and co-products facilities via its pipeline system, pipelines owned by unrelated parties or on-site production. Substantially all of the ethylene used in Equistar s polyethylene production is produced internally by Equistar s ethylene and co-products facilities. However, the polyethylene plants at Chocolate Bayou, La Porte and Bayport, Texas are connected by pipeline to unrelated parties and could receive ethylene via exchanges or purchases. The polypropylene facility at Morris, Illinois receives propylene from Equistar s ethylene and co-products facilities, as well as unrelated parties.

The raw materials for ethylene, co-products and derivatives are, in general, commodity chemicals with numerous bulk suppliers and ready availability at competitive prices. Historically, raw material availability for ethylene, co-products and derivatives has not been an issue. For additional discussion regarding the effects of raw material pricing and supply on recent operating results, see Item 1A. Risk Factors Risks Relating to the Businesses Costs of raw materials and energy, as well as reliability of supply, may result in increased operating expenses and reduced results of operations and Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations.

Competition and Industry Conditions

Competition in the ethylene, co-products and derivatives businesses is based on price, product quality, product delivery, reliability of supply, product performance and customer service. Industry consolidation has brought North American production capacity under the control of fewer, although larger, competitors.

Profitability is affected not only by supply and demand for ethylene, co-products and derivatives, but also by raw material costs and price competition among producers, which may intensify due to, among other things, the addition of new capacity. In general, demand is a function of economic growth in the United States and elsewhere in the world, which fluctuates. It is not possible to accurately predict the changes in raw material costs, market conditions, capacity utilization and other factors that will affect industry profitability in the future. In 2005, temporary hurricane-related shutdowns greatly impacted supply and demand during the last four months of 2005, and significant U.S. production outages carried over into the first quarter of 2006. During the next five years, forecasts for the worldwide average annual ethylene capacity additions are projected at more than 5%, with more than 80% of these additions in the Middle East and Northeast Asia. The average worldwide demand growth is expected to lag this rate only by approximately 1%. In the U.S., relatively stable ethylene supply combined with sustained demand levels are projected to result in continued high average operating rates through 2008. Capacity share figures for Equistar and its competitors, discussed below, are based on completed production facilities and, where appropriate, include the full capacity of joint venture facilities and certain long-term supply arrangements.

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Equistar competes with other large domestic marketers and producers for sales of ethylene and co-products, including Chevron Phillips Chemical Company LP (ChevronPhillips), Enterprise Products Partners L.P., Exxon Mobil Corporation (ExxonMobil), Huntsman Corporation (Huntsman), Ineos and Shell Chemical Company. Equistar s ethylene rated capacity at December 31, 2006 was approximately 10.8 billion pounds per year, or approximately 14% of total North American ethylene production capacity. Based on published rated production capacities, Equistar is the second largest producer of ethylene in North America. North American ethylene rated capacity at December 31, 2006 was approximately 77 billion pounds per year, with approximately 77% of that North American capacity located along the Gulf Coast.

Equistar competes with other large marketers and producers for sales of derivatives, including Celanese, ChevronPhillips, Dow, Eastman Chemical Company, ExxonMobil, Formosa Plastics Corporation, Huntsman, Ineos, NOVA Chemicals Corporation, TOTAL and Westlake Polymers. Based on published rated industry capacities, Equistar is the third largest producer of polyethylene in North America. The rated capacity of Equistar s polyethylene units as of December 31, 2006 was approximately 5.8 billion pounds per year, or approximately 14% of total industry capacity in North America. There are many other North American producers of polyethylene, the most significant of which are ChevronPhillips, Dow and ExxonMobil.

OTHER

Millennium also produces fragrance and flavors chemicals. The Brunswick, Georgia and Jacksonville, Florida facilities manufacture terpene-based fragrance ingredients and flavor ingredients, primarily for the oral care markets. These products are also used in a number of other applications, including chemical reaction agents, or initiators, for the rubber industry and solvents and cleaners, such as pine oil, for the hard surface cleaner markets.

ENVIRONMENTAL CAPITAL EXPENDITURES

Millennium and its joint ventures (together with the industries in which they operate) are subject to extensive national, state and local environmental laws and regulations concerning, and are required to have permits and licenses regulating, emissions to the air, discharges onto land or waters and the generation, handling, storage, transportation, treatment and disposal of waste materials. In some cases, compliance with environmental, health and safety laws and regulations can only be achieved by capital expenditures. In the years ended December 31, 2006, 2005 and 2004, Millennium spent approximately $5 million, $8 million and $8 million, respectively, for environmentally related capital expenditures at existing facilities. Millennium currently estimates that environmentally related capital expenditures at its facilities will be approximately $10 million for 2007 and $15 million for 2008, reflecting the addition of a new waste disposal landfill and fume containment equipment at a TiO_2 plant.

In the years ended December 31, 2006, 2005 and 2004, Equistar spent approximately $60 million, $62 million and $44 million, respectively, for environmentally related capital expenditures at existing facilities. Equistar currently estimates that environmentally related capital expenditures at its facilities will be approximately $30 million for 2007 and $15 million for 2008. Capital expenditures during 2005 and 2006 included significant expenditures for projects related to air emission reduction and wastewater management. The decreasing levels of estimated environmentally related capital expenditures for 2007 and 2008 reflect the completion or near completion of these projects.

For additional information regarding environmentally related capital expenditures, see Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations Environmental Matters.

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RESEARCH AND TECHNOLOGY; INTELLECTUAL PROPERTY

Millennium Millennium conducts research principally at technology centers in Baltimore, Maryland; Stallingborough, United Kingdom; and Jacksonville, Florida. Millennium s research and development expenditures were $26 million in 2006, $23 million in 2005 and $21 million in 2004.

Millennium maintains an extensive patent portfolio and continues to file new patent applications related to its TiO_2, acetyls and fragrance and flavor businesses. As of December 31, 2006, Millennium owned approximately 55 United States patents and approximately 115 worldwide patents. Millennium owns trademarks and trademark registrations in the United States and in other countries, including the Millennium trade name. Millennium does not regard its business as being materially dependent upon any single patent, trademark or license.

Equistar Equistar conducts research and development principally at its technology centers in Cincinnati, Ohio and Chocolate Bayou, Texas. Equistar s research and development expenditures were $34 million in 2006, $33 million in 2005 and $34 million in 2004.

Equistar maintains an extensive patent portfolio and continues to file new patent applications related to its businesses. As of December 31, 2006, Equistar owned approximately 260 United States patents and approximately 410 worldwide patents. Equistar owns globally registered and unregistered trademarks, including the Equistar logo. Equistar does not regard its business as being materially dependent upon any single patent, trademark or license.

EMPLOYEE RELATIONS

Millennium At December 31, 2006, Millennium had approximately 3,240 full-time and part-time employees, approximately 1,155 of whom were located in the United States, approximately 1,045 of whom were located in Europe, approximately 665 of whom were located in Brazil, approximately 355 of whom were located in Australia and approximately 20 of whom were located in Asia. As of December 31, 2006, approximately 26% of the employees located in the U.S., approximately 78% of the employees located in Europe and substantially all of the employees located in Brazil were represented by labor unions. In addition to its own employees, Millennium uses the services of Lyondell and Equistar employees pursuant to shared services and loaned employee arrangements and also uses the services of independent contractors in the routine conduct of its business. Millennium believes that its relations with its employees are good.

Equistar At December 31, 2006, Equistar employed approximately 3,260 full-time and part-time employees. Approximately 4.5% of Equistar s employees are covered by collective bargaining agreements. In addition to its own employees, Equistar uses the services of Lyondell and Millennium employees pursuant to shared services and loaned employee arrangements and also uses the services of independent contractors in the routine conduct of its business. Equistar believes that its relations with its employees are good.

Item 1A. *Risk Factors*

There are many factors that may affect the businesses and results of operations of Millennium and its joint ventures. For additional discussion regarding factors that may affect the businesses and operating results of Millennium and its joint ventures, see Item 1. Business, Item 3. Legal Proceedings, Forward-Looking Statements, Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations and Item 7A. Disclosure of Market Risk. If one or more of these risks actually occur, Millennium s business, financial position or results of operations could be materially and adversely affected.

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Risks Relating to the Businesses

Costs of raw materials and energy, as well as reliability of supply, may result in increased operating expenses and reduced results of operations.

Millennium and its joint ventures purchase large amounts of raw materials and energy for their businesses. The cost of these raw materials and energy, in the aggregate, represents a substantial portion of their operating expenses. The costs of raw materials and energy used for acetyls and Equistar s products, and the energy costs for TiO_2 generally follow price trends of, and vary with the market conditions for, crude oil and natural gas, which may be highly volatile and cyclical. The costs of energy and certain raw materials remain at high levels. There have been in the past, and will likely be in the future, periods of time when Millennium and its joint ventures are unable to pass raw material and energy cost increases on to customers quickly enough to avoid adverse impacts on their results of operations. Customer consolidation also has made it more difficult to pass along cost increases to customers. The results of operations of Millennium and its joint ventures have been, and could be in the future, significantly affected by increases and volatility in these costs. Cost increases also may increase working capital needs, which could reduce liquidity and cash flow for Millennium and its joint ventures. In addition, when raw material and energy costs increase rapidly and are passed along to customers as product price increases, the credit risks associated with certain customers can be compounded. To the extent Millennium and its joint ventures increase their product sales prices to reflect rising raw material and energy costs, demand for products may decrease as customers reduce their consumption or use substitute products, which may have an adverse impact on Millennium s or its joint ventures results of operations. See Millennium and its joint ventures sell commodity products in highly competitive global markets and face significant price pressures below.

In addition, higher North American and European natural gas prices relative to natural gas cost-advantaged regions, such as the Middle East, have diminished the ability of many chemical producers to compete internationally since natural gas prices affect a significant portion of the industry s raw materials and energy sources. This environment has in the past caused and may in the future cause a reduction in Millennium s or Equistar s exports, and has in the past reduced and may in the future reduce the competitiveness of U.S. and European producers. It also has in the past increased the competition for sales of chemicals within North America and Europe, as production that would otherwise have been sold in other geographic regions was instead offered for sale in these regions, resulting in excess supply and lower margins in North America and Europe, and may do so in the future.

Furthermore, for Millennium and its joint ventures, there are a limited number of suppliers for some of their raw materials and utilities and, in some cases, the number of sources for and availability of raw materials is specific to the particular geographic region in which a facility is located. In addition, for some products of Millennium and its joint ventures, the facilities and/or distribution channels of raw material suppliers and Millennium and its joint ventures form an integrated system. This is especially true in the U.S. Gulf Coast where the infrastructure of the chemical and refining industries is tightly integrated such that a major disruption of supply of a given commodity can negatively affect numerous participants, including suppliers of other raw materials. If one or more of Millennium s or its joint ventures significant suppliers were unable to meet its obligations under present supply arrangements or supplies are otherwise disrupted, Millennium s or its joint ventures businesses could suffer reduced supplies or be forced to incur increased costs for their raw materials, which would have a direct negative impact on plant operations. For example, Hurricanes Katrina and Rita negatively affected crude oil and natural gas supplies, as well as supplies of some of Millennium s and its joint ventures other raw materials, contributing to increases in raw material prices during the second half of 2005 and, in some cases, disrupting production. In addition, hurricane-related disruption of rail and pipeline traffic in the U.S. Gulf Coast area negatively affected shipments of raw materials and product.

The cyclicality and volatility of the chemical industry may cause significant fluctuations in Millennium s and its joint ventures operating results.

The historical operating results of Millennium and its joint ventures reflect the cyclical and volatile nature of the supply-demand balance in the chemical industry, and their future operating results are expected to continue to be affected by this cyclicality and volatility. This cyclicality and volatility results in significant fluctuations in profits and cash flow from period to period and over the business cycles.

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Conditions for ethylene and its derivatives, and acetyls, are cyclical and volatile, and these businesses are particularly sensitive to capacity additions. These businesses historically have experienced alternating periods of capacity shortages leading to tight supply, causing prices and profit margins to increase, followed by periods when substantial capacity is added, resulting in oversupply, declining capacity utilization rates and declining prices and profit margins. The volatility these businesses experience occurs as a result of changes in supply and demand for products, changes in energy prices and changes in various other economic conditions around the world.

Although less cyclical and volatile than ethylene and its derivatives, and acetyls, demand for TiO_2 also has fluctuated from year to year. For example, the U.S. housing market began experiencing a slowdown during the second half of 2006, which adversely impacted demand for and profitability of Millennium s TiO_2 business.

The chemical industry has experienced tight supply in many product areas and increased demand as the global economy has improved over the past several years. As a result, profitability in the industry increased, even in a world of volatile raw material and energy costs. However, the sustainability of these positive business conditions remains subject to uncertainty. The global economic and political environment continues to be uncertain, and a recession or other negative changes could result in a decline in demand and place pressure on Millennium s and its joint ventures results of operations. In addition, new capacity additions by some participants in the industry, especially those in the Middle East and Asia that began in 2006 and are expected to continue through the latter part of the decade, could lead to another period of oversupply and poor profitability.

Millennium and its joint ventures may reduce production at or idle a facility for an extended period of time or exit a business because of an oversupply of a particular product and/or a lack of demand for that particular product, or high raw material prices, which makes production uneconomical. Any decision to permanently close facilities or exit a business would result in impairment and other charges to earnings. Temporary outages sometimes last for several quarters or, in certain cases, longer, and could cause Millennium and its joint ventures to incur costs, including the expenses of maintaining and restarting these facilities. It is possible that factors such as increases in raw material costs or lower demand in the future will cause Millennium or its joint ventures to reduce operating rates, idle facilities or exit uncompetitive businesses.

External factors beyond Millennium s or its joint ventures control can cause fluctuations in demand for their products and in their prices and margins, which may result in lower operating results.

External factors beyond Millennium s or its joint ventures control can cause volatility in the price of raw materials and other operating costs, as well as significant fluctuations in demand for their products and can magnify the impact of economic cycles on their businesses. Examples of external factors include:

- supply of and demand for raw materials;
- changes in customer buying patterns and demand for Millennium s and its joint ventures products;
- general economic conditions;
- domestic and international events and circumstances;
- competitor actions;
- governmental regulation in the U.S. and abroad; and

severe weather and natural disasters.

Millennium believes that events in the Middle East have had an impact on its acetyls business and Equistar s businesses in recent years and may continue to do so. In addition, a number of Millennium s and its joint ventures products are highly dependent on durable goods markets, such as the housing and automotive markets, which also are cyclical and impacted by many of the external factors referenced above. Many of Millennium s and its joint ventures products are components of other chemical products that, in turn, are subject to the supply-demand balance of the chemical industry and general economic conditions. The global economy has remained strong, with relatively stable demand for Millennium s and its joint ventures products. This has occurred even as the volatility and elevated level of prices for crude oil and natural gas have resulted in increased raw material costs. However, the

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impact of the factors cited above and others may once again cause a slowdown in the business cycle, reducing demand and lowering operating rates and, ultimately, reducing profitability.

Millennium and its joint ventures sell commodity products in highly competitive global markets and face significant price pressures.

Millennium and its joint ventures sell their products in highly competitive global markets. Due to the commodity nature of certain of their products, competition in these markets is based primarily on price and to a lesser extent on product performance, product quality, product deliverability, reliability of supply and customer service. As a result, Millennium and its joint ventures generally are not able to protect their market position for these products by product differentiation and may not be able to pass on cost increases to their customers.

In addition, Millennium and its joint ventures face increased competition from companies that may have different cost structures or strategic goals than Millennium and its joint ventures, such as privately-held companies, large integrated oil companies (many of which also have chemical businesses), government-owned businesses, and companies that receive subsidies or other government incentives to produce certain products in a specified geographic region. Increased competition from these companies, especially in Equistar s ethylene business, could limit Millennium s and its joint ventures ability to increase product sales prices in response to raw material and other cost increases, or could cause Millennium and its joint ventures to reduce product sales prices to compete effectively, which could reduce their profitability.

Accordingly, increases in raw material and other costs may not necessarily correlate with changes in prices for these products, either in the direction of the price change or in magnitude. In addition, their ability to increase product sales prices, and the timing of those increases, are affected by the supply-demand balances for their products, as well as the capacity utilization rates for those products. Timing differences in pricing between rising raw material costs, which may change daily, and contract product prices, which in many cases are negotiated only monthly or less often, sometimes with an additional lag in effective dates for increases, have reduced and may continue to reduce profitability.

Further, volatility in costs and pricing can result in commercial disputes with customers and suppliers with respect to interpretations of complex contractual arrangements. Significant adverse resolution of any such disputes also could reduce profitability.

Millennium s international operations are subject to exchange rate fluctuations, exchange controls, political risks and other risks relating to non-U.S. operations.

Millennium has substantial international operations, which are subject to the risks of doing business abroad, including fluctuations in currency exchange rates, transportation delays and interruptions, political and economic instability and disruptions, restrictions on the transfer of funds, the imposition of duties and tariffs, import and export controls, changes in governmental policies, labor unrest and current and changing regulatory environments. These events could reduce the demand for Millennium s products internationally, decrease the prices at which it can sell its products internationally or disrupt production or other operations internationally, which could reduce its operating results. In addition, Millennium and Equistar obtain a substantial portion of their principal raw materials from sources outside the U.S., which are subject to these same risks. Although Millennium and Equistar have compliance programs and processes intended to ensure compliance with applicable customs, currency exchange control regulations, transfer pricing regulations or any other laws or regulations to which they may be subject, they are subject to the risk that their compliance could be challenged. Furthermore, these laws may be modified, the result of which may be to prevent or limit non-U.S. subsidiaries from transferring cash to Millennium. For geographic data, see Note 21 to the Consolidated Financial Statements.

In addition, Millennium generates revenue from export sales and operations conducted outside the U.S. that may be denominated in currencies other than the relevant functional currency. Exchange rates between these currencies and U.S. dollars in recent years have fluctuated significantly and may do so in the future. Future events, which may significantly increase or decrease the risk of future movement in foreign currencies in which it conducts its business, cannot be predicted. Millennium also may hedge certain revenues and costs using derivative instruments to minimize the impact of changes in the exchange rates of those currencies compared to the respective

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functional currencies. It is possible that fluctuations in foreign exchange rates will result in reduced operating results.

Millennium s and its joint ventures operations and assets are subject to extensive environmental, health and safety and other laws and regulations, which could result in material costs or liabilities.

Millennium and its joint ventures cannot predict with certainty the extent of future liabilities and costs under environmental, health and safety and other laws and regulations and whether liabilities and costs will be material. Millennium and its joint ventures also may face liability for alleged personal injury or property damage due to exposure to chemicals or other hazardous substances at their facilities or chemicals that they manufacture, handle or own. In addition, because the chemical products of Millennium and its joint ventures are components of a variety of other end-use products, Millennium and its joint ventures, along with other members of the chemical industry, are inherently subject to potential claims related to those end-use products. Although claims of the types described above have not historically had a material impact on Millennium s or its joint ventures operations, a substantial increase in the success of these types of claims could result in the expenditure of a significant amount of cash by Millennium or its joint ventures to pay claims, and could reduce their operating results.

Millennium and its joint ventures (together with the industries in which they operate) are subject to extensive national, state and local environmental laws and regulations concerning, and are required to have permits and licenses regulating, emissions to the air, discharges onto land or waters and the generation, handling, storage, transportation, treatment and disposal of waste materials. Many of these laws and regulations provide for substantial fines and potential criminal sanctions for violations. Some of these laws and regulations are subject to varying and conflicting interpretations. In addition, some of these laws and regulations require Millennium and its joint ventures to meet specific financial responsibility requirements. Millennium cannot accurately predict future developments, such as increasingly strict environmental laws, and inspection and enforcement policies, as well as higher compliance costs, which might affect the handling, manufacture, use, emission or disposal of products, other materials or hazardous and non-hazardous waste. Some risk of environmental costs and liabilities is inherent in Millennium s and its joint ventures operations and products, as it is with other companies engaged in similar businesses, and there is no assurance that material costs and liabilities will not be incurred. In general, however, with respect to the costs and risks described above, Millennium does not expect that it or its joint ventures will be affected differently than the rest of the chemical industry where their facilities are located.

Environmental laws may have a significant effect on the nature and scope of cleanup of contamination at current and former operating facilities, the costs of transportation and storage of raw materials and finished products and the costs of the storage and disposal of wastewater. Also, U.S. Superfund statutes may impose joint and several liability for the costs of remedial investigations and actions on the entities that generated waste, arranged for disposal of the wastes, transported to or selected the disposal sites and the past and present owners and operators of such sites. All such responsible parties (or any one of them, including Millennium and its joint ventures) may be required to bear all of such costs regardless of fault, the legality of the original disposal or ownership of the disposal site. In addition, similar environmental laws and regulations that have been or may be enacted in countries outside of the U.S. may impose similar liabilities and costs upon Millennium.

Millennium and its joint ventures have on-site solid-waste management units at several facilities. It is anticipated that corrective measures will be necessary to comply with federal and state requirements with respect to these facilities. Millennium and its joint ventures also have liabilities under the Resource Conservation and Recovery Act and various state and non-U.S. government regulations related to several current and former plant sites. Millennium and its joint ventures also are responsible for a portion of the remediation of certain off-site waste disposal facilities. Millennium and its joint ventures are contributing funds to the cleanup of several waste sites throughout the U.S. under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) and the Superfund Amendments and Reauthorization Act of 1986, including the Kalamazoo River Superfund Site discussed below. Millennium and its joint ventures also have been named as potentially responsible parties at several other sites. Millennium s policy is to accrue remediation expenses when it is probable that such efforts will be required and the related expenses can be reasonably estimated. Estimated costs for future environmental compliance and remediation are necessarily imprecise due to such factors as the continuing evolution of environmental laws and regulatory requirements, the availability and application of technology, the identification of presently unknown remediation sites and the allocation of costs among the potentially responsible parties under

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applicable statutes. For further discussion regarding Millennium s and its joint ventures environmental matters and related accruals (including those discussed in this risk factor), and environmentally-related capital expenditures, see also Item 1. Business Environmental Capital Expenditures, Item 3. Legal Proceedings Environmental Matters, Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations Environmental Matters and Note 18 to the Consolidated Financial Statements. If actual expenditures exceed the amounts accrued, that could have an adverse effect on Millennium s and its joint ventures results of operations and financial position.

Kalamazoo River Superfund Site A Millennium subsidiary has been identified as a Potential Responsible Party (PRP) with respect to the Kalamazoo River Superfund Site. The site involves cleanup of river sediments and floodplain soils contaminated with polychlorinated biphenyls, cleanup of former paper mill operations, and cleanup and closure of landfills associated with the former paper mill operations. Litigation concerning the matter commenced in December 1987 but was subsequently stayed and is being addressed under CERCLA. In 2000, the Kalamazoo River Study Group (the KRSG), of which the Millennium subsidiary and other PRPs are members, submitted to the State of Michigan a Draft Remedial Investigation and Draft Feasibility Study, which evaluated a number of remedial options for the river. The estimated costs for these remedial options ranged from $0 to $2.5 billion.

At the end of 2001, the U.S. Environmental Protection Agency (EPA) took lead responsibility for the river portion of the site at the request of the State of Michigan. In 2004, the EPA initiated a confidential process to facilitate discussions among the agency, the Millennium subsidiary, other PRPs, the Michigan Departments of Environmental Quality and Natural Resources, and certain federal natural resource trustees about the need for additional investigation activities and different possible approaches for addressing the contamination in and along the Kalamazoo River. These discussions are continuing.

As of December 31, 2006, the probable future remediation spending associated with the river cannot be determined with certainty. Although the KRSG study identified a broad range of remedial options, not all of those options would represent reasonably possible outcomes. Management does not believe that it can identify a single remedy among those options that would represent the highest-cost reasonably possible outcome. However, in 2004, Millennium recognized a liability representing Millennium s interim allocation of 55% of the $73 million total of estimated cost of bank stabilization, recommended as the preferred remedy in 2000 by the KRSG study, and of certain other costs. At December 31, 2006, the balance of this liability was $58 million.

In addition, in 2004, Millennium recognized a liability primarily related to Millennium s estimated share of remediation costs for two former paper mill sites and associated landfills, which are also part of the Kalamazoo River Superfund Site. At December 31, 2006, the balance of the liability was $48 million. Although no final agreement has been reached as to the ultimate remedy for these locations, Millennium has begun remediation activity related to these sites.

Millennium s ultimate liability for the Kalamazoo River Superfund Site will depend on many factors that have not yet been determined, including the ultimate remedy selected, the determination of natural resource damages, the number and financial viability of the other PRPs, and the determination of the final allocation among the PRPs. Millennium s ultimate liability for the Kalamazoo River Superfund Site will not be affected by the proposed sale of the inorganic chemicals business, which is anticipated to close in the first half of 2007.

Other Regulatory Requirements In addition to the matters described above, Millennium and its joint ventures are subject to other material regulatory requirements that could result in higher operating costs, such as regulatory requirements relating to the security of chemical facilities, and the transportation, exportation or registration of products. Although Millennium and its joint ventures have compliance programs and other processes intended to ensure compliance with all such regulations, Millennium and its joint ventures are subject to the risk that their compliance with such regulations could be challenged. Non-compliance with certain of these regulations could result in the incurrence of additional costs, penalties or assessments that could be significant.

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Proceedings related to the alleged exposure to lead-based paints and lead pigments could require Millennium to spend material amounts in litigation and settlement costs and judgments.

Together with alleged past manufacturers of lead-based paint and lead pigments for use in paint, Millennium has been named as a defendant in various legal proceedings alleging personal injury, property damage, and remediation costs allegedly associated with the use of these products. The plaintiffs include individuals and governmental entities, and seek recovery under a variety of theories, including negligence, failure to warn, breach of warranty, conspiracy, market share liability, fraud, misrepresentation and nuisance. The majority of these legal proceedings assert unspecified monetary damages in excess of the statutory minimum and, in certain cases, equitable relief such as abatement of lead-based paint in buildings. These legal proceedings are in various trial stages and post-dismissal settings, some of which are on appeal. One legal proceeding relating to lead pigment or paint was tried in 2002. On October 29, 2002, the judge in that case declared a mistrial after the jury declared itself deadlocked. The sole issue before the jury was whether lead pigment in paint in and on Rhode Island buildings constituted a public nuisance. The re-trial of this case began on November 1, 2005. On February 22, 2006, a jury returned a verdict in favor of the State of Rhode Island finding that the cumulative presence of lead pigments in paints and coatings on buildings in the state constitutes a public nuisance; that a Millennium subsidiary, Millennium Holdings, LLC, and other defendants either caused or substantially contributed to the creation of the public nuisance; and that those defendants, including the Millennium subsidiary, should be ordered to abate the public nuisance. On February 28, 2006, the judge held that the state could not proceed with its claim for punitive damages. As a result, the jury was discharged. The court has not entered a final judgment on the jury s verdict; however, on February 26, 2007, the court issued its decision denying the post-verdict motions of the defendants, including Millennium, for a mistrial or a new trial. The court concluded that it would enter an order of abatement and appoint a special master to assist the court in determining the scope of the abatement remedy.

While Millennium believes that it has valid defenses to all the lead-based paint and lead pigment proceedings and is vigorously defending them, litigation is inherently subject to many uncertainties. Additional lead-based paint and lead pigment litigation may be filed against Millennium in the future asserting similar or different legal theories and seeking similar or different types of damages and relief, and any adverse court rulings or determinations of liability, among other factors, could affect this litigation by encouraging an increase in the number of future claims and proceedings. In addition, from time to time, legislation and administrative regulations have been enacted or proposed to impose obligations on present and former manufacturers of lead-based paint and lead pigment respecting asserted health concerns associated with such products or to overturn successful court decisions. Millennium is unable to predict the outcome of lead-based paint and lead pigment litigation, the number or nature of possible future claims and proceedings, and the effect that any legislation and/or administrative regulations may have on Millennium. In addition, Millennium cannot reasonably estimate the scope or amount of the costs and potential liabilities related to such litigation, or any such legislation and regulations. Thus, any liability Millennium incurs with respect to pending or future lead-based paint or lead pigment litigation, or any legislation or regulations could, to the extent not covered or reduced by insurance or other recoveries, have a material impact on Millennium s results of operations. In addition, Millennium has not accrued any liabilities for judgments or settlements against Millennium resulting from lead-based paint and lead pigment litigation. Any liability that Millennium may ultimately incur with respect to lead-based paint and lead pigment litigation will not be affected by the proposed sale of the inorganic chemicals business, which is anticipated to close in the first half of 2007. See Item 3. Legal Proceedings Litigation Matters for additional discussion regarding lead-based paint and lead pigment litigation.

Interruptions of operations at the facilities of Millennium and its joint ventures may result in liabilities or lower operating results.

Millennium and its joint ventures own and operate large-scale chemical facilities, and their operating results are dependent on the continued operation of their various production facilities and the ability to complete construction and maintenance projects on schedule. Material operating interruptions at Millennium s or its joint ventures facilities, including, but not limited to, interruptions caused by the events described below, may materially reduce the productivity and profitability of a particular manufacturing facility, or Millennium as a whole, during and after the period of such operational difficulties. For example, unscheduled downtime at Millennium s U.K. facility had a significant negative impact on Millennium s operating results in 2006.

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Although Millennium and its joint ventures take precautions to enhance the safety of their operations and minimize the risk of disruptions, their operations, along with the operations of other members of the chemical industry, are subject to hazards inherent in chemical manufacturing and the related storage and transportation of raw materials, products and wastes. These potential hazards include:

- pipeline leaks and ruptures;
- explosions;
- fires;
- severe weather and natural disasters;
- mechanical failure;
- unscheduled downtimes;
- supplier disruptions;
- labor shortages or other difficulties;
- transportation interruptions;
- remediation complications;
- chemical spills;
- discharges or releases of toxic or hazardous substances or gases;
- storage tank leaks;
- other environmental risks; and
- terrorist acts.

Some of these hazards can cause personal injury and loss of life, severe damage to or destruction of property and equipment and environmental damage, and may result in suspension of operations and the imposition of civil or criminal penalties. Furthermore, Millennium and its joint ventures also will continue to be subject to present and future claims with respect to workplace exposure, workers compensation and other matters.

Millennium and its joint ventures maintain property, business interruption and casualty insurance that they believe are in accordance with customary industry practices, but they are not fully insured against all potential hazards incident to their businesses, including losses resulting from natural disasters, war risks or terrorist acts. Changes in insurance market conditions have caused, and may in the future cause, premiums and deductibles for certain insurance policies to increase substantially and, in some instances, for certain insurance to become unavailable or available only for reduced amounts of coverage. If Millennium or its joint ventures were to incur a significant liability for which they were not fully insured, that company might not be able to finance the amount of the uninsured liability on terms acceptable to it or at all, and might be obligated to divert a significant portion of its cash flow from normal business operations.

Conflicts of interest between Lyondell, Equistar and/or Millennium could be resolved in a manner that may be perceived to be adverse to Millennium and/or Equistar.

Lyondell owns 70.5% of Equistar, and Millennium owns the remaining 29.5% of Equistar. As a result of Lyondell s November 30, 2004 acquisition of Millennium, Millennium and Equistar are wholly-owned subsidiaries of Lyondell. All executive officers of Millennium and Equistar and all members of Equistar s Partnership Governance Committee and Millennium s Board of Directors also serve as officers of Lyondell. Conflicts of interest may arise between Lyondell, Equistar and/or Millennium when decisions arise that could have different implications for Lyondell, Equistar and/or Millennium. Their respective debt agreements generally require related party transactions to be on an arm s-length basis; however, because Lyondell owns both Millennium and Equistar, conflicts of interest could be resolved in a manner that may be perceived to be adverse to Millennium and/or Equistar.

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Millennium and Equistar depend to a significant degree on Lyondell for the administration of their businesses, and Equistar has product supply arrangements with its owners and other related parties. If those parties do not fulfill their obligations under the arrangements, Millennium s and/or Equistar s revenues, margins and cash flow could be adversely affected.

Lyondell and Equistar and parties related to them have various agreements and transactions with Millennium. For example, Millennium is party to shared services, loaned employee and operating arrangements with Lyondell and Equistar pursuant to which Lyondell, Equistar and Millennium provide many administrative and operating services to each other. Lyondell provides to Millennium and Equistar services that are essential to the administration and management of Millennium s and Equistar s businesses, which from time to time may include information technology, human resources, sales and marketing, raw material supply, supply chain, health, safety and environmental, engineering, research and development, facility services, legal, accounting, treasury, internal audit and tax services. Accordingly, Millennium and Equistar depend to a significant degree on Lyondell for the administration of their businesses. If Lyondell did not fulfill its obligations under the shared services arrangement, it would disrupt Millennium s and Equistar s businesses and could have a material adverse effect on their businesses and results of operations. In addition, Equistar has product supply agreements with Lyondell and Millennium and various other related parties pursuant to which Equistar sells a substantial amount of its products. Equistar expects to continue to derive a significant portion of its business from transactions with these parties. If they are unable or otherwise cease to purchase Equistar s products, Equistar s revenues and margins and, therefore, Millennium s cash flow could be adversely affected.

Millennium pursues acquisitions, dispositions and joint ventures, which may not yield the expected benefits.

Millennium may purchase or sell assets or enter into contractual arrangements or joint ventures in an effort to generate value. For example, on February 23, 2007, Millennium and Cristal signed an agreement for a proposed sale of Millennium s worldwide inorganic chemicals business to Cristal for $1.05 billion, in cash, plus the assumption of specified liabilities. Transactions that Millennium pursues may be intended to, among other things, result in the realization of synergies, the creation of efficiencies or the generation of cash to reduce debt. To the extent permitted under Millennium s credit facility and other debt agreements, some of these transactions may be financed with additional borrowings by Millennium or its joint ventures. Although these transactions may be expected to yield longer-term benefits if the expected efficiencies and synergies of the transactions are realized, they could reduce the operating results of Millennium or its joint ventures in the short term because of the costs, charges and financing arrangements associated with such transactions or the benefits of a transaction may not be realized to the extent anticipated. Other transactions may advance future cash flows from some of Millennium s or its joint ventures businesses, thereby yielding increased short-term liquidity, but consequently resulting in lower cash flows from these operations over the longer term.

The pursuit of strategic transactions also may have other consequences. For example, as Millennium pursues the sale of the inorganic chemicals business, its operating results could be negatively impacted if Millennium experiences a loss of employees, customers or suppliers or an increase in operating or other costs or operating interruptions.

Risks Relating to Debt

Millennium s consolidated balance sheet is highly levered, and Millennium s business and future prospects could be limited by its significant amount of debt and other financial obligations.

Millennium s consolidated balance sheet is highly levered. Millennium s total consolidated debt was $853 million at December 31, 2006, or 82% of its total capitalization. In addition, Millennium has contractual commitments and ongoing pension and post-retirement benefit obligations that will require cash contributions in 2007 and beyond, as described in Contractual and Other Obligations under Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations.

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Millennium s level of debt and other obligations could have significant adverse consequences on its business and future prospects, including the following:

- Millennium may not be able to obtain financing in the future for working capital, capital expenditures, acquisitions, debt service requirements or other purposes;

- less levered competitors could have a competitive advantage because they have lower debt service requirements; and

- in the event of poor business conditions, Millennium may be less able to take advantage of significant business opportunities and to react to changes in market or industry conditions than its competitors.

For a discussion regarding Millennium s ability to pay or refinance its debt, see the Liquidity and Capital Resources section under Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations.

Millennium and Equistar each require a significant amount of cash to service their indebtedness, and the ability of each of them to generate cash depends on many factors beyond their control.

Due to debt covenant limitations on transferring cash between the entities discussed below in this Item 1A. Risk Factors, the ability of each of Millennium and Equistar to make payments on and to refinance its respective indebtedness may depend solely upon its individual ability to generate cash. Each of Millennium and Equistar is separately responsible for its respective outstanding debt (except that $150 million of Equistar s debt is guaranteed by Lyondell). The businesses of each of Millennium and Equistar may not generate sufficient cash flow from operations to meet their respective debt service obligations, future borrowings may not be available under current or future credit facilities of each entity in an amount sufficient to enable each of them to pay their respective indebtedness at or before maturity, and each entity may not be able to refinance its respective indebtedness on reasonable terms, if at all. Factors beyond the control of Millennium and Equistar affect the ability of each of them to make these payments and refinancings. These factors include those discussed elsewhere in these Risk Factors and the Forward-Looking Statements section of this Annual Report on Form 10-K.

Further, the ability of Millennium and Equistar to fund capital expenditures and working capital depends on the ability of each entity to generate cash and depends on the availability of funds under lines of credit and other liquidity facilities. If, in the future, sufficient cash is not generated from their respective operations to meet their respective debt service obligations and sufficient funds are not available under lines of credit or other liquidity facilities, Millennium and Equistar each may need to reduce or delay non-essential expenditures, such as capital expenditures and research and development efforts. In addition, Millennium and Equistar may need to refinance debt, obtain additional financing or sell assets, which they may not be able to do on reasonable terms, if at all.

Debt and other agreements restrict Millennium s and Equistar s ability to take certain actions and require the maintenance of certain financial ratios; failure to comply with these requirements could result in acceleration of debt.

Millennium s Debt Millennium has a U.S. and an Australian revolving credit facility, an Australian term loan facility and a U.K. revolving credit facility. Millennium s facilities and its indentures contain covenants that, subject to exceptions, restrict, among other things, dividends, debt incurrence, lien incurrence, investments, sale and leaseback transactions, sales of assets, affiliate transactions, mergers, accounts receivable securitization transactions, purchase of equity and payments on indebtedness. Pursuant to these provisions, Millennium is prohibited from making restricted payments, including paying certain dividends. Other than the U.K. facility, Millennium s facilities also contain covenants that require the maintenance of specified financial ratios: (1) the Leverage Ratio (as defined) is required to be less than 4.50 to 1 and (2) the Interest Coverage Ratio (as defined) for any period of four consecutive fiscal quarters is required to be equal to or greater than 2.25 to 1. Millennium s U.K. facility does not require the maintenance of specified financial ratios as long as certain conditions are met.

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Equistar s Debt and Accounts Receivable Facility Equistar has an inventory-based revolving credit facility and an accounts receivable sales facility. Both of these facilities and Equistar s indentures contain covenants that, subject to exceptions, restrict, among other things, lien incurrence, debt incurrence, dividends, sales of assets, investments, accounts receivable securitizations, purchase of equity, payments on indebtedness, affiliate transactions, sale and leaseback transactions and mergers. Equistar s credit facility does not require the maintenance of specified financial ratios as long as certain conditions are met. Some of Equistar s indentures require additional interest payments to the note holders if Equistar makes distributions when Equistar s Fixed Charge Coverage Ratio (as defined) is less than 1.75 to 1. Equistar met this ratio as of December 31, 2006.

Effects of a Breach A breach by Millennium or Equistar of any of the covenants or other requirements in their respective debt instruments could (1) permit their respective note holders or lenders to declare the outstanding debt under the breached debt instrument due and payable, (2) permit the lenders under their respective credit facilities to terminate future lending commitments and (3) permit acceleration of the breaching entity s other debt instruments that contain cross-default or cross-acceleration provisions. The respective debt agreements of Millennium and Equistar contain various event of default and cross-default provisions. It is not likely that Millennium or Equistar, as the case may be, would have, or be able to obtain, sufficient funds to make these accelerated payments. In that event, the breaching entity s lenders could proceed against any assets that secure their debt. Similarly, the breach by Equistar of covenants in its accounts receivable sales facility would permit the counterparties to terminate further purchases of interests in accounts receivable and to receive all collections from previously sold interests until they had collected on their interests in those receivables, thus reducing Equistar s liquidity.

Debt covenants limit transfers of cash between Lyondell, Millennium and Equistar.

Although Equistar and Millennium are wholly-owned subsidiaries of Lyondell, debt covenants limit the ability to transfer cash among Lyondell, Equistar and Millennium. For example, Lyondell s indentures contain a covenant that prohibits it from making investments in subsidiaries and joint ventures that are not restricted subsidiaries as defined in the indentures, subject to limited exceptions. Neither Millennium nor Equistar currently is a restricted subsidiary. Lyondell s credit facility also contains a covenant that places limitations on its ability to make investments in joint ventures. Millennium s flexibility to make investments in Equistar also is limited by its debt covenants. As a result, Lyondell s cash flow may not be available to fund cash needs of Millennium, and the cash flow of Lyondell and Millennium may not be available to fund cash needs of Equistar, such as servicing debt or paying capital expenditures.

Some of Equistar s indentures require additional interest payments to the note holders if Equistar makes distributions when Equistar does not meet a specified fixed charge coverage ratio. Equistar met this ratio as of December 31, 2006. In addition, Equistar s credit facility prohibits the payment of distributions during any default under the facility. These provisions may deter or limit the movement of cash from Equistar to Lyondell and Millennium.

Applicable laws may also limit the amounts Equistar is permitted to pay as distributions to Lyondell and Millennium. The ability of Equistar to distribute cash to Lyondell and Millennium, and the ability of Lyondell to make cash investments in Millennium, also is dependent upon their economic performance, which is dependent on a variety of factors, including factors described elsewhere in these Risk Factors and the Forward-Looking Statements section of this Annual Report on Form 10-K.

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FORWARD-LOOKING STATEMENTS

Certain of the statements contained in this report are forward-looking statements within the meaning of the federal securities laws. Forward-looking statements can be identified by words such as estimate, believe, expect, anticipate, plan, budget or other words that cor uncertainty of future events or outcomes. Many of these forward-looking statements have been based on expectations and assumptions about future events that may prove to be inaccurate. While management considers these expectations and assumptions to be reasonable, they are inherently subject to significant business, economic, competitive, regulatory and other risks, contingencies and uncertainties, most of which are difficult to predict and many of which are beyond Millennium s control. Millennium s or its joint ventures actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including but not limited to:

- the availability, cost and price volatility of raw materials and utilities,
- the supply/demand balances for Millennium s and its joint ventures products, and the related effects of industry production capacities and operating rates,
- operating interruptions (including leaks, explosions, fires, weather-related incidents, mechanical failure, unscheduled downtime, supplier disruptions, labor shortages or other labor difficulties, transportation interruptions, spills and releases and other environmental risks),
- legal, tax and environmental proceedings,
- uncertainties associated with the U. S. and worldwide economies, including those due to political tensions in the Middle East and elsewhere,
- the cyclical nature of the chemical industry,
- Millennium s ability to implement its business strategies, including Millennium s ability to successfully complete the proposed sale of the inorganic chemicals business in the time period anticipated, and for the purchase price and on the other terms set forth in the transaction agreement,
- current and potential governmental regulatory actions in the U. S. and in other countries,
- terrorist acts and international political unrest,
- risks of doing business outside the U.S., including foreign currency fluctuations,
- access to capital markets,

competitive products and pricing pressures, and

technological developments.

Any of these factors, or a combination of these factors, could materially affect Millennium s or its joint ventures future results of operations and the ultimate accuracy of the forward-looking statements. These forward-looking statements are not guarantees of Millennium s or its joint ventures future performance, and Millennium s or its joint ventures actual results and future developments may differ materially from those projected in the forward-looking statements. Management cautions against putting undue reliance on forward-looking statements or projecting any future results based on such statements or present or prior earnings levels.

All forward-looking statements in this Form 10-K are qualified in their entirety by the cautionary statements contained in this section and elsewhere in this report. See Item 1. Business, Item 1A. Risk Factors, Item 3. Legal Proceedings, Item 7. Management s Discussion and Analys of Financial Condition and Results of Operations and Item 7A. Disclosure of Market Risk for additional information about factors that may affect the businesses and operating results of Millennium and its joint ventures. These factors are not necessarily all of the important factors that could affect Millennium and its joint ventures. Use caution and common sense when considering these forward-looking statements. Millennium does not intend to update these statements unless securities laws require it to do so.

In addition, this report contains summaries of contracts and other documents. These summaries may not contain all of the information that is important to an investor, and reference is made to the actual contract or document for a more complete understanding of the contract or document involved.

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INDUSTRY AND OTHER INFORMATION

The data included or incorporated by reference in this report regarding the chemical industry, product capacity and ranking, including Millennium s and Equistar s respective capacity positions, the capacity positions of their competitors for certain products and expected rates of demand, is based on independent industry publications, reports from government agencies or other published industry sources and estimates of Millennium and/or Equistar. These estimates are based on information obtained from Millennium s and/or Equistar s customers, distributors, suppliers, trade and business organizations and other contacts in the markets in which Millennium and Equistar operate and managements knowledge and experience. These estimates involve risks and uncertainties and are subject to change based on various factors, including those discussed under Item 1A. Risk Factors and Forward-Looking Statements.

NON-GAAP FINANCIAL MEASURES

The body of generally accepted accounting principles is commonly referred to as GAAP. For this purpose, a non-GAAP financial measure is generally defined by the Securities and Exchange Commission as one that purports to measure historical or future financial performance, financial position or cash flows but excludes or includes amounts that would not be so adjusted in the most comparable U.S. GAAP measure. From time to time Millennium discloses so-called non-GAAP financial measures, primarily EBITDA, or earnings before interest, taxes, depreciation and amortization of long-lived assets. The non-GAAP financial measures described herein or in other documents issued by Millennium are not a substitute for the GAAP measures of earnings, for which management has responsibility.

Millennium sometimes uses EBITDA in its communications with investors, financial analysts and the public. This is because EBITDA is perceived as a useful and comparable measure of operating performance and the contribution of operations to liquidity. For example, interest expense is dependent on the capital structure and credit rating of a company. However, debt levels, credit ratings and, therefore, the impact of interest expense on earnings vary in significance between companies. Similarly, the tax positions of individual companies can vary because of their differing abilities to take advantage of tax benefits, with the result that their effective tax rates and tax expense can vary considerably. Finally, companies differ in the age and method of acquisition of productive assets, and thus the relative costs of those assets, as well as in the depreciation (straight-line, accelerated, units of production) method, which can result in considerable variability in depreciation and amortization expense between companies. Thus, for comparison purposes, management believes that EBITDA can be useful as an objective and comparable measure of operating profitability and the contribution of operations to liquidity because it excludes these elements of earnings that do not provide information about the current operations of existing assets. Accordingly, management believes that disclosure of EBITDA can provide useful information to investors, financial analysts and the public in their evaluation of companies operating performance and the contribution of operations to liquidity.

Millennium also sometimes reports adjusted net income (loss) or adjusted EBITDA, excluding specified items that are unusual in nature or are not comparable from period to period and that are included in GAAP measures of earnings. Management believes that excluding these items may help investors compare operating performance between two periods. Such adjusted data is always reported with an explanation of the items that are excluded.

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Item 2. ***Properties***
Principal Manufacturing Facilities and Mine

The principal manufacturing facilities and mine are set forth below, and are identified by the principal segment or segments using the facility or mine. The facilities producing fragrance and flavors chemicals also are identified below. The facilities and mine are wholly owned, except as otherwise noted below.

Location	Principal Products
Inorganic Chemicals Segment	
Ashtabula, Ohio (a) *	TiO_2 and $TiCl_4$
Baltimore, Maryland (Hawkins Point)	TiO_2
Baltimore, Maryland (St. Helena)	Silica gel
Bunbury, Western Australia (b)*	TiO_2
Le Havre, France (c)	TiO_2
Mataraca, Paraiba, Brazil (mine) (d)*	Ilmenite (generally consumed in the Salvador TiO_2 plant), zircon and natural rutile titanium ore
Salvador, Bahia, Brazil (d)	TiO_2
Stallingborough, United Kingdom *	TiO_2
Thann, France	TiO_2, $TiCl_4$ and ultra-fine TiO_2
Ethylene, Co-Products and Derivatives Segment	
Bayport (Pasadena), Texas	EO, EG and other EO Derivatives
Bayport (Pasadena), Texas (e)	LDPE
Beaumont, Texas (f)	EG
Channelview, Texas (g)	Ethylene, Propylene, Butadiene, Benzene, Toluene, Alkylate and MTBE
Chocolate Bayou, Texas (h)(c)	Ethylene, Propylene, Butadiene, Benzene, Toluene and MTBE
Chocolate Bayou, Texas (h)	HDPE
Clinton, Iowa	Ethylene, Propylene, LDPE and HDPE
Corpus Christi, Texas	Ethylene, Propylene, Butadiene and Benzene
Fairport Harbor, Ohio (i)	Performance polymers
Lake Charles, Louisiana (j)	Ethylene and Propylene
La Porte, Texas	Ethylene, Propylene, LDPE and LLDPE
La Porte, Texas	VAM and Acetic Acid
La Porte, Texas (k)	Methanol
Matagorda, Texas	HDPE
Morris, Illinois	Ethylene, Propylene, LDPE, LLDPE and Polypropylene
Newark, New Jersey	Denatured Alcohol
Tuscola, Illinois	Ethanol
Victoria, Texas (c)	HDPE
Other	
Brunswick, Georgia	Fragrance and Flavor Chemicals
Jacksonville, Florida	Fragrance and Flavor Chemicals

Facilities which received the OSHA Star Certification, which is the highest safety designation issued by the U.S. Department of Labor.
* Facilities which received ISO 14001 Certification of their environmental management systems.
(a) There are two manufacturing plants at Ashtabula, Ohio.

(b) The Bunbury site includes the Kemerton plant and the Australind plant. The plants, as owned and leased by Millennium s Australian subsidiary, are not on contiguous property and are mortgaged as collateral for Millennium s Australian credit facility.
(c) The facility is located on leased land.
(d) Unrelated equity investors hold a minority ownership interest in Millennium s Brazilian subsidiary that owns the facility. See Item 1. Business Inorganic Chemicals Segment for a description of the mine.
(e) The facility is located on leased land. The facility is owned by Equistar and operated by an unrelated party.
(f) The Beaumont facility is owned by PD Glycol, a partnership owned 50% by Equistar and 50% by an unrelated party.

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(g) The Channelview facility has two ethylene processing units owned by Equistar. An unrelated party owns an idled facility at the site on land leased from Equistar. Equistar also operates a styrene maleic anhydride unit and a polybutadiene unit, which are owned by an unrelated party and are located on property leased from Equistar within the Channelview facility.

(h) Millennium and Occidental each contributed to Equistar a facility located at the Chocolate Bayou site. These facilities are not on contiguous property.

(i) The building and land are leased.

(j) The Lake Charles facility has been idled since the first quarter of 2001. Although Equistar retains the physical ability to restart or sell that facility, in the third quarter of 2006 Equistar determined that it had no expectation of resuming production at that facility. The facility and land are leased from Occidental under a lease that expires in May 2009.

(k) The facility is owned by La Porte Methanol Company, a partnership owned 15% by an unrelated party.

Other Locations and Properties

Millennium Millennium leases warehouses, offices and its research facility in Maryland. Lyondell provides office space to Millennium in Greenville, Delaware as part of a shared services arrangement. Millennium also has barge docking facilities and related equipment for loading and unloading raw materials and products. Millennium owns and leases railcars for use in its businesses.

Equistar Equistar owns storage capacity for NGLs, ethylene, propylene and other hydrocarbons in caverns within a salt dome in Mont Belvieu, Texas. There are additional ethylene and propylene storage facilities with related brine facilities operated by Equistar on leased property in Markham, Texas.

Equistar uses an extensive pipeline system, some of which it owns and some of which it leases, extending from Corpus Christi to Mont Belvieu to Port Arthur and around the Lake Charles area. Equistar owns other pipelines in connection with its Chocolate Bayou, Corpus Christi, La Porte, Matagorda and Victoria facilities. Equistar uses a pipeline owned and operated by an unaffiliated party to transport ethylene from its Morris facility to its Tuscola facility. Equistar owns and leases several pipelines connecting the Channelview facility, Lyondell s refinery and the Mont Belvieu storage facility, which are used to transport raw materials, butylenes, hydrogen, butane, MTBE and unfinished gasolines. Equistar also has barge docking facilities and related terminal equipment for loading and unloading raw materials and products. Equistar owns and leases railcars for use in its businesses.

Lyondell provides office space to Equistar for its executive offices in downtown Houston, Texas as part of a shared services arrangement. In addition, Equistar owns facilities that house its research operations. Equistar also leases various sales facilities and storage facilities, primarily in the U.S. Gulf Coast area, for the handling of products.

Item 3. *Legal Proceedings*

Litigation Matters

Millennium and its joint ventures are, from time to time, defendants in lawsuits, some of which are not covered by insurance. Many of these suits make no specific claim for relief. Although final determination of legal liability and the resulting financial impact with respect to any such litigation cannot be ascertained with any degree of certainty, Millennium does not believe that any ultimate uninsured liability resulting from the legal proceedings in which it or its joint ventures currently are involved (directly or indirectly) will individually, or in the aggregate, have a material adverse effect on the business or financial position of Millennium. However, the adverse resolution in any reporting period of one or more of these suits could have a material impact on Millennium s results of operations for that period, which may be mitigated by contribution or indemnification obligations of co-defendants or others, or by any insurance coverage that may be available.

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Although Millennium and its joint ventures are involved in numerous and varied legal proceedings, a significant portion of their outstanding litigation arose in five contexts: (1) claims for personal injury or death allegedly arising out of exposure to the products produced by or located on the premises of the respective entities; (2) claims for personal injury or death, and/or property damage allegedly arising out of the generation and disposal of chemical wastes at Superfund and other waste disposal sites; (3) claims for personal injury, property damage and/or air, noise and water pollution allegedly arising out of operations; (4) employment and benefits related claims; and (5) commercial disputes.

In 2004, Millennium received requests from the staff of the Northeast Regional Office of the Securities and Exchange Commission for the voluntary production of documents in connection with an informal inquiry into the previously disclosed restatement of Millennium s financial statements for the years 1998 through 2002 and for the first quarter of 2003. Millennium has complied with all such requests received.

Together with alleged past manufacturers of lead-based paint and lead pigments for use in paint, Millennium has been named as a defendant in various legal proceedings alleging personal injury, property damage, and remediation costs allegedly associated with the use of these products. The plaintiffs include individuals and governmental entities, and seek recovery under a variety of theories, including negligence, failure to warn, breach of warranty, conspiracy, market share liability, fraud, misrepresentation and nuisance. The majority of these legal proceedings assert unspecified monetary damages in excess of the statutory minimum and, in certain cases, seek equitable relief such as abatement of lead-based paint in buildings. Legal proceedings relating to lead pigment or paint are in various trial stages and post-dismissal settings, some of which are on appeal.

Millennium s defense costs to date for lead-based paint and lead pigment litigation largely have been covered by insurance. Millennium has not accrued any liabilities for any lead-based paint and lead pigment litigation. Millennium has insurance policies that potentially provide approximately $1.0 billion in indemnity coverage for lead-based paint and lead pigment litigation. Millennium s ability to collect under the indemnity coverage would depend upon, among other things, the resolution of certain potential coverage defenses that the insurers are likely to assert and the solvency of the various insurance carriers that are part of the coverage block at the time of such a request. As a result of insurance coverage litigation initiated by Millennium, an Ohio trial court issued a decision in 2002 effectively requiring certain insurance carriers to resume paying defense costs in the lead-based paint and lead pigment cases. Indemnity coverage was not at issue in the Ohio court s decision. On February 23, 2006, certain Lloyd s, London insurance underwriters filed a declaratory judgment action in the Supreme Court of the State of New York (trial court) against several of their policyholders, including Millennium, contesting their responsibility to provide insurance coverage for all of the lead-based paint and lead pigment cases, including the Rhode Island case discussed below. On March 14, 2006, Millennium filed a motion to dismiss the New York case in favor of the pre-existing Ohio action, and on April 27, 2006, the Supreme Court of the State of New York stayed the New York case in favor of the prior-filed Ohio action. On or about October 5, 2006, Lloyd s, London filed a notice of appeal of the New York trial court s decision. In addition, on March 7, 2006, Millennium filed an amended complaint in the Ohio case referenced above that revived its Ohio state court litigation, seeking, among other relief, a declaratory judgment as to the responsibility of all of its insurance carriers for any judgments or settlements in connection with any lead-based paint and lead pigment litigation involving Millennium. On April 26, 2006, the judge in the Ohio case granted Millennium s motion to amend the complaint to include all insurance carriers. The insurance carriers have in the past and may in the future attempt to deny indemnity coverage if there is ever a settlement or a final, non-appealable adverse judgment in any lead-based paint or lead pigment case.

After owning the Glidden Paints business for six months, in 1986, a predecessor of a current subsidiary of Millennium sold, through a stock sale, its Glidden Paints business. As part of that sale, the seller and purchaser agreed to provide indemnification to each other against certain claims made during the first eight years after the sale, and the purchaser agreed to fully indemnify the seller against such claims made after the eight-year period. With the exception of two cases described below, all pending lead-based paint and lead pigment litigation involving Millennium, including the Rhode Island case, were filed after the eight-year period. Accordingly, Millennium believes that it is entitled to full indemnification from the purchaser against lead-based paint and lead pigment cases filed after the eight-year period. The purchaser disputes that it has such an indemnification obligation, and claims that the seller must indemnify it. As Millennium has not paid either a settlement or any judgment, its indemnification claims have not been finally resolved. The only two remaining cases originally filed within the eight-year period following the 1986 sale of the Glidden Paints business include as parties a current Millennium

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subsidiary and an alleged predecessor company. One case filed by the New York City Housing Authority remains inactive. The other matter is a personal injury case in Ohio. On January 25, 2007, the Ohio Court of Appeals affirmed summary judgment in favor of Millennium and its co-defendants.

Lyondell believes that Millennium has valid defenses to all pending lead-based paint and lead pigment proceedings and is vigorously defending them. However, litigation is inherently subject to many uncertainties. Additional lead-based paint and lead pigment litigation may be filed against Millennium in the future asserting similar or different legal theories and seeking similar or different types of damages and relief, and any adverse court rulings or determinations of liability, among other factors, could affect the litigation by encouraging an increase in the number of future claims and proceedings. In addition, from time to time, legislation and administrative regulations have been enacted or proposed to impose obligations on present and former manufacturers of lead-based paint and lead pigment respecting asserted health concerns associated with such products or to overturn successful court decisions. Millennium is unable to predict the outcome of lead-based paint and lead pigment litigation, the number or nature of possible future claims and proceedings, or the effect that any legislation and/or administrative regulations may have on Millennium. In addition, management cannot reasonably estimate the scope or amount of the costs and potential liabilities related to such litigation, or any such legislation and regulations. Accordingly, Lyondell has not accrued any amounts for such litigation.

Millennium is currently named a defendant in 55 cases arising from Glidden s manufacture of lead pigments that are in various stages of the litigation process. Of these, three have been dismissed in favor of Millennium and its co-defendants by the trial court, but remain open and are on appeal. There are three inactive cases which remain open pending administrative closure by the courts. The remainder of the cases are in various pre-trial stages. In addition, there are two personal injury cases filed in which Millennium has been named as a defendant, but has not been formally served. Of the 50 open and active cases, most seek damages for personal injury and are brought by individuals, and ten of the cases seek damages and abatement remedies based on public nuisance and are brought by states, cities and/or counties in five states (California, Missouri, New Jersey, Ohio and Rhode Island).

On October 29, 2002, after a trial in which the jury deadlocked, the court in *State of Rhode Island v. Lead Industries Association, Inc., et al.* (which commenced in the Superior Court of Providence, Rhode Island, on October 13, 1999) declared a mistrial. The sole issue before the jury was whether lead pigment in paint in and on public and private Rhode Island buildings constituted a public nuisance. The new trial in this case began on November 1, 2005. On February 22, 2006, a jury returned a verdict in favor of the State of Rhode Island finding that the cumulative presence of lead pigments in paints and coatings on buildings in the state constitutes a public nuisance; that a Millennium subsidiary and other defendants either caused or substantially contributed to the creation of the public nuisance; and that those defendants, including the Millennium subsidiary, should be ordered to abate the public nuisance. On February 28, 2006, the judge held that the state could not proceed with its claim for punitive damages. As a result, the jury was discharged. The court has not entered a final judgment on the jury s verdict; however, on February 26, 2007, the court issued its decision denying the post-verdict motions of the defendants, including Millennium, for a mistrial or a new trial. The court concluded that it would enter an order of abatement and appoint a special master to assist the court in determining the scope of the abatement remedy.

Environmental Matters

From time to time Millennium and its joint ventures receive notices or inquiries from federal, state or local governmental entities of alleged violations of environmental laws and regulations pertaining to, among other things, the disposal, emission and storage of chemical and petroleum substances, including hazardous wastes. Any such alleged violations may become the subject of enforcement actions, settlement negotiations or other legal proceedings and may (individually or in the aggregate) involve monetary sanctions of $100,000 or more (exclusive of interest and costs).

Millennium s accrued liability for future environmental remediation costs at current and former plant sites and other remediation sites totaled $172 million as of December 31, 2006. The remediation expenditures are expected to occur over a number of years, and not to be concentrated in any single year. In the opinion of management, there is no material estimable range of reasonably possible loss in excess of the liabilities recorded for environmental remediation. However, it is possible that new information about the sites for which the accrual has been established,

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new technology or future developments such as involvement in investigations by regulatory agencies, could require Millennium to reassess its potential exposure related to environmental matters. The liabilities for individual sites range from less than $1 million to $106 million. The $106 million liability relates to the Kalamazoo River Superfund Site. For additional information regarding environmental matters, including the liability related to the Kalamazoo River Superfund Site, see Item 1A. Risk Factors Risks Relating to the Businesses Millennium s and its joint ventures operations and assets are subject to extensive environmental, health and safety and other laws and regulations, which could result in material costs or liabilities, Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations Environmental Matters and Note 18 to the Consolidated Financial Statements.

A Millennium subsidiary has been identified as a PRP with respect to the Kalamazoo River Superfund Site. The site involves cleanup of river sediments and floodplain soils contaminated with polychlorinated biphenyls, cleanup of former paper mill operations, and cleanup and closure of landfills associated with the former paper mill operations. Litigation concerning the matter commenced in December 1987 but was subsequently stayed and is being addressed under CERCLA. Millennium s ultimate liability for the Kalamazoo River Superfund Site will depend on many factors that have not yet been determined, including the ultimate remedy selected, the determination of natural resource damages, the number and financial viability of the other PRPs, and the determination of the final allocation among the PRPs.

In December 2006, the State of Texas filed a lawsuit in the District Court, Travis County, Texas, against Equistar and its owners, Lyondell and Millennium, alleging past violations of various environmental regulatory requirements at Equistar s Channelview, Chocolate Bayou and La Porte, Texas facilities and Millennium s La Porte, Texas facility, and seeking an unspecified amount of damages. The previously disclosed Texas Commission on Environmental Quality notifications alleging noncompliance of emissions monitoring requirements at Millennium s La Porte facility and Equistar s Channelview facility and seeking civil penalties of $179,520 and $167,000, respectively, have been included as part of this lawsuit. Millennium and Equistar do not believe that the ultimate resolution of this matter will have a material adverse effect on their respective businesses, financial positions, liquidity or results of operations.

Indemnification

Millennium and its joint ventures are parties to various indemnification arrangements, including arrangements entered into in connection with acquisitions, divestitures and the formation of joint ventures. For example, Millennium entered into indemnification arrangements in connection with its demerger from Hanson plc, and Equistar and its owner companies (including Millennium) entered into indemnification arrangements in connection with the formation of Equistar. Pursuant to these arrangements, Millennium and its joint ventures provide indemnification to and/or receive indemnification from other parties in connection with liabilities that may arise in connection with the transactions and in connection with activities prior to completion of the transactions. These indemnification arrangements typically include provisions pertaining to third party claims relating to environmental and tax matters and various types of litigation. As of December 31, 2006, Millennium has not accrued any significant amounts for such indemnification obligations and is not aware of other circumstances that would be likely to lead to significant future indemnification claims against Millennium. Millennium cannot determine with certainty the potential amount of future payments under the indemnification arrangements until events arise that would trigger a liability under the arrangements.

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

Omitted pursuant to General Instruction I of Form 10-K.

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PART II

Item 5. ***Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities***

Millennium does not have a class of equity securities registered pursuant to Section 12 of the Securities Exchange Act of 1934. There is no established public trading market for the common stock of Millennium. As a result of Lyondell s acquisition of Millennium, Millennium is a wholly-owned subsidiary of Lyondell.

Millennium did not pay dividends on its common stock during 2005 and 2006. Millennium s credit facility contains certain restrictions on Millennium s ability to pay dividends on its common stock. In addition, Millennium is prohibited from paying any dividends under provisions of the 9.25% Senior Notes. For a description of those restrictions, see Item 1A. Risk Factors Risks Relating to Debt Debt and other agreements restrict Millennium s and Equistar s ability to take certain actions and require the maintenance of certain financial ratios; failure to comply with these requirements could result in acceleration of debt, Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations Financial Condition Liquidity and Capital Resources and Note 13 to the Consolidated Financial Statements.

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

The following selected financial data should be read in conjunction with the Consolidated Financial Statements and the notes thereto and Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations.

	For the year ended December 31,				
Millions of dollars, except per share data	**2006**	**2005**	**2004**	**2003**	**2002**
Results of Operations Data:					
Sales and other operating revenues	$ 1,948	$ 1,959	$ 1,888	$ 1,687	$ 1,554
Income (loss) from equity investment in Equistar	181	221	81	(100)	(73)
Income (loss) before cumulative effect of accounting change (a)	159	28	(31)	(185)	(39)
Cumulative effect of accounting change (b)	- -	- -	- -	(1)	(305)
Net income (loss)	159	28	(31)	(186)	(344)
Basic and diluted loss per share (c)	- -	- -	- -	(2.91)	(5.41)
Dividends per share (d)	- -	- -	- -	0.27	0.54
Balance Sheet Data:					
Total assets	2,414	2,532	2,584	2,411	2,408
Long-term debt	849	966	1,398	1,461	1,212
Cash Flow Data:					
Cash provided (used) by -					
Operating activities	193	275	195	(92)	80
Investing activities	(65)	(60)	(41)	(48)	(64)
Financing activities	(290)	(272)	(38)	205	(4)

(a) The 2004 and 2003 losses before cumulative effect of accounting change include after-tax business combination costs of $46 million in 2004 and after-tax impairment charges of $101 million in 2003. The 2003 charges were the result of the write down of property, plant and equipment at Millennium s Le Havre, France TiO_2 facility.

(b) Cumulative effect of accounting change in 2003 reflects a change in accounting for asset retirement obligations, and cumulative effect of accounting change in 2002 reflects a change in accounting for goodwill.

(c) Basic and diluted loss per share are the same for applicable years.

(d) In July 2003, the payment of dividends on common stock was suspended.

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

This discussion should be read in conjunction with the information contained in the Consolidated Financial Statements of Millennium Chemicals Inc., together with its consolidated subsidiaries (collectively, Millennium or the Company), and the notes thereto.

In addition to comparisons of annual operating results, Millennium has included, as additional disclosure, certain trailing quarter comparisons of fourth quarter 2006 operating results to third quarter 2006 operating results. Millennium s businesses are highly cyclical, in addition to experiencing some less significant seasonal effects. Trailing quarter comparisons may offer important insight into current business directions.

OVERVIEW

General Millennium, a global manufacturer and marketer of chemicals, primarily titanium dioxide (TiO_2) and acetyls, is a wholly-owned subsidiary of Lyondell Chemical Company (Lyondell). Millennium was acquired by Lyondell on November 30, 2004. Millennium s operates in two reportable segments: inorganic chemicals, which primarily consist of TiO_2; and ethylene, co-products and derivatives (EC&D). The EC&D segment includes Millennium s acetyls business and Millennium s 29.5% interest in Equistar Chemicals, LP (together with its consolidated subsidiaries, Equistar), which is accounted for by Millennium using the equity method. Other subsidiaries of Lyondell hold the remaining interest in Equistar. On February 23, 2007, Millennium signed an agreement for a proposed sale of Millennium s worldwide inorganic chemicals business for $1.05 billion, in cash, plus the assumption of specified liabilities. Closing is anticipated to occur in the first half of 2007.

2006 Versus 2005 Demand for TiO_2 in 2006 was negatively affected by a weaker U.S. housing market during the latter half of the year. During 2006 and 2005, the markets for Equistar s ethylene products generally continued to experience favorable supply and demand conditions.

Operating results for the inorganic chemicals segment in 2006 compared to 2005 were negatively affected by higher raw material and utility costs compared to 2005, as well as by production problems primarily at a plant in the U.K. Compared to 2005, product sales prices in 2006 were moderately higher. The 2005 operating results were negatively affected by inventory reduction efforts, including reduced plant operating rates, which were initiated in the third quarter 2005 in response to weak 2005 demand.

In 2006 compared to 2005, the acetyls business benefited from higher market sales prices for methanol. Overall raw material and energy costs were higher in 2006 compared to 2005 due to higher average market prices for ethylene, which were only partly offset by lower average market prices for natural gas.

Millennium s equity investment in Equistar resulted in 2006 income of $181 million compared to 2005 income of $221 million as Equistar s average product margins improved. Equistar s results for 2006 included a pretax charge of $135 million, of which Millennium s proportionate share was $40 million, related to impairment of the net book value of Equistar s idled Lake Charles, Louisiana ethylene facility. Equistar s operating results for 2006 reflected the benefits of higher sales prices, including significantly higher co-product and polyethylene sales prices, which were substantially offset by higher costs, primarily higher raw material costs, compared to 2005.

2005 versus 2004 The TiO_2 market experienced weaker demand in 2005 compared to 2004. However, in 2005, the chemical industry generally experienced improved profitability compared to 2004, despite higher crude oil and natural gas prices that pushed up raw material costs for most of the year and the disruptive effects of two major U.S. Gulf Coast hurricanes.

The U.S. Gulf Coast hurricanes, Katrina and Rita, negatively affected crude oil and natural gas supplies, as well as supplies of other raw materials, contributing to the increases in raw material prices in 2005. Supply/demand balances and prices were affected beginning in September 2005 as most Gulf Coast producers of chemicals suspended operations in preparation for the hurricanes, with some sustaining major damage as a result of the hurricanes. Millennium s and Equistar s Gulf Coast plants experienced only minor hurricane damage; however, they suspended plant operations in preparation for Hurricane Rita, resulting in lost production and higher costs during 2005.

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Operating results for the inorganic chemicals segment in 2005 compared to conditions in 2004 reflected benefits from higher sales prices, offset by the negative effects of weaker TiO_2 demand. In response to the weaker 2005 demand, Millennium initiated inventory reduction efforts, including reduced 2005 plant operating rates that lowered earnings by approximately $20 million.

The acetyls business was negatively affected in 2005 compared to 2004 by higher raw material and energy costs, due to higher ethylene and natural gas prices, and lower sales volumes, resulting from weaker demand. These negative effects were only partly offset by the benefits of higher average product sales prices.

Millennium s equity investment in Equistar resulted in 2005 income of $221 million compared to 2004 income of $81 million as Equistar s average product margins improved. The benefit of the higher average product margins was partly offset by the negative effects of hurricane-related costs and lower sales volumes.

RESULTS OF OPERATIONS

Revenues Millennium s revenues of $1,948 million for 2006 were comparable to 2005 revenues of $1,959 million as lower product sales volumes were substantially offset by higher average sales prices. Acetyls sales volumes decreased due primarily to a 10% decrease in vinyl acetate monomer (VAM) sales, while TiO_2 sales volumes were 4% lower.

Revenues of $1,959 million for 2005 increased 4% compared to $1,888 million in 2004 due to higher acetyls and TiO_2 sales prices in 2005, partly offset by the effect of lower sales volumes. Acetyls sales volumes decreased due primarily to a 17% decrease in VAM sales, while TiO_2 sales volumes were 7% lower.

Cost of Sales Millennium s cost of sales of $1,732 million in 2006 was comparable to $1,715 million in 2005 as higher production costs, reflecting higher raw material, distribution and utility costs, were substantially offset by the effect of lower sales volumes in 2006 compared to 2005.

Cost of sales of $1,715 million in 2005 increased 7% compared to $1,602 million in 2004, primarily due to rising energy and raw material costs, particularly natural gas. In 2005, reduced plant operating rates resulting from the inventory reduction program also affected cost of sales negatively. These effects were partly offset by the effect of lower sales volumes in 2005 compared to 2004.

SG&A Expenses SG&A expenses were $158 million, $194 million and $164 million in 2006, 2005 and 2004, respectively. The 19% decrease in SG&A expenses in 2006 compared to 2005 was principally due to lower provisions for environmental remediation costs. Higher compensation and employee benefit costs in 2006 were substantially offset by lower legal expenses and other costs compared to 2005. The 18% increase in SG&A expenses in 2005 compared to 2004 was primarily due to legal services and estimated environmental remediation costs.

Business Combination Costs The decrease of $69 million in business combination costs from 2004 to 2005 was the result of Millennium incurring $71 million of business combination costs in connection with Lyondell s November 30, 2004 acquisition of Millennium, which costs primarily consisted of change-of-control liabilities to officers and key employees of Millennium and the vesting of certain of their benefits in 2004, compared to only $2 million in 2005.

Asset Impairments Millennium s asset impairment charges of $22 million in 2006, $15 million in 2005, and $14 million in 2004 reflected impairments of capital expenditures for Millennium s Le Havre, France TiO_2 manufacturing facility as well as, in 2006, $7 million of certain software costs. See Note 5 to the Consolidated Financial Statements.

Operating Income Millennium had operating income of $8 million in 2006 compared to $10 million in 2005. The combined effects of higher raw material and energy costs, plant operating problems, primarily in the U.K., and lower sales volumes were substantially offset by $36 million of lower environmental remediation costs in 2006 compared to 2005.

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Millennium had operating income of $10 million in 2005 compared to $7 million in 2004. The increase in 2005 compared to 2004 was primarily the result of a $69 million decrease in business combination costs, which was substantially offset by $30 million of higher legal costs and provisions for estimated environmental remediation costs and lower product margins. The lower product margins in 2005 reflected the effect of higher energy and raw material costs, which were only partially offset by higher average sales prices compared to 2004.

Interest Expense Interest expense was $78 million in 2006, $130 million in 2005 and $106 million in 2004. Interest expense in 2005 included $29 million of interest associated with income tax issues. The remaining decrease in 2006 of $23 million reflected net repayments of debt of $541 million since January 1, 2005. See the Financing Activities section of Financial Condition below for a description of the issuance and repayment of debt during 2005 and 2006.

Other Income (Expense), net Millennium had $24 million of other income, net, in 2006, $19 million of other expense, net, in 2005 and other income, net, of $14 million in 2004. Other income, net, in 2006 included a net benefit of $29 million related to the reversal of interest expense accruals as a result of a favorable settlement of prior year income tax issues, partially offset by a $7 million charge for debt prepayment premiums. Other expense, net, in 2005 included $10 million of debt prepayment premiums and $9 million of charges related to other investments. Other income, net, in 2004 included $6 million related to the reversal of interest expense accruals as a result of the favorable settlement of tax issues.

Income from Equity Investment in Equistar Millennium s equity investment in Equistar resulted in income of $181 million, $221 million and $81 million in 2006, 2005 and 2004, respectively. See Note 7 to the Consolidated Financial Statements. Equistar s operating results are reviewed in the discussion of the EC&D segment below.

Income Taxes Millennium had an income tax benefit of $19 million in 2006 and tax provisions of $67 million and $33 million in 2005 and 2004, respectively. The $19 million tax benefit on income before tax and minority interest of $142 million primarily reflected the $80 million effect of favorable settlements of and changes in estimates for prior year items during 2006, partly offset by an $18 million increase in the valuation allowance for tax assets of French subsidiaries. The $67 million provision in 2005 exceeded the U.S. statutory rate due primarily to a $13 million increase in estimates of taxes for prior years and a $16 million increase in the valuation allowance for tax assets of French subsidiaries. The $33 million provision in 2004 exceeded the U.S. statutory rate, reflecting an increase of $28 million in estimates of taxes for prior years and a $20 million increase in the valuation allowance for tax assets of French subsidiaries.

Net Income Millennium reported net income of $159 million and $28 million in 2006 and 2005, respectively, and a net loss of $31 million in 2004. The $131 million increase in profitability in 2006 compared to 2005 reflected a $102 million benefit from income tax effects and after-tax increases of $28 million in other income (expense), net, and $27 million in interest expense, net, all of which were partially offset by after-tax decreases of $26 million in income from Millennium s equity investment in Equistar. Operating income in 2006 was comparable to 2005. The $59 million improvement in 2005 compared to 2004 was primarily the result of the increase in income from Millennium s equity investment in Equistar of $91 million after tax and a decrease in business combination costs of $45 million after tax. These improvements were partly offset by the increases in SG&A, interest expense and other expense, net, noted above, totaling $45 million after tax, and the after-tax effect of lower sales volumes of approximately $30 million in 2005 compared to 2004.

Fourth Quarter 2006 versus Third Quarter 2006 Millennium had a net loss of $5 million in the fourth quarter 2006 compared to net income of $17 million in the third quarter 2006. The decrease in the fourth quarter 2006 reflected after-tax decreases of $24 million in operating income and $12 million attributable to income tax effects, partially offset by an after-tax increase of $14 million in income from its equity investment in Equistar. Millennium s third quarter 2006 income from its equity investment in Equistar included its $26 million after tax proportionate share of Equistar s pretax impairment charge of $135 million. The remaining decrease in Equistar s fourth quarter 2006 results compared to the third quarter 2006 was due to lower margins and the effect of lower sales volumes.

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Segment Analysis

Millennium s principal operations are grouped into two business segments: inorganic chemicals; and EC&D. The EC&D segment includes Millennium s acetyls business and Millennium s 29.5% interest in Equistar, which is accounted for under the equity method. See Note 7 to the Consolidated Financial Statements.

The following table reflects summarized financial information for Millennium s segments. Other operating loss includes income and expense not identified with the two businesses, including certain of Millennium s SG&A expenses, business combination costs and employee-related costs from predecessor businesses.

Millions of dollars	For the year ended December 31, 2006	2005	2004
Revenues:			
Inorganic chemicals segment	$ 1,354	$ 1,360	$ 1,340
EC&D segment acetyls business	481	504	453
Operating income (loss):			
Inorganic chemicals segment	(2)	24	51
EC&D segment acetyls business	36	45	59
Other	(26)	(59)	(103)
Income from equity investment in Equistar	181	221	81
Volumes			
Inorganic chemicals:			
TiO_2 (metric kilotons)	594	618	665
EC&D Acetyls (volumes in millions):			
Vinyl Acetate Monomer (VAM) (pounds)	644	712	856
Acetic acid (pounds)	589	546	520
Methanol (gallons)	52	64	57

Inorganic Chemicals Segment

Overview The Inorganic Chemicals (Inorganics) segment primarily produces TiO_2, but also produces titanium tetrachloride ($TiCl_4$), titanyl sulfate ($TiOSO_4$), ultra-fine TiO_2 and other inorganic chemicals. On February 23, 2007, Millennium signed an agreement for a proposed sale of Millennium s worldwide inorganic chemicals business (See Note 22 to the Consolidated Financial Statements).

Operating results for the Inorganics segment included pretax asset impairment charges of $22 million in 2006, $15 million in 2005 and $14 million in 2004 associated with the write-down of property, plant and equipment at the Le Havre, France TiO_2 manufacturing facility as well as, in 2006, certain software costs.

Revenues Revenues of $1,354 million in 2006 were comparable to revenues of $1,360 million in 2005. Revenues in 2006 reflected the effects of 4% higher average U.S. dollar sales prices that were offset by the effect of 4% lower sales volumes compared to 2005. Sales volumes in 2006 were lower compared to 2005 as a result of lower U.S. demand and production problems, primarily at a U.K. plant.

Revenues of $1,360 million in 2005 were comparable to revenues of $1,340 million in 2004 as 9% higher average sales prices were substantially offset by the effect of 7% lower sales volumes. Sales volumes were lower in 2005 despite the positive effect of hurricane-related supply disruptions at another TiO_2 producer s facility during part of 2005. The lower 2005 sales volumes compared to 2004 reflected weaker 2005 demand and Millennium s 2004 efforts to reduce inventory levels through a strong sales volume push.

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Operating Income The Inorganics segment had an operating loss of $2 million in 2006 compared to operating income of $24 million in 2005. The $26 million decrease was primarily attributable to approximately $25 million of higher production costs, reflecting higher raw material, distribution and energy costs and the effects of operating problems, primarily in the U.K., the $13 million effect of lower product sales volumes and a $7 million charge for impairment of certain software costs, all of which were partially offset by the $20 million effect of higher average U.S. dollar sales prices compared to 2005.

The Inorganics segment had operating income of $24 million in 2005 compared to $51 million in 2004. The decrease in operating income reflected the negative effect of lower sales volumes of approximately $15 million and a $15 million provision for estimated environmental remediation costs. Product margins were relatively unchanged as higher product sales prices substantially offset the negative effects of lower sales volumes as a result of weaker TiO_2 demand. In response to the weaker 2005 demand, Millennium initiated inventory reduction efforts, including reduced 2005 plant operating rates.

Ethylene, Co-products and Derivatives Segment

Millennium s EC&D segment comprises its wholly-owned acetyls business and its equity investment in Equistar.

Acetyls Business

Overview The acetyls business produces and markets VAM, acetic acid and methanol.

Revenues Acetyls revenues of $481 million in 2006 were 5% lower compared to revenues of $504 million in 2005, primarily due to lower sales volumes, partially offset by the effects of higher average sales prices. The decrease in sales volumes in 2006 compared to 2005 primarily reflected 10% lower sales volumes for VAM reflecting lower sales to U.S. and Asian markets. The increase in average sales prices was primarily due to higher average sales prices for methanol.

Acetyls revenues of $504 million in 2005 increased by $51 million, or 11%, compared to revenues of $453 million in 2004 primarily due to higher average sales prices, which were partly offset by lower sales volumes. In 2005, the aggregate sales price for VAM and acetic acid was 17% higher than in 2004 as price increases were implemented in response to higher raw material and energy costs. The sales volume decrease in 2005 compared to 2004 primarily reflected lower VAM sales volumes.

Operating Income Operating income was $36 million in 2006 compared to $45 million in 2005. The $9 million decrease was primarily due to lower margins, which reflected $39 million of higher costs, partially offset by the $34 million effect of higher average sales prices. The higher costs were primarily due to higher raw material costs reflecting an increase in ethylene prices, partially offset by the benefit of lower natural gas prices. Lower sales volumes in 2006 had a $4 million negative effect.

The acetyls business had operating income of $45 million in 2005 compared to operating income of $59 million in 2004. The $14 million decrease was primarily due to higher raw material and energy costs of approximately $90 million and the effect of lower sales volumes of approximately $10 million, partially offset by approximately $85 million of higher sales prices.

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Equity Investment in Equistar

Overview Equistar manufactures and markets ethylene and its co-products, primarily propylene, butadiene and aromatics, which include benzene and toluene. Equistar also manufactures and markets ethylene derivatives, primarily polyethylene (including high density polyethylene (HDPE), low density polyethylene (LDPE) and linear-low density polyethylene (LLDPE)), ethylene glycol, ethylene oxide (EO) and other EO derivatives, and ethanol. Equistar also manufactures and markets fuel products, such as methyl tertiary butyl ether (MTBE) and alkylate, as well as polypropylene. As a result of the acquisition of Millennium by Lyondell on November 30, 2004, Equistar became a wholly-owned subsidiary of Lyondell.

2006 Versus 2005 During 2006 and 2005, the markets for Equistar s ethylene products generally continued to experience favorable supply and demand conditions. Raw material costs averaged higher in 2006 compared to the already high levels experienced in 2005, resulting primarily from the effect of higher average crude oil prices. Despite increased volatility during 2006 and a decrease late in the year, crude oil prices averaged higher in 2006 compared to 2005. U.S. market demand increased an estimated 5% for ethylene and an estimated 5% for polyethylene in 2006 compared to 2005.

Equistar s operating results for 2006 reflected the benefits of higher sales prices, including significantly higher co-product and polyethylene sales prices, which were substantially offset by higher costs, primarily higher raw material costs, compared to 2005. Results for 2006 included a charge of $135 million related to impairment of the net book value of the idled Lake Charles, Louisiana ethylene facility.

2005 Versus 2004 In 2005, the chemical industry experienced improved profitability compared to 2004, despite higher crude oil and natural gas prices that pushed up raw material costs for most of the year and the disruptive effects of two major U.S. Gulf Coast hurricanes. Improvement in supply and demand balances, which began in mid-2004 continued into 2005. Tight gasoline markets in 2005 resulted in higher sales prices and margins for fuel products compared to the already high levels experienced in 2004. U.S. ethylene industry demand decreased 6% and polyethylene demand decreased 4% in 2005 compared to 2004, due primarily to the effects of the U.S. Gulf Coast hurricanes.

The U.S. Gulf Coast hurricanes, Katrina and Rita, negatively affected crude oil and natural gas supplies, as well as supplies of other raw materials, contributing to the increases in raw material prices in 2005. Supply/demand balances and prices were affected beginning in September 2005 as most Gulf Coast refiners and producers of chemicals suspended operations in preparation for the hurricanes, with some sustaining major damage as a result of the hurricanes. Equistar s Gulf Coast plants experienced only minor hurricane damage; however, Equistar suspended plant operations in preparation for Hurricane Rita, resulting in lost production and higher costs during 2005.

Equistar s earnings in 2005 reflected higher average product margins compared to 2004, partly offset by the negative effects of hurricane-related costs and lower sales volumes.

Benchmark Indicators Benchmark crude oil and natural gas prices generally have been indicators of the level and direction of movement of raw material and energy costs for Equistar. Ethylene and its co-products are produced from two major raw material groups:

- crude oil-based liquids (liquids or heavy liquids), including naphthas, condensates, and gas oils, the prices of which are generally related to crude oil prices; and

- natural gas liquids (NGLs), principally ethane and propane, the prices of which are generally affected by natural gas prices.

Equistar has the ability to shift its ratio of raw materials used in the production of ethylene and co-products to take advantage of the relative costs of heavy liquids and NGLs.

The following table shows the average U.S. benchmark prices for crude oil and natural gas for the applicable three-year period, as well as benchmark U.S. sales prices for ethylene, propylene, benzene and HDPE, which Equistar produces and sells. The benchmark weighted average cost of ethylene production, which is reduced by co-product revenues, is based on CMAI s estimated ratio of heavy liquid raw materials and NGLs used in U.S. ethylene production and is subject to revision.

	Average Benchmark Price for the Year and Percent Change Versus Prior Year Average				
	2006	Percent Increase (Decrease)	2005	Percent Increase	2004
Crude oil dollars per barrel	66.03	17%	56.44	36%	41.42
Natural gas dollars per million BTUs	6.42	(15)%	7.58	31%	5.78
Weighted average cost of ethylene production cents per pound	31.08	5%	29.58	25%	23.68
Ethylene cents per pound	48.08	9%	44.21	31%	33.75
Propylene cents per pound	45.83	12%	40.75	28%	31.96
Benzene cents per gallon	326.33	13%	289.88	1%	287.96
HDPE cents per pound	71.42	6%	67.29	23%	54.75

Although benchmark crude oil prices decreased late in 2006, benchmark crude oil prices averaged higher in 2006 compared to 2005 and averaged significantly higher in 2005 compared to 2004. Natural gas prices, which affect energy costs in addition to NGL-based raw materials, averaged lower in 2006 compared to 2005, and averaged significantly higher in 2005 compared to 2004. Despite the 2006 decrease in natural gas prices, NGL-based raw material prices averaged higher in 2006 than in 2005. As a result, overall raw material costs averaged higher in 2006 compared to 2005 and significantly higher in 2005 compared to 2004.

Revenues Equistar s revenues of $12,765 million in 2006 were 9% higher compared to revenues of $11,686 million in 2005. The higher revenues in 2006 reflected the effects of higher average sales prices compared to 2005. Sales volumes increased 2% in 2006 compared to 2005.

Revenues of $11,686 million in 2005 increased 25% compared to revenues of $9,316 million in 2004. The increase in 2005 reflected higher average sales prices, partially offset by lower sales volumes. As noted in the table above, benchmark sales prices for ethylene, propylene and HDPE averaged significantly higher in 2005 compared to 2004, while benzene average sales prices in 2005 were comparable to 2004. Ethylene and derivative sales volumes were 5% lower in 2005 compared to 2004.

Net Income Equistar had net income of $614 million in 2006 compared to $748 million in 2005. The decrease was primarily attributable to the $135 million impairment charge. Operationally, higher 2006 sales prices were substantially offset by higher costs, primarily higher raw material costs.

Equistar had net income of $748 million in 2005 compared to $276 million in 2004. The $472 million improvement was primarily the result of higher average product margins. The benefit of the higher 2005 average product margins was partly offset by the negative effects of hurricane-related costs and lower sales volumes. Hurricane-related costs included $20 million of charges, representing Equistar s exposure to industry losses expected to be underwritten by industry insurance consortia, and $19 million of costs incurred in conjunction with suspending and restarting operations.

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Other operations include Millennium s flavors and fragrances business, and unallocated operating expenses that are not identified with the reportable business segments.

Other operating losses were $26 million in 2006, $59 million in 2005 and $103 million in 2004. Other operating losses in 2006 included $12 million of accruals for estimated environmental remediation costs and in 2005 included $43 million of accruals for estimated environmental remediation costs and $13 million of charges related to other investments. The 2004 amount included $71 million of business combination costs, $31 million of accruals for estimated environmental remediation costs and $3 million of reorganization costs.

FINANCIAL CONDITION

Operating Activities Operating activities provided cash of $193 million in 2006, $275 million in 2005 and $195 million in 2004, respectively. The $82 million decrease in 2006 compared to 2005 was primarily due to increased cash usage related to the main components of working capital accounts receivable and inventories, net of accounts payable and $44 million of lower distributions of earnings from Equistar. Although higher compared to 2005, net income in 2006 included reversals of previous tax-related liabilities, which did not provide cash.

A net increase in the main components of working capital used cash of $16 million in 2006 compared to a net decrease in 2005 that provided cash of $29 million. The increase in 2006 was primarily due to a $50 million increase in cash used by accounts payable, partially offset by a $28 million decrease in cash used by accounts receivable. The cash used to reduce accounts payable primarily reflected the timing of payments for shared services provided by Equistar. The decrease in accounts receivable reflected lower sales volumes late in 2006 compared to the same period in 2005.

The $80 million improvement in operating cash flow in 2005 compared to 2004 was primarily due to $133 million of higher distributions of earnings from Equistar and reductions in the main components of working capital accounts receivable and inventory, net of accounts payable - partly offset by the effects of lower 2005 earnings at Millennium. The main components of working capital decreased, providing cash of $29 million in 2005, primarily due to a $77 million increase in accounts payable, which reflected higher raw material and energy prices in December 2005.

Investing Activities Investing activities used cash of $65 million in 2006, $60 million in 2005 and $41 million in 2004, primarily reflecting Millennium s capital expenditures. In addition, in 2004, Millennium received $12 million of distributions in excess of earnings from Equistar.

Capital expenditures were $66 million in 2006, $60 million in 2005 and $55 million in 2004. Millennium s capital expenditures for this three-year period primarily included replacement capital projects and certain environmental, cost reduction, and yield-improvement projects. Planned capital spending in 2007 is projected to be approximately $78 million, primarily for base asset support and projects to improve manufacturing efficiency.

Financing Activities Financing activities used cash of $290 million in 2006, $272 million in 2005 and $38 million in 2004, primarily for debt repayment. Millennium intends to continue to reduce its indebtedness as market conditions permit.

In 2006, Millennium purchased $158 million principal amount of its 7% Senior Notes due 2006, paying a premium of $2 million, and purchased $85 million principal amount of 9.25% Senior Notes due 2008, paying a premium of $5 million. Other reductions of debt in 2006 totaled $39 million of principal, including $29 million principal amount of the Australian term loan.

During 2006, a U.K. subsidiary of Millennium entered into a new 60 million, five-year, revolving credit facility. There were no amounts outstanding at December 31, 2006. See Liquidity and Capital Resources.

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In 2005, Millennium purchased $342 million principal amount of its 7% Senior Notes due 2006, $13 million of the 9.25% Senior Notes due 2008 and $1 million of the 7.625% Senior Debentures due 2026, paying a total premium of $10 million. See Liquidity and Capital Resources below regarding the May 2005 credit facility amendment, which permitted the purchases, and other amendments to the Millennium credit facility. Additionally in 2005, Millennium paid a cash dividend totaling $6 million to minority interests during 2005 and received a contribution of $6 million from Lyondell.

In August 2005, Millennium amended and restated its $150 million credit facility, replacing it with a $125 million U.S. revolving credit facility, a $25 million Australian revolving credit facility, and a $100 million Australian senior term loan, all of which mature in August 2010. See Liquidity and Capital Resources below for a description of availability under the new credit facilities. The U.S. revolving credit facility and the Australian revolving credit facility are used for liquidity and general corporate purposes. The Australian term loan facilitated the repatriation of non-U.S. earnings and returns of investment that were primarily used to reduce Millennium indebtedness as discussed below.

Pursuant to the indenture governing the 9.25% Senior Notes, Millennium was required to purchase $4 million principal amount of its 9.25% Senior Notes and pay a 1% premium as a result of Lyondell s acquisition of Millennium on November 30, 2004.

In 2004 cash was used to prepay $55 million of debt, and cash proceeds from stock option exercises were $17 million.

Liquidity and Capital Resources Millennium s balance sheet remains highly levered. As of December 31, 2006, total debt, including current maturities, was $853 million, or 82% of total capitalization. At December 31, 2006, Millennium had $121 million of cash on hand and $189 million of unused availability under its revolving credit facilities as follows:

- $128 million in total under Millennium s $125 million U.S. and $25 million Australian secured revolving credit facilities, which mature in August 2010. Availability under the revolving credit facilities is reduced to the extent of outstanding letters of credit provided under the facilities. Letters of credit outstanding under the $125 million U.S. revolving credit facility at December 31, 2006 totaled $22 million. At December 31, 2006, there were no outstanding letters of credit under the $25 million Australian revolving credit facility, and there was no outstanding borrowing under either revolving credit facility.

- 46 million, or approximately $61 million, under Millennium s 60 million, five-year, U.K. revolving credit facility. Availability under the facility gives effect to the borrowing base, as determined using a formula applied to accounts receivable and inventory balances, and is reduced to the extent of outstanding borrowing, and letters of credit provided under the facility. At December 31, 2006, there was no outstanding borrowing, and there were no outstanding letters of credit under the revolving credit facility.

In addition to letters of credit outstanding under the U.S. revolving credit facility, Millennium had other outstanding letters of credit and bank guarantees under other arrangements of $8 million at December 31, 2006.

Historically, Millennium has financed its operations primarily through cash generated from its operations, cash distributions from Equistar, and debt financing. Cash generated from operations is, to a large extent, dependent on economic, financial, competitive and other factors affecting Millennium s and Equistar s businesses. The amount of cash distributions received from Equistar is affected by Equistar s results of operations and current and expected future cash flow requirements. Some of Equistar s indentures require additional interest payments to the note holders if Equistar makes distributions when its Fixed Charge Coverage Ratio, as defined, is less than 1.75 to 1. Millennium received $170 million, $214 million and $93 million, respectively, of distributions from Equistar during 2006, 2005 and 2004.

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Millennium s ability to pay or refinance its debt also may depend on future operating performance, which could be affected by general economic, financial, competitive, legislative, regulatory, business and other factors, many of which are beyond its control. However, Millennium believes that conditions will be such that cash balances, cash generated from operating activities, cash distributions from Equistar and funds from lines of credit will be adequate to meet anticipated future cash requirements, including scheduled debt repayments, necessary capital expenditures and ongoing operations.

On February 23, 2007, Millennium signed an agreement for a proposed sale of Millennium s worldwide inorganic chemicals business for $1.05 billion, in cash, plus the assumption of specified liabilities. Closing is anticipated to occur in the first half of 2007.

In June 2006, Standard & Poor s Rating Services (S&P) lowered its ratings for Millennium from BB- to B+ with a negative outlook following the February 2006 Rhode Island jury verdict against a Millennium subsidiary, Millennium Holdings, LLC, and other defendants. See the Litigation section of Note 18 to the Consolidated Financial Statements. In June 2006, Moody s Investors Service (Moody s) reinstated Millennium s debt ratings at Ba3 and, in July 2006, Moody s placed the ratings of Millennium under review for possible downgrade. In September 2006, Moody s confirmed the rating of Millennium and revised its outlook for Millennium to stable, reflecting Moody s belief that the additional debt incurred in connection with the Houston Refining LP acquisition by Lyondell will be reduced over the next several years using anticipated increased refining cash flow.

In May 2006, Millennium amended its senior secured revolving credit facilities and, in July 2006, amended the indenture governing its 4% Convertible Senior Debentures primarily to exclude a subsidiary of Millennium, Millennium Holdings, LLC, and its subsidiaries (collectively Millennium Holdings) from events-of-default provisions that could be triggered in connection with judgments against Millennium Holdings. In August 2005, Millennium amended and restated its $150 million credit facility, as described above.

In May 2005, Millennium obtained an amendment to its previous $150 million credit facility to allow for the unrestricted repurchase of indebtedness in the form of bonds, debentures, notes, or similar instruments. On February 2, 2005, as a result of certain adjustments and charges related to the February 2005 restatement of Millennium s financial statements, Millennium entered into an amendment and waiver to its previous $150 million credit facility, which amended the credit facility definition of EBITDA and waived any and all defaults or events of default that may have occurred on or prior to the amendment and waiver.

Millennium s facilities and its indentures contain restrictive covenants. Pursuant to these provisions, Millennium is currently prohibited from making restricted payments, including paying certain dividends. Other than the U.K. facility, Millennium s facilities also contain covenants that require the maintenance of specified financial ratios. These covenants, as well as debt guarantees, are described in Note 13 to the Consolidated Financial Statements. The potential impact of a breach of these covenants is discussed below. Millennium s U.K. facility does not require the maintenance of specified financial ratios as long as certain conditions are met.

A breach by Millennium of any of the covenants or other requirements in its debt instruments could (1) permit the note holders or lenders to declare the outstanding debt under the breached debt instrument due and payable, (2) permit the lenders under that credit facility to terminate future lending commitments and (3) permit acceleration of Millennium s other debt instruments that contain cross-default or cross-acceleration provisions. The debt agreements of Millennium contain various event of default and cross-default provisions. If Millennium was unable to obtain sufficient funds to make these accelerated payments, Millennium s lenders could proceed against any assets that secure their debt.

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Millennium has outstanding $150 million aggregate principal amount of 4% Convertible Senior Debentures, which are due in 2023, unless earlier redeemed, converted or repurchased. As a result of Lyondell s acquisition of Millennium, the Debentures are convertible into shares of Lyondell s common stock or, at Lyondell s discretion, equivalent cash or a combination thereof. As of December 31, 2006, based on a quarterly test related to the price of Lyondell common stock, the Debentures were convertible at a conversion rate of 74.758 Lyondell shares per one thousand dollar principal amount of the Debentures. As of December 31, 2006, the amount of the Debentures converted into shares of Lyondell common stock was not significant. The Debenture redemption terms are described in Note 13 to the Consolidated Financial Statements.

Future Tax Obligations Certain income tax returns for Millennium s U.S. and non-U.S. subsidiaries are currently under examination by the Internal Revenue Service (IRS), and various other tax authorities. In many cases, these audits result in proposed assessments by the tax authority. Millennium believes that its tax positions comply with applicable tax law and intends to defend its positions through appropriate administrative and judicial processes. Millennium believes it has adequately provided for any probable outcome related to these matters, and does not anticipate any material adverse effect on its financial position or results of operations from their ultimate resolution. During 2006, certain income tax returns and related liabilities under examination by Her Majesty s Revenue and Customs (formerly Inland Revenue) of the U.K., representing approximately $50 million of taxes at issue, were satisfactorily resolved. However, the settlement of one or more remaining tax matters could require substantial cash payments during the next twelve to eighteen months.

Off-Balance Sheet Arrangements The Securities and Exchange Commission (SEC) has described various characteristics to identify contractual arrangements that would fall within the SEC s definition of off-balance sheet arrangements. Millennium is not a party to any such contractual arrangements.

Other obligations that do not give rise to liabilities that would be reflected in Millennium s balance sheet are described below under Purchase Obligations and Operating Leases.

Contractual and Other Obligations The following table summarizes as of December 31, 2006, Millennium s minimum payments for long-term debt, and contractual and other obligations for the next five years and thereafter.

		Payments Due By Period					
Millions of dollars	**Total**	**2007**	**2008**	**2009**	**2010**	**2011**	**Thereafter**
Long-term debt	$ 853	$ 4	$ 376	$ 3	$ 73	$ 3	$ 394
Interest on long-term debt	541	64	45	30	28	25	349
Pension benefits:							
PBO	961	62	64	67	64	66	638
Assets	(786)	- -	- -	- -	- -	- -	(786)
Funded status	175						
Other postretirement benefits	29	3	3	3	3	3	14
Other	386	2	42	41	41	41	219
Deferred income taxes	278	38	71	42	41	40	46
Other obligations:							
Purchase obligations	1,185	315	174	148	115	84	349
Operating leases	163	24	20	16	14	12	77
Total	$ 3,610	$ 512	$ 795	$ 350	$ 379	$ 274	$ 1,300

Long-Term Debt Millennium s long term debt includes credit facilities and debt obligations. See Note 13 to the Consolidated Financial Statements for a discussion of covenant requirements under the credit facilities and indentures and additional information regarding long-term debt.

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Interest The long-term debt agreements contain provisions for the payment of either monthly or semi-annual interest at a stated rate of interest over the term of the debt. These payment obligations are reflected in the table above.

Pension Benefits Millennium maintains several defined benefit pension plans as described in Note 16 to the Consolidated Financial Statements. At December 31, 2006, the projected benefit obligation for Millennium s pension plans exceeded the fair value of plan assets by $175 million. Subject to future actuarial gains and losses, as well as actual asset earnings, Millennium, together with its consolidated subsidiaries, will be required to fund the $175 million, with interest, in future years. Millennium s pension contributions were $24 million, $28 million and $15 million for the years 2006, 2005 and 2004, respectively, and are expected to be approximately $35 million for 2007. Estimates of pension benefit payments through 2011 are included in the table above.

Pension expense for 2006, 2005 and 2004 was $39 million, $32 million and $30 million, respectively. The 2004 pension expense included $13 million of curtailment charges, resulting from severances subsequent to Lyondell s acquisition of Millennium in 2004. Pension expense increased in 2006 due to a reduction in the discount rate assumption related to Millennium s pension plans and the amortized recognition of pension fund investment losses in the financial markets in recent years prior to 2003.

Other Postretirement Benefits Millennium provides other postretirement benefits, as described in Note 16 to the Consolidated Financial Statements. Other postretirement benefits are unfunded and are paid by Millennium as incurred.

As a result of rising medical benefit costs and competitive business conditions, effective April 1, 2004 Millennium reduced the level of retiree medical benefits provided to essentially all of its retirees by offering a monthly subsidy in 2004 to retirees that enrolled in designated preferred provider organization plans or Medicare supplement insurance plans. This change reduced Millennium s accumulated postretirement benefit obligation by approximately $48 million. This reduction is being recognized ratably over approximately thirteen years through the postretirement net periodic benefit cost. Estimates of other postretirement benefit payments through 2011 are included in the table above.

Other Other primarily consists of liabilities for environmental remediation, deferred compensation arrangements and accrued liabilities for the resolution of probable tax assessments. The timing of payments of the latter is subject to considerable uncertainty.

Deferred Income Taxes The scheduled settlement of the deferred tax liabilities shown in the table is based on the scheduled reversal of the underlying temporary differences, all of which would be fully offset during the first five years by Millennium s tax loss carry forwards. Actual cash tax payments will vary depending upon future taxable income.

Purchase Obligations In the ordinary course of business, Millennium enters into contractual obligations to purchase raw materials, utilities and services for fixed or minimum amounts. See the Commitments section of Note 18 to the Consolidated Financial Statements for a description of Millennium s commitments and contingencies, including these purchase obligations.

Operating Leases Millennium leases various facilities and equipment under noncancelable lease arrangements for various periods. See Note 14 to the Consolidated Financial Statements for related lease disclosures.

Equistar Liquidity and Capital Resources At December 31, 2006, Equistar s long-term debt totaled $2.2 billion, or approximately 57% of its total capitalization, and there were no current maturities. At December 31, 2006, Equistar had cash on hand of $133 million and the total amount available under both the $400 million inventory-based revolving credit facility and the $600 million accounts receivable sales facility totaled approximately $938 million, after giving effect to the borrowing base net of a $50 million unused availability requirement, any outstanding amount of accounts receivable sold under the accounts receivable sales facility, of which there was none at December 31, 2006, and $12 million of outstanding letters of credit under the revolving credit facility as of December 31, 2006. The borrowing base is determined using a formula applied to accounts

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receivable and inventory balances. The revolving credit facility requires that the unused available amounts under that facility and the $600 million accounts receivable sales facility equal or exceed $50 million, or $100 million if the Interest Coverage Ratio, as defined, at the end of any period of four consecutive fiscal quarters is less than 2:1. There was no outstanding borrowing under the revolving credit facility at December 31, 2006.

Equistar s ability to continue to pay or refinance its debt will depend on future operating performance, which could be affected by general economic, financial, competitive, legislative, regulatory, business and other factors, many of which are beyond its control. However, Equistar believes that conditions will be such that cash balances, cash generated from operating activities, cash generated from higher utilization of the accounts receivable sales facility and funding under the credit facility will be adequate to meet anticipated future cash requirements, including scheduled debt repayments, necessary capital expenditures and ongoing operations.

In August 2006, S&P removed Equistar s ratings from CreditWatch and revised its outlook to stable, reflecting S&P s belief that the intermediate-range benefits of the Houston Refining LP acquisition by Lyondell will outweigh the temporary increase in debt leverage. In September 2006, Moody s confirmed the rating of Equistar and revised its outlook for Equistar to stable, reflecting Moody s belief that the additional debt incurred in connection with the Houston Refining LP acquisition by Lyondell will be reduced over the next several years using anticipated increased refining cash flow.

Equistar s inventory-based revolving credit facility, accounts receivable sales facility and indentures contain restrictive covenants. These covenants are described in Notes 6 and 12 to Equistar s Consolidated Financial Statements included in Equistar s Annual Report on Form 10-K for the year ended December 31, 2006. The potential impact of a breach of these covenants is discussed in Liquidity and Capital Resources under Item 7 of Equistar s Annual Report on Form 10-K for the year ended December 31, 2006. The credit facility does not require the maintenance of specified financial ratios as long as certain conditions are met. Some of Equistar s indentures require additional interest payments to the note holders if Equistar makes distributions when its Fixed Charge Coverage Ratio, as defined, is less than 1.75 to 1.

CURRENT BUSINESS OUTLOOK

For Millennium s inorganic chemicals segment, first quarter 2007 operations and order volumes have improved versus the fourth quarter 2006. Thus far in 2007, the inorganic chemicals segment has benefited from the correction of the 2006 operating problems. For the EC&D segment, underlying business fundamentals continue to be sound thus far in 2007. For 2007, fundamental supply and demand conditions for the EC&D segment s products should be relatively unchanged from the favorable conditions experienced in 2006.

RELATED PARTY TRANSACTIONS

In view of Occidental Petroleum Corporation s (together with its subsidiaries and affiliates, collectively Occidental) relationship with Lyondell, which owns 100% of Millennium as a result of the acquisition on November 30, 2004, Occidental s transactions with Millennium are reported as related party transactions in Millennium s Consolidated Financial Statements.

Millennium purchases products from Equistar, a joint venture with Lyondell, and Occidental at market-related prices and, sells products to Equistar and Lyondell at market-based prices. As a result of the acquisition of Millennium by Lyondell on November 30, 2004, Millennium and Lyondell entered into an agreement for the provision of administrative services by Lyondell to Millennium, as well as a tax-sharing agreement.

Millennium believes that such transactions are effected on terms substantially no more or less favorable than those that would have been agreed upon by unrelated parties on an arm s length basis. See Note 6 to the Consolidated Financial Statements for further discussion of related party transactions.

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CRITICAL ACCOUNTING POLICIES

Millennium applies those accounting policies that management believes best reflect the underlying business and economic events, consistent with accounting principles generally accepted in the U.S. Millennium s more critical accounting policies include those related to liabilities for anticipated expenditures to comply with environmental regulations, accruals for taxes based on income, the equity interest in Equistar, long-lived assets, including the costs of major maintenance turnarounds and repairs, the valuation of goodwill, and accruals for long-term employee benefit costs such as pension and postretirement costs. Inherent in such policies are certain key assumptions and estimates made by management. Management periodically updates its estimates used in the preparation of the financial statements based on its latest assessment of the current and projected business and general economic environment. These critical accounting policies have been discussed with Millennium s Board of Directors. Millennium s significant accounting policies are summarized in Note 2 to the Consolidated Financial Statements.

Liabilities for Environmental Remediation Costs Anticipated expenditures related to investigation and remediation of contaminated sites, which include current and former plant sites and other remediation sites, are accrued when it is probable a liability has been incurred and the amount of the liability can be reasonably estimated. Only ongoing operating and monitoring costs, the timing of which can be determined with reasonable certainty are discounted to present value. Future legal costs associated with such matters, which generally are not estimable, are not included in these liabilities.

As of December 31, 2006, Millennium s accrued liability for future environmental remediation costs at current and former plant sites and other remediation sites totaled $172 million. The liabilities for individual sites range from less than $1 million to $106 million, and remediation expenditures are expected to occur over a number of years, and not to be concentrated in any single year. In the opinion of management, there is no material estimable range of reasonably possible loss in excess of the liabilities recorded for environmental remediation. However, it is possible that new information about the sites for which the accrual has been established, new technology or future developments such as involvement in investigations by regulatory agencies, could require Millennium to reassess its potential exposure related to environmental matters. See Note 18 to the Consolidated Financial Statements for further discussion of environmental remediation matters.

Accruals for Taxes Based on Income Uncertainties exist with respect to interpretation of complex U.S. federal and non-U.S. tax regulations. Management expects that Millennium s interpretations will prevail. Also, Millennium has recognized deferred tax benefits relating to its future utilization of past operating losses. Millennium believes it is more likely than not that the amounts of deferred tax assets in excess of the related valuation reserves will be realized. Further details on Millennium s income taxes appear in Note 17 to the Consolidated Financial Statements.

Equity Interest in Equistar Millennium has evaluated the carrying value of its investment in Equistar at December 31, 2006 using fair value estimates prepared by Lyondell in connection with Lyondell s accounting for its acquisition of Millennium, and by third parties. Based on those estimates, Millennium has determined that the fair value exceeded Millennium s carrying value for its Equistar investment. The carrying value of Millennium s investment in Equistar at December 31, 2006 was $470 million. If future valuation estimates for Millennium s interest in Equistar are lower than Millennium s carrying value for its interest in Equistar, an adjustment to write down the investment would be required.

Long-Lived Assets With respect to long-lived assets, key assumptions include the estimates of useful asset lives and the recoverability of carrying values of fixed assets and other intangible assets, as well as the existence of any obligations associated with the retirement of fixed assets. Such estimates could be significantly modified and/or the carrying values of the assets could be impaired by such factors as new technological developments, new chemical industry entrants with significant raw material or other cost advantages, uncertainties associated with the U.S. and world economies, the cyclical nature of the chemical and refining industries, and uncertainties associated with governmental actions. Impairments were recorded in each of the years 2006, 2005 and 2004 for the LeHavre, France, TiO_2 facility and in 2006 for certain software costs.

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The estimated useful lives of long-lived assets range from 5 to 40 years. Depreciation and amortization of these assets, including amortization of deferred turnaround costs, under the straight-line method over their estimated useful lives totaled $101 million, $107 million and $114 million in 2006, 2005 and 2004, respectively. If the useful lives of the assets were found to be shorter than originally estimated, depreciation and amortization charges would be accelerated over the revised useful life.

Millennium defers the costs of major periodic maintenance and repair activities (turnarounds) amortizing such costs over the period until the next expected major turnaround of the affected unit. During 2006, 2005 and 2004, cash expenditures of approximately $15 million, $11 million and $12 million, respectively, were deferred and are being amortized, generally over 18 months to 3 years. Amortization of previously deferred turnaround costs was $8 million in each of 2006 and 2005, and $12 million in 2004.

Additional information on long-lived assets, deferred turnaround costs and related depreciation and amortization appears in Note 10 to the Consolidated Financial Statements.

Goodwill Goodwill represents the excess of purchase price paid over the fair value assigned to the net tangible and identifiable intangible assets of acquired businesses. Millennium evaluates the carrying value of goodwill annually or more frequently if events or changes in circumstances indicate that the carrying amount may exceed fair value. Recoverability is determined by comparing the estimated fair value of the reporting unit to which the goodwill applies to the carrying value, including goodwill, of that reporting unit. The carrying value of goodwill at December 31, 2006 was $104 million, of which $55 million was associated with Millennium s inorganics segment and $49 million with the acetyls business. The recoverability of Millennium s goodwill is dependent upon the future valuations associated with these businesses, which could change significantly based upon business performance or other factors.

Long-Term Employee Benefit Costs The costs to Millennium of long-term employee benefits, particularly pension and postretirement medical and life insurance benefits, are incurred over long periods of time, and involve many uncertainties over those periods. The net periodic benefit cost attributable to current periods is based on several assumptions about such future uncertainties, and is sensitive to changes in those assumptions. It is management s responsibility, often with the assistance of independent experts, to select assumptions that in its judgment represent its best estimates of the future effects of those uncertainties. It also is management s responsibility to review those assumptions periodically to reflect changes in economic or other factors that affect those assumptions.

The current benefit service costs, as well as the existing liabilities, for pensions and other postretirement benefits are measured on a discounted present value basis. The discount rate is a current rate, related to the rate at which the liabilities could be settled. Millennium s assumed discount rate is based on average rates published by Moody s and Merrill Lynch for high-quality (Aa rating) ten-year fixed income securities. For the purpose of measuring the U.S. benefit obligations at December 31, 2006, Millennium increased its assumed discount rate from 5.5% to 5.75%, reflecting market interest rates at December 31, 2006. The 5.75% rate also will be used to measure net periodic benefit cost during 2007. A one percentage point reduction in the assumed discount rate would increase Millennium s benefit obligation for pensions and other postretirement benefits by approximately $119 million, and would reduce Millennium s net income by approximately $9 million.

The benefit obligation and the periodic cost of postretirement medical benefits also are measured based on assumed rates of future increase in the per capita cost of covered health care benefits. As of December 31, 2006, the assumed rate of increase was 9% for 2007, decreasing 1% per year to 6% in 2010 and 5% in 2012 and thereafter. A one percentage point change in the health care cost trend rate assumption would have no significant effect on either the benefit liability or the net periodic cost.

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The net periodic cost of pension benefits included in expense also is affected by the expected long-term rate of return on plan assets assumption. Investment returns that are recognized currently in net income represent the expected long-term rate of return on plan assets applied to a market-related value of plan assets which, for Millennium, is defined as the market value of assets. The expected rate of return on plan assets is a longer term rate, and is expected to change less frequently than the current assumed discount rate, reflecting long-term market expectations, rather than current fluctuations in market conditions.

Millennium s expected long-term rate of return on U.S. plan assets of 8% is based on the average level of earnings that its independent pension investment advisor had advised could be expected to be earned over time. The expectation is based on an asset allocation of 55% U.S. equity securities (9.5% expected return), 15% non-U.S. equity securities (9.5% expected return), and 30% fixed income securities (5.5% expected return) recommended by the advisor, and has been adopted for the plans. The actual return on plan assets in 2006 was 11%.

The actual rate of return on plan assets may differ from the expected rate due to the volatility normally experienced in capital markets. Management s goal is to manage the investments over the long term to achieve optimal returns with an acceptable level of risk and volatility. Based on the market value of plan assets at December 31, 2006, a one percentage point decrease in this assumption for Millennium would decrease Millennium s net income by approximately $5 million.

Net periodic pension cost recognized each year includes the expected asset earnings, rather than the actual earnings or loss. As a result of asset earnings significantly below the expected return on plan assets rate over the last several years, the level of unrecognized investment losses, together with the net actuarial gains and losses, is $318 million at December 31, 2006. This unrecognized amount, to the extent it exceeds ten percent of the projected benefit obligation for the respective plan, will be recognized as additional net periodic benefit cost over the average remaining service period of the participants in each plan. This annual amortization charge will be approximately $19 million per year based on the December 31, 2006 unrecognized amount.

Additional information on the key assumptions underlying these benefit costs appears in Note 16 to the Consolidated Financial Statements.

ACCOUNTING AND REPORTING CHANGES

Effective December 31, 2006, Millennium adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans- An Amendment of FASB Statements No. 87, 88, 106, and 132R,* which primarily requires an employer to recognize in its statement of financial position an asset for a plan s overfunded status or a liability for a plan s underfunded status through comprehensive income in the year in which changes occur. Millennium s application of SFAS No. 158 as of December 31, 2006 resulted in increases of $4 million and $73 million in its current and long-term benefit liabilities, respectively, a decrease of $7 million in other assets, a decrease of $27 million in deferred tax liabilities and an increase of $57 million in accumulated other comprehensive loss in its consolidated balance sheet as of December 31, 2006. (See Note 16 to the Consolidated Financial Statements.)

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 157, *Fair Value Measurements*. The new standard defines fair value, establishes a framework for its measurement and expands disclosures about such measurements. For Millennium, the standard will be effective beginning in 2008. Millennium does not expect the application of SFAS No. 157 to have a material effect on its consolidated financial statements.

In July 2006, the FASB issued Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109,* to clarify the accounting for uncertain income tax positions. FIN No. 48 prescribes, among other things, a recognition threshold and measurement attribute for the financial statement recognition and measurement of an uncertain tax position. The provisions of FIN No. 48 will apply to Millennium beginning in 2007. Millennium expects the application of FIN No. 48 to result in an increase of $40 million to $50 million in its estimate of future obligations for income taxes and related interest.

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Effective January 1, 2006, Millennium adopted the provisions of SFAS No. 123 (revised 2004), *Share-Based Payment* using the modified prospective method and, consequently, has not adjusted results of prior periods. Millennium previously accounted for these plans using the intrinsic value method prescribed in Accounting Principles Board (APB) Opinion No. 25 and related interpretations. Millennium s application of SFAS No. 123 (revised 2004) had no material effect on its consolidated financial statements.

Effective April 1, 2006, Millennium adopted the provisions of Emerging Issues Task Force (EITF) Issue No. 04-13, *Accounting for Purchases and Sales of Inventory with the Same Counterparty*. EITF Issue No. 04-13 requires that inventory purchases and sales transactions with the same counterparty that are entered into in contemplation of one another be combined for purposes of applying APB Opinion No. 29, *Accounting for Nonmonetary Transactions*. The effect of this requirement is to reduce reported revenues and cost of sales for affected transactions. Millennium s application of EITF 04-13 had no material effect on its consolidated financial statements.

In December 2003, the FASB issued Interpretation No. 46 (Revised December 2003), *Consolidation of Variable Interest Entities* (FIN 46R), primarily to clarify the required accounting for interests in variable interest entities (VIEs). This standard replaces FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, which was issued in January 2003 to address certain situations in which a company should include in its financial statements the assets, liabilities and activities of another entity. Millennium evaluated its long-term obligations with one entity that may be a VIE. Millennium has no equity interest in this entity and has confirmed that the entity is consolidated by an equity owner. Millennium has not been able to obtain the financial information from the entity necessary to determine whether Millennium is the primary beneficiary of the entity. Management of the entity cited confidentiality considerations with regard to the decision not to provide certain financial information to Millennium. Millennium pays approximately $2 million in plant and equipment rental charges on an annual basis to this entity.

ENVIRONMENTAL MATTERS

Various environmental laws and regulations impose substantial requirements upon the operations of Millennium. Millennium s policy is to be in compliance with such laws and regulations, which include, among others, the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA or Superfund) as amended, the Resource Conservation and Recovery Act (RCRA) and the Clean Air Act Amendments (Clean Air Act). Millennium does not specifically track all recurring costs associated with managing hazardous substances and pollution in ongoing operations. Such costs are included in cost of sales.

Millennium s accrued liability for future environmental remediation costs at current and former plant sites and other remediation sites totaled $172 million as of December 31, 2006. The remediation expenditures are expected to occur over a number of years, and not to be concentrated in any single year. In the opinion of management, there is no material estimable range of reasonably possible loss in excess of the liabilities recorded for environmental remediation. However, it is possible that new information about the sites for which the accrual has been established, new technology or future developments such as involvement in investigations by regulatory agencies, could require Millennium to reassess its potential exposure related to environmental matters. The liabilities for individual sites range from less than $1 million to $106 million. The $106 million liability relates to the Kalamazoo River Superfund Site. See Critical Accounting Policies above and the Environmental Remediation section of Note 18 to the Consolidated Financial Statements for additional discussion of Millennium s liabilities for environmental remediation, including the liability related to the Kalamazoo River Superfund Site.

Millennium also makes capital expenditures to comply with environmental regulations. Capital expenditures for regulatory compliance totaled approximately $5 million in 2006 and $8 million in each of 2005 and 2004. Millennium currently estimates environmentally-related capital expenditures at its facilities will be approximately $10 million in 2007 and $15 million in 2008, reflecting the addition of a new waste disposal landfill and fume containment equipment at a TiO_2 plant.

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

See Note 15 to the Consolidated Financial Statements for discussion of Millennium s management of commodity price risk, foreign currency exposure and interest rate risk through its use of derivative instruments and hedging activities.

COMMODITY PRICE RISK

A substantial portion of Millennium s products and raw materials are commodities whose prices fluctuate as market supply and demand fundamentals change. Accordingly, product margins and the level of Millennium s profitability tend to fluctuate with changes in the business cycle.

Millennium selectively entered into commodity derivative hedging transactions, primarily price swaps, options, and futures, to help manage the exposure to commodity price risk with respect to purchases of raw materials and product sales. The net losses recognized in earnings in each of 2005 and 2004 were less than $1 million. During 2005 and 2004, the derivative transactions were not significant compared to Millennium s overall inventory purchases and product sales; there were no derivative transactions in 2006. Millennium had no outstanding commodity derivative transactions at December 31, 2006 and 2005.

FOREIGN EXCHANGE RISK

Millennium manufactures and markets its products in a number of countries throughout the world and, as a result, is exposed to changes in foreign currency exchange rates. Costs in some countries are incurred, in part, in currencies other than the applicable functional currency. Millennium s non-U.S. operations account for approximately 58% of consolidated revenues and 53% of long-lived assets. Millennium has selectively utilized forward, swap and option derivative contracts with terms normally lasting less than three months to protect against the adverse effect that exchange rate fluctuations may have on foreign currency denominated trade receivables and trade payables. These derivatives generally are not designated as hedges for accounting purposes. There were no outstanding foreign currency forward, swap and option contracts at December 31, 2006 and 2005.

INTEREST RATE RISK

Millennium is exposed to interest rate risk with respect to variable rate debt. At December 31, 2006, Millennium had $70 million of outstanding variable rate debt. Using sensitivity analysis and a hypothetical 10% increase in interest rates from those in effect at year end, the increase in annual interest expense on the variable-rate debt would reduce net income by less than $1 million.

Derivative instruments have been used selectively to manage the ratio of fixed- to variable-rate debt at Millennium. At December 31, 2006 and 2005, there were outstanding interest rate swap agreements in the notional amount of $175 million, which were designated as fair-value hedges of underlying fixed-rate obligations. The fair value of these interest rate swap agreements was an obligation of $3 million and $4 million, respectively, at December 31, 2006 and 2005, resulting in a decrease in the carrying value of long-term debt and the recognition of a corresponding liability. Using sensitivity analysis, the negative impact on the fair value of the obligation at December 31, 2006 would be approximately $1 million assuming a 10% unfavorable change in variable interest rates.

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Item 8. ***Financial Statements and Supplementary Data***

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MANAGEMENT S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The management of Millennium is responsible for establishing and maintaining adequate internal control over financial reporting. Millennium s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Millennium management assessed the effectiveness of Millennium s internal control over financial reporting as of December 31, 2006. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control Integrated Framework*. Based on its assessment, Millennium s management has concluded that Millennium s internal control over financial reporting was effective as of December 31, 2006 based on those criteria.

PricewaterhouseCoopers LLP, the independent registered public accounting firm that audited the financial statements included in this Annual Report on Form 10-K, has audited management s assessment of the effectiveness of Millennium s internal control over financial reporting as of December 31, 2006, as stated in their report that appears on the following page.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders

of Millennium Chemicals Inc.:

We have completed integrated audits of Millennium Chemicals Inc. s 2006 and 2005 consolidated financial statements and of its internal control over financial reporting as of December 31, 2006, and an audit of its 2004 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated financial statements

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of Millennium Chemicals Inc. and its subsidiaries at December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 2 to the consolidated financial statements, effective December 31, 2006, the Company changed its method of accounting for defined benefit pension and other postretirement plans.

Internal control over financial reporting

Also, in our opinion, management s assessment, included in Management s Report on Internal Control Over Financial Reporting appearing under Item 8, that the Company maintained effective internal control over financial reporting as of December 31, 2006 based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control - Integrated Framework* issued by the COSO. The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management s assessment and on the effectiveness of the Company s internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail,

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accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP

Houston, Texas

February 28, 2007

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MILLENNIUM CHEMICALS INC.

CONSOLIDATED STATEMENTS OF INCOME

Millions of dollars	For the year ended December 31, 2006	2005	2004
Sales and other operating revenues:			
Trade	$ 1,881	$ 1,914	$ 1,878
Related parties	67	45	10
	1,948	1,959	1,888
Operating costs and expenses:			
Cost of sales	1,732	1,715	1,602
Selling, general and administrative expenses	158	194	164
Research and development expenses	26	23	21
Business combination costs	2	2	71
Asset impairments	22	15	14
Reorganization and other costs	- -	- -	9
	1,940	1,949	1,881
Operating income	8	10	7
Interest expense	(78)	(130)	(106)
Interest income	7	18	12
Other income (expense), net	24	(19)	14
Loss before equity investment, minority interest and income taxes	(39)	(121)	(73)
Income from equity investment in Equistar Chemicals, LP	181	221	81
Income before income taxes and minority interest	142	100	8
Provision for (benefit from) income taxes	(19)	67	33
Income (loss) before minority interest	161	33	(25)
Minority interest	(2)	(5)	(6)
Net income (loss)	$ 159	$ 28	$ (31)

See Notes to the Consolidated Financial Statements.

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MILLENNIUM CHEMICALS INC.

CONSOLIDATED BALANCE SHEETS

Millions of dollars	December 31, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 121	$ 279
Accounts receivable:		
Trade, net	332	331
Related parties	15	30
Inventories	440	429
Prepaid expenses and other current assets	31	64
Deferred tax assets	71	20
Total current assets	1,010	1,153
Property, plant and equipment, net	651	647
Investment in Equistar Chemicals, LP	470	464
Goodwill, net	104	104
Deferred tax assets	84	54
Other assets, net	95	110
Total assets	$ 2,414	$ 2,532
LIABILITIES AND STOCKHOLDER S EQUITY		
Current liabilities:		
Current maturities of long-term debt	$ 4	$ 169
Accounts payable:		
Trade	312	305
Related parties	18	62
Accrued liabilities	175	157
Total current liabilities	509	693
Long-term debt	849	966
Other liabilities	590	644
Deferred income taxes	278	225
Commitments and contingencies		
Minority interest	45	42
Stockholder s equity (deficit):		
Common stock, $0.01 par value, 1,000 shares authorized, 709 shares issued	- -	- -
Additional paid-in capital	1,176	1,176
Retained deficit	(840)	(999)
Accumulated other comprehensive loss	(103)	(125)
Treasury stock, at cost, (48 shares issued)	(90)	(90)
Total stockholder s equity (deficit)	143	(38)
Total liabilities and stockholder s equity	$ 2,414	$ 2,532

See Notes to the Consolidated Financial Statements.

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MILLENNIUM CHEMICALS INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

Millions of dollars	For the year ended December 31, 2006	2005	2004
Cash flows from operating activities:			
Net income (loss)	$ 159	$ 28	$ (31)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	101	107	114
Asset impairments	22	15	14
Equity investment in Equistar Chemicals, LP -			
Amount included in net (income) loss	(181)	(221)	(81)
Distributions of earnings	170	214	81
Deferred income taxes	(48)	(4)	(75)
Debt prepayment premiums and charges	7	11	- -
Changes in assets and liabilities that provided (used) cash:			
Accounts receivable	28	(28)	(15)
Inventories	6	(20)	56
Accounts payable	(50)	77	44
Other, net	(21)	96	88
Net cash provided by operating activities	193	275	195
Cash flows from investing activities:			
Expenditures for property, plant and equipment	(66)	(60)	(55)
Distributions from affiliates in excess of earnings	- -	- -	12
Other	1	- -	2
Net cash used in investing activities	(65)	(60)	(41)
Cash flows from financing activities:			
Repayment of long-term debt	(289)	(374)	(89)
Issuance of long-term debt	1	100	34
Proceeds from exercise of stock options	- -	- -	17
Contribution from affiliate	- -	6	- -
Other	(2)	(4)	- -
Net cash used in financing activities	(290)	(272)	(38)
Effect of exchange rate changes on cash	4	(8)	19
Increase (decrease) in cash and cash equivalents	(158)	(65)	135
Cash and cash equivalents at beginning of period	279	344	209
Cash and cash equivalents at end of period	$ 121	$ 279	$ 344

See Notes to the Consolidated Financial Statements.

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MILLENNIUM CHEMICALS INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

Millions of dollars	Common Stock Issued	Common Stock Treasury	Additional Paid In Capital	Retained Deficit	Accumulated Other Comprehensive Loss	Total Stockholders Equity (Deficit)	Comprehensive Income (Loss)
Balance, January 1, 2004	$ - -	$ (260)	$ 1,305	$ (995)	$ (141)	$ (91)	
Net loss	- -	- -	- -	(31)	- -	(31)	$ (31)
Retirement of treasury shares pursuant to merger	- -	137	(124)	- -	- -	13	- -
Foreign currency translation	- -	- -	- -	- -	50	50	50
Minimum pension liability, net of tax of $7 million	- -	- -	- -	- -	(15)	(15)	(15)
Exercise of stock options	- -	22	(3)	- -	- -	19	- -
Shares purchased by employee benefit plan trusts	- -	3	(7)	- -	- -	(4)	- -
Shares issued to fund 401(k) plan	- -	4	(1)	- -	- -	3	- -
Net gains on derivative financial instruments	- -	- -	- -	- -	1	1	1
Comprehensive income							$ 5
Balance, December 31, 2004	$ - -	$ (94)	$ 1,170	$ (1,026)	$ (105)	$ (55)	
Net income	- -	- -	- -	28	- -	28	$ 28
Foreign currency translation	- -	- -	- -	- -	(24)	(24)	(24)
Minimum pension liability, net of tax of $4 million	- -	- -	- -	- -	4	4	4
Capital contribution from Lyondell	- -	- -	6	- -	- -	6	- -
Shares sold by employee benefit plan trust	- -	4	- -	(1)	- -	3	- -
Comprehensive income							$ 8
Balance, December 31, 2005	$ - -	$ (90)	$ 1,176	$ (999)	$ (125)	$ (38)	
Net income	- -	- -	- -	159	- -	159	$ 159
Foreign currency translation	- -	- -	- -	- -	32	32	32
Minimum pension liability, net of tax of $24 million	- -	- -	- -	- -	47	47	47
Change in accounting for employee benefit plans, net of tax of $27 million	- -	- -	- -	- -	(57)	(57)	- -
Comprehensive income							$ 238

Balance, December 31, 2006	$ - -	$ (90)	$ 1,176	$ (840)	$ (103)	$ 143

See Notes to the Consolidated Financial Statements.

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MILLENNIUM CHEMICALS INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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States and political subdivisions
$
714

$
12,538

$
26,289

$
54,473

$
94,014

Residential mortgage-backed securities
994

12,898

46,292

654,176

714,360

Commercial mortgage-backed securities
—

5,678

—

1,183

6,861

Bank-issued trust preferred securities
—

—

4,196

—

4,196

Total available-for-sale securities
$
1,708

$
31,114

$
76,777

$
709,832

$
819,431

Fair value

Obligations of:

States and political subdivisions
$
713

$
12,489

$
26,184

$
54,404

$
93,790

Residential mortgage-backed securities
990

12,590

44,656

630,420

688,656

Commercial mortgage-backed securities
—

5,548

—

1,165

6,713

Bank-issued trust preferred securities
—

—

4,166

—

4,166

Total available-for-sale securities
$
1,703

$
30,627

$
75,006

$
685,989

$

793,325

Total weighted-average yield
2.52
%
2.78
%
3.38
%
2.84
%
2.88
%

Held-to-Maturity

The following table summarizes Peoples’ held-to-maturity investment securities:

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
September 30, 2018				
Obligations of:				
States and political subdivisions	$ 4,451	$ 438	$ —	$4,889
Residential mortgage-backed securities	29,765	79	(1,126)	28,718
Commercial mortgage-backed securities	3,574	—	(86)	3,488
Total held-to-maturity securities	$ 37,790	$ 517	$ (1,212)	$37,095
December 31, 2017				
Obligations of:				
States and political subdivisions	$ 3,810	$ 607	$ —	$4,417
Residential mortgage-backed securities	32,487	269	(529)	32,227
Commercial mortgage-backed securities	4,631	—	(62)	4,569
Total held-to-maturity securities	$ 40,928	$ 876	$ (591)	$41,213

There were no gross gains or gross losses realized by Peoples from sales of held-to-maturity securities for the three and nine months ended September 30, 2018 and 2017.

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The following table presents a summary of held-to-maturity investment securities that had an unrealized loss:

(Dollars in thousands)	Less than 12 Months			12 Months or More			Total	
	Fair Value	Unrealized Loss	No. of Securities	Fair Value	Unrealized Loss	No. of Securities	Fair Value	Unrealized Loss
September 30, 2018								
Residential mortgage-backed securities	$11,826	$ 182	6	$11,260	$ 944	3	$23,086	$ 1,126
Commercial mortgage-backed securities	—	—	—	3,488	86	1	3,488	86
Total	$11,826	$ 182	6	$14,748	$ 1,030	4	$26,574	$ 1,212
December 31, 2017								
Residential mortgage-backed securities	$1,476	$ 4	2	$12,098	$ 525	3	$13,574	$ 529
Commercial mortgage-backed securities	—	—	—	4,569	62	1	4,569	62
Total	$1,476	$ 4	2	$16,667	$ 587	4	$18,143	$ 591

The table below presents the amortized cost, fair value and total weighted-average yield of held-to-maturity securities by contractual maturity at September 30, 2018. The weighted-average yields are based on the amortized cost. In some cases, the issuers may have the right to call or prepay obligations without call or prepayment penalties prior to the contractual maturity date.

(Dollars in thousands)	Within 1 Year	1 to 5 Years	5 to 10 Years	Over 10 Years	Total
Amortized cost					
Obligations of:					
States and political subdivisions	$ —	$309	$2,982	$1,160	$4,451
Residential mortgage-backed securities	—	428	8,060	21,277	29,765
Commercial mortgage-backed securities	—	—	—	3,574	3,574
Total held-to-maturity securities	$ —	$737	$11,042	$26,011	$37,790
Fair value					
Obligations of:					
States and political subdivisions	$ —	$309	$3,410	$1,170	$4,889
Residential mortgage-backed securities	—	415	8,028	20,275	28,718
Commercial mortgage-backed securities	—	—	—	3,488	3,488
Total held-to-maturity securities	$ —	$724	$11,438	$24,933	$37,095
Total weighted-average yield	— %	2.97 %	3.08 %	2.70 %	2.82 %

Other Investment Securities

Peoples' other investment securities on the Consolidated Balance Sheet consist largely of shares of FHLB of Cincinnati and FRB of Cleveland, and equity investment securities. As of January 1, 2018, Peoples adopted ASU 2016-01, resulting in the reclassification of equity investment securities from available-for-sale investment securities to other investment securities.

The following table summarizes the carrying value of Peoples' other investment securities:

(Dollars in thousands)	September 30, 2018	December 31, 2017
FHLB stock	$ 29,368	$ 28,132
FRB stock	12,294	10,179
Equity investment securities (a)	278	—
Other	1,104	60
Total other investment securities	$ 43,044	$ 38,371

(a) As of January 1, 2018, Peoples adopted ASU 2016-01, resulting in the reclassification of equity investment securities from available-for-sale investment securities to other investment securities.

At September 30, 2018, there were no equity investment securities of a single issuer that exceeded 10% of Peoples' stockholders' equity.

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Pledged Securities

Peoples had pledged available-for-sale investment securities with carrying values of $514.9 million and $522.7 million at September 30, 2018 and December 31, 2017, respectively, and held-to-maturity investment securities with carrying values of $17.1 million and $18.3 million at September 30, 2018 and December 31, 2017, respectively, to secure public and trust department deposits, and repurchase agreements in accordance with federal and state requirements. Peoples also pledged available-for-sale investment securities with carrying values of $61.8 million and $6.7 million at September 30, 2018 and December 31, 2017, respectively, and held-to-maturity securities with carrying values of $17.4 million and $19.9 million at September 30, 2018 and December 31, 2017, respectively, to secure additional borrowing capacity at the FHLB and the FRB.

Note 4 Loans

Peoples' loan portfolio consists of various types of loans originated primarily as a result of lending opportunities within Peoples' primary market areas of northeastern, central, southwestern and southeastern Ohio, west central West Virginia, and northeastern Kentucky. Acquired loans consist of loans purchased in 2012 or thereafter. Loans that were acquired and subsequently re-underwritten, are reported as originated upon execution of such credit actions (for example, renewals and increases in lines of credit). The major classifications of loan balances (in each case, net of deferred fees and costs) excluding loans held for sale, were as follows:

(Dollars in thousands)	September 30, 2018	December 31, 2017
Originated loans:		
Commercial real estate, construction	$ 103,562	$ 107,118
Commercial real estate, other	630,720	595,447
Commercial real estate	734,282	702,565
Commercial and industrial	510,591	438,051
Residential real estate	299,768	304,523
Home equity lines of credit	92,892	88,902
Consumer, indirect	396,701	340,390
Consumer, direct	72,601	67,010
Consumer	469,302	407,400
Deposit account overdrafts	649	849
Total originated loans	$ 2,107,484	$ 1,942,290
Acquired loans:		
Commercial real estate, construction	$ 13,050	$ 8,319
Commercial real estate, other	191,993	165,120
Commercial real estate	205,043	173,439
Commercial and industrial	41,188	34,493
Residential real estate	308,178	184,864
Home equity lines of credit	42,961	20,575
Consumer, indirect	161	329
Consumer, direct	2,712	1,147
Consumer	2,873	1,476
Total acquired loans	$ 600,243	$ 414,847
Loans, net of deferred fees and costs	$ 2,707,727	$ 2,357,137

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Peoples has acquired various loans through business combinations for which there was, at acquisition, evidence of deterioration of credit quality since origination, and for which it was probable that all contractually required payments would not be collected. The carrying amounts of these purchased credit impaired loans included in the loan balances above are summarized as follows:

(Dollars in thousands)	September 30, 2018	December 31, 2017
Commercial real estate, other	$ 12,812	$ 8,117
Commercial and industrial	1,343	767
Residential real estate	20,488	19,532
Consumer	61	33
Total outstanding balance	$ 34,704	$ 28,449
Net carrying amount	$ 23,639	$ 19,564

Changes in the accretable yield for purchased credit impaired loans for the nine months ended September 30 were as follows:

(Dollars in thousands)	September 30, 2018	September 30, 2017
Balance, beginning of period	$ 6,704	$ 7,132
Reclassification from nonaccretable to accretable	2,019	1,285
Additions:		
ASB Financial Corp. (preliminary)	2,047	—
Accretion	(1,392)	(1,279)
Balance, September 30	$ 9,378	$ 7,138

Peoples completes annual re-estimations of cash flows on acquired purchased credit impaired loans in August of each year. At the end of each quarter, Peoples evaluates factors to determine if a material change has occurred in acquired loans accounted for and if a re-estimation is needed. Factors evaluated to determine if a re-estimation is needed include changes in: risk ratings, maturity dates, charge-offs, payoffs, nonaccrual status and loans that have become past due. Prepayments affect the estimated life of the loans and could change the amount of interest income, and possibly the amount of principal, expected to be collected. In reforecasting future estimated cash flows, credit loss expectations are adjusted as necessary. Peoples evaluates changes quarterly and compares the new estimated cash flows to those at the previous cash flow re-estimation date and the related materiality of the changes, and when compared to the total loan portfolio, the differences in estimated cash flows at the most recent cash flow re-estimation date compared to the previous cash flow re-estimation date would not have a material impact on amounts recorded since the last re-estimation. Peoples completed a re-estimation of cash flows on purchased credit impaired loans in August 2018, resulting in the reclassification from nonaccretable to accretable yield shown in the table above.
Cash flows expected to be collected on purchased credit impaired loans are estimated by incorporating several key assumptions, similar to the initial estimate of fair value. These key assumptions include probability of default and the amount of actual prepayments after the acquisition date. Prepayments affect the estimated life of the loans and could change the amount of interest income and possibly the principal expected to be collected. In re-forecasting future estimated cash flows, credit loss expectations are adjusted as necessary.

Pledged Loans

Peoples pledges certain loans secured by 1-4 family and multifamily residential mortgages under a blanket collateral agreement to secure borrowings from the FHLB of Cincinnati. The amount of such pledged loans totaled $524.1 million and $487.2 million at September 30, 2018 and December 31, 2017, respectively. Peoples also pledges commercial loans to secure borrowings with the FRB of Cleveland. The outstanding balances of these loans totaled $198.9 million and $74.0 million at September 30, 2018 and December 31, 2017, respectively.

Nonaccrual and Past Due Loans

A loan is considered past due if any required principal and interest payments have not been received as of the date such payments were required to be made under the terms of the loan agreement. A loan may be placed on nonaccrual status regardless of whether or not such loan is considered past due.

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The recorded investments in loans on nonaccrual status and loans delinquent for 90 days or more and accruing were as follows:

(Dollars in thousands)	Nonaccrual Loans		Loans 90+ Days Past Due and Accruing	
	September 30, 2018	December 31, 2017	September 30, 2018	December 31, 2017
Originated loans:				
Commercial real estate, construction	$725	$ 754	$—	$ —
Commercial real estate, other	6,712	6,877	—	—
Commercial real estate	7,437	7,631	—	—
Commercial and industrial	1,308	739	—	—
Residential real estate	3,842	3,546	373	548
Home equity lines of credit	582	550	84	50
Consumer, indirect	405	256	—	—
Consumer, direct	31	39	—	16
Consumer	436	295	—	16
Total originated loans	$13,605	$ 12,761	$457	$ 614
Acquired loans:				
Commercial real estate, construction	$—	$ —	$401	$ —
Commercial real estate, other	225	192	60	215
Commercial real estate	225	192	461	215
Commercial and industrial	61	259	—	45
Residential real estate	1,970	2,168	965	730
Home equity lines of credit	374	312	—	22
Consumer, indirect	—	—	2	—
Total acquired loans	$2,630	$ 2,931	$1,428	$ 1,012
Total loans	$16,235	$ 15,692	$1,885	$ 1,626

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The following table presents the aging of the recorded investment in past due loans:

(Dollars in thousands)	Loans Past Due 30 - 59 days	60 - 89 days	90 + Days	Total	Current Loans	Total Loans
September 30, 2018						
Originated loans:						
Commercial real estate, construction	$—	$—	$725	$725	$102,837	$103,562
Commercial real estate, other	521	601	6,418	7,540	623,180	630,720
Commercial real estate	521	601	7,143	8,265	726,017	734,282
Commercial and industrial	624	865	988	2,477	508,114	510,591
Residential real estate	826	2,544	2,126	5,496	294,272	299,768
Home equity lines of credit	320	62	410	792	92,100	92,892
Consumer, indirect	2,308	222	220	2,750	393,951	396,701
Consumer, direct	289	5	20	314	72,287	72,601
Consumer	2,597	227	240	3,064	466,238	469,302
Deposit account overdrafts	—	—	—	—	649	649
Total originated loans	$4,888	$4,299	$10,907	$20,094	$2,087,390	$2,107,484
Acquired loans:						
Commercial real estate, construction	$9	$—	$401	$410	$12,640	$13,050
Commercial real estate, other	1,318	136	140	1,594	190,399	191,993
Commercial real estate	1,327	136	541	2,004	203,039	205,043
Commercial and industrial	1,263	15	20	1,298	39,890	41,188
Residential real estate	1,382	1,215	1,963	4,560	303,618	308,178
Home equity lines of credit	572	107	210	889	42,072	42,961
Consumer, indirect	5	—	2	7	154	161
Consumer, direct	19	12	—	31	2,681	2,712
Consumer	24	12	2	38	2,835	2,873
Total acquired loans	$4,568	$1,485	$2,736	$8,789	$591,454	$600,243
Total loans	$9,456	$5,784	$13,643	$28,883	$2,678,844	$2,707,727

(Dollars in thousands)	Loans Past Due 30 - 59 days	60 - 89 days	90 + Days	Total	Current Loans	Total Loans
December 31, 2017						
Originated loans:						
Commercial real estate, construction	$—	$—	$—	$—	$107,118	$107,118
Commercial real estate, other	990	—	6,492	7,482	587,965	595,447
Commercial real estate	990	—	6,492	7,482	695,083	702,565
Commercial and industrial	1,423	92	706	2,221	435,830	438,051
Residential real estate	4,562	1,234	2,408	8,204	296,319	304,523
Home equity lines of credit	502	80	395	977	87,925	88,902
Consumer, indirect	2,153	648	105	2,906	337,484	340,390
Consumer, direct	417	46	48	511	66,499	67,010
Consumer	2,570	694	153	3,417	403,983	407,400
Deposit account overdrafts	—	—	—	—	849	849
Total originated loans	$10,047	$2,100	$10,154	$22,301	$1,919,989	$1,942,290
Acquired loans:						
Commercial real estate, construction	$—	$—	$—	$—	$8,319	$8,319
Commercial real estate, other	775	948	312	2,035	163,085	165,120
Commercial real estate	775	948	312	2,035	171,404	173,439
Commercial and industrial	—	1	171	172	34,321	34,493
Residential real estate	4,656	1,391	1,910	7,957	176,907	184,864
Home equity lines of credit	126	—	301	427	20,148	20,575
Consumer, indirect	3	—	—	3	326	329
Consumer, direct	10	11	—	21	1,126	1,147
Consumer	13	11	—	24	1,452	1,476
Total acquired loans	$5,570	$2,351	$2,694	$10,615	$404,232	$414,847
Total loans	$15,617	$4,451	$12,848	$32,916	$2,324,221	$2,357,137

Delinquency trends remained stable as 98.9% of Peoples' portfolio was considered “current” at September 30, 2018, compared to 99.0% at June 30, 2018 and 98.8% at September 30, 2017.

Credit Quality Indicators

As discussed in Note 1 of the Notes to the Consolidated Financial Statements included in Peoples' 2017 Form 10-K, Peoples categorizes the majority of its loans into risk categories based upon an established risk grading matrix using a scale of 1 to 8. A description of the general characteristics of the risk grades used by Peoples is as follows:

“Pass” (grades 1 through 4): Loans in this risk category involve borrowers of acceptable-to-strong credit quality and risk who have the apparent ability to satisfy their loan obligations. Loans in this risk grade would possess sufficient mitigating factors, such as adequate collateral or strong guarantors possessing the capacity to repay the loan if required, for any weakness that may exist.

“Special Mention” (grade 5): Loans in this risk grade are the equivalent of the regulatory definition of “Other Assets Especially Mentioned.” Loans in this risk category possess some credit deficiency or potential weakness, which requires a high level of management attention. Potential weaknesses include declining trends in operating earnings and cash flows and/or reliance on a secondary source of repayment. If left uncorrected, these potential weaknesses may result in noticeable deterioration of the repayment prospects for the loan or in Peoples' credit position.

“Substandard” (grade 6): Loans in this risk grade are inadequately protected by the borrower's current financial condition and payment capability or the collateral pledged, if any. Loans so classified have one or more well-defined weaknesses that jeopardize the orderly repayment of the loan. They are characterized by the distinct possibility that Peoples will sustain some loss if the deficiencies are not corrected.

“Doubtful” (grade 7): Loans in this risk grade have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or orderly repayment in full, on the basis of current existing facts, conditions and values, highly questionable and improbable. Possibility of loss is extremely high, but because of

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certain important and reasonably specific factors that may work to the advantage and strengthening of the exposure, classification of the loan as an estimated loss is deferred until its more exact status may be determined.
“Loss” (grade 8): Loans in this risk grade are considered to be non-collectible and of such little value that their continuance as bankable assets is not warranted. This does not mean a loan has absolutely no recovery value, but rather it is neither practical nor desirable to defer writing off the loan, even though partial recovery may be obtained in the future. Charge-offs against the allowance for loan losses are taken during the period in which the loan becomes uncollectible. Consequently, Peoples typically does not maintain a recorded investment in loans within this category.
Consumer loans and other smaller-balance loans are evaluated and categorized as “substandard,” “doubtful,” or “loss” based upon the regulatory definition of these classes and consistent with regulatory requirements. All other loans not evaluated individually, nor meeting the regulatory conditions to be categorized as described above, would be considered as being “not rated.”
The following table summarizes the risk category of loans within Peoples' loan portfolio based upon the most recent analysis performed:

(Dollars in thousands)	Pass Rated (Grades 1 - 4)	Special Mention (Grade 5)	Substandard (Grade 6)	Doubtful (Grade 7)	Not Rated	Total Loans
September 30, 2018						
Originated loans:						
Commercial real estate, construction	$101,274	$—	$ 1,496	$ —	$792	$103,562
Commercial real estate, other	603,723	13,992	13,005	—	—	630,720
Commercial real estate	704,997	13,992	14,501	—	792	734,282
Commercial and industrial	459,927	42,036	8,628	—	—	510,591
Residential real estate	14,483	537	12,506	294	271,948	299,768
Home equity lines of credit	453	—	—	—	92,439	92,892
Consumer, indirect	45	—	—	—	396,656	396,701
Consumer, direct	39	—	—	—	72,562	72,601
Consumer	84	—	—	—	469,218	469,302
Deposit account overdrafts	—	—	—	—	649	649
Total originated loans	$1,179,944	$56,565	$ 35,635	$ 294	$835,046	$2,107,484
Acquired loans:						
Commercial real estate, construction	$10,138	$1,280	$ 1,632	$ —	$—	$13,050
Commercial real estate, other	175,375	8,450	8,070	98	—	191,993
Commercial real estate	185,513	9,730	9,702	98	—	205,043
Commercial and industrial	38,424	1,400	1,364	—	—	41,188
Residential real estate	18,477	1,950	1,825	140	285,786	308,178
Home equity lines of credit	34	—	—	—	42,927	42,961
Consumer, indirect	4	—	—	—	157	161
Consumer, direct	39	—	—	—	2,673	2,712
Consumer	43	—	—	—	2,830	2,873
Total acquired loans	$242,491	$13,080	$ 12,891	$ 238	$331,543	$600,243
Total loans	$1,422,435	$69,645	$ 48,526	$ 532	$1,166,589	$2,707,727

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(Dollars in thousands)	Pass Rated (Grades 1 - 4)	Special Mention (Grade 5)	Substandard (Grade 6)	Doubtful (Grade 7)	Not Rated	Total Loans
December 31, 2017						
Originated loans:						
Commercial real estate, construction	$100,409	$5,502	$ 754	$ —	$453	$107,118
Commercial real estate, other	561,320	17,189	16,938	—	—	595,447
Commercial real estate	661,729	22,691	17,692	—	453	702,565
Commercial and industrial	420,477	13,062	4,512	—	—	438,051
Residential real estate	17,896	1,000	11,371	216	274,040	304,523
Home equity lines of credit	454	—	—	—	88,448	88,902
Consumer, indirect	55	8	—	—	340,327	340,390
Consumer, direct	33	—	—	—	66,977	67,010
Consumer	88	8	—	—	407,304	407,400
Deposit account overdrafts	—	—	—	—	849	849
Total originated loans	$1,100,644	$36,761	$ 33,575	$ 216	$771,094	$1,942,290
Acquired loans:						
Commercial real estate, construction	$8,267	$—	$ 52	$ —	$—	$8,319
Commercial real estate, other	149,486	6,527	9,107	—	—	165,120
Commercial real estate	157,753	6,527	9,159	—	—	173,439
Commercial and industrial	32,011	157	2,325	—	—	34,493
Residential real estate	12,543	593	1,105	—	170,623	184,864
Home equity lines of credit	124	—	—	—	20,451	20,575
Consumer, indirect	12	—	—	—	317	329
Consumer, direct	35	—	—	—	1,112	1,147
Consumer	47	—	—	—	1,429	1,476
Total acquired loans	$202,478	$7,277	$ 12,589	$ —	$192,503	$414,847
Total loans	$1,303,122	$44,038	$ 46,164	$ 216	$963,597	$2,357,137

In the first nine months of 2018, Peoples' classified loans, which are loans categorized as substandard or doubtful, increased compared to the balances at December 31, 2017 mostly due to acquired ASB Financial Corp. ("ASB") loans, which were partially offset by paydowns on classified loans. Compared to June 30, 2018, the improvement in classified loans was mostly due to a single commercial relationship that was upgraded from substandard to special mention during the quarter.

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Impaired Loans

The following table summarizes loans classified as impaired:

(Dollars in thousands)	Unpaid Principal Balance	Recorded Investment With Allowance	Recorded Investment Without Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
September 30, 2018							
Commercial real estate, construction	$ 2,483	$ —	$ 2,396	$ 2,396	$ —	$ 1,571	$ 46
Commercial real estate, other	17,119	269	15,710	15,979	91	13,795	349
Commercial real estate	19,602	269	18,106	18,375	91	15,366	395
Commercial and industrial	2,395	899	1,286	2,185	191	2,068	53
Residential real estate	26,732	234	24,913	25,147	40	22,724	898
Home equity lines of credit	2,298	486	1,784	2,270	83	1,801	84
Consumer, indirect	518	242	285	527	140	242	16
Consumer, direct	77	32	45	77	32	66	11
Consumer	595	274	330	604	172	308	27
Total	$ 51,622	$ 2,162	$ 46,419	$ 48,581	$ 577	$ 42,267	$ 1,457
December 31, 2017							
Commercial real estate, construction	$ 821	$ —	$ 754	$ 754	$ —	$ 788	$ —
Commercial real estate, other	14,909	14	13,606	13,620	1	14,392	503
Commercial real estate	15,730	14	14,360	14,374	1	15,180	503
Commercial and industrial	1,690	951	572	1,523	199	1,668	65
Residential real estate	24,743	477	22,626	23,103	58	23,195	1,246
Home equity lines of credit	1,707	81	1,624	1,705	18	1,505	85
Consumer, indirect	273	70	206	276	26	184	20
Consumer, direct	87	56	28	84	37	79	7
Consumer	360	126	234	360	63	263	27
Total	$ 44,230	$ 1,649	$ 39,416	$ 41,065	$ 339	$ 41,811	$ 1,926

Peoples' impaired loans shown in the table above included loans that were classified as troubled debt restructurings ("TDRs").

In assessing whether or not a borrower is experiencing financial difficulties, Peoples considers information currently available regarding the financial condition of the borrower. This information includes, but is not limited to, whether (i) the borrower is currently in payment default on any of the borrower's debt; (ii) a payment default is probable in the foreseeable future without the modification; (iii) the borrower has declared or is in the process of declaring bankruptcy; and (iv) the borrower's projected cash flow is insufficient to satisfy contractual payments due under the original terms of the loan without a modification.

Peoples considers all aspects of the modification to loan terms to determine whether or not a concession has been granted to the borrower. Key factors considered by Peoples include the borrower's ability to access funds at a market rate for debt with similar risk characteristics, the significance of the modification relative to the unpaid principal balance or collateral value of the debt, and the significance of a delay in the timing of payments relative to the original contractual terms of the loan. The most common concessions granted by Peoples generally include one or more modifications to the terms of the loan, such as (i) a reduction in the interest rate for the remaining life of the loan, (ii) an extension of the maturity date at an interest rate lower than the current market rate for new loans with similar risk, (iii) a temporary period of interest-only payments, and (iv) a reduction in the contractual payment amount for either a short period or the remaining term of the loan.

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The following table summarizes the loans that were modified as a TDR during the three months ended September 30:

		Three Months Ended		
		Recorded Investment (a)		
(Dollars in thousands)	Number of Contracts	Pre-Modification	Post-Modification	Remaining Recorded Investment
September 30, 2018				
Originated loans:				
Residential real estate	3	$ 87	$ 87	$ 87
Home equity lines of credit	4	533	533	531
Consumer, indirect	7	150	150	150
Total originated loans	14	$ 770	$ 770	$ 768
Acquired loans:				
Residential real estate	3	$ 272	$ 272	$ 272
Home equity lines of credit	1	54	54	54
Total acquired loans	4	$ 326	$ 326	$ 326
September 30, 2017				
Originated loans:				
Commercial and industrial	1	$ 36	$ 36	$ 36
Residential real estate	1	90	90	90
Home equity lines of credit	2	22	22	19
Consumer, indirect	5	34	34	34
Consumer, direct	2	9	9	9
Consumer	7	43	43	43
Total originated loans	11	$ 191	$ 191	$ 188
Acquired loans:				
Residential real estate	2	$ 61	$ 61	$ 61
Home equity lines of credit	1	34	34	34
Total acquired loans	3	$ 95	$ 95	$ 95

(a) The amounts shown are inclusive of all partial paydowns and charge-offs. Loans modified in a TDR that were fully paid down, charged-off or foreclosed upon by period end are not reported.

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The following table summarizes the loans that were modified as a TDR during the nine months ended September 30:

(Dollars in thousands)	Number of Contracts	Nine Months Ended Recorded Investment (a) Pre-Modification	Post-Modification	Remaining Recorded Investment
September 30, 2018				
Originated loans:				
Residential real estate	9	$871	$ 871	$ 871
Home equity lines of credit	6	565	565	562
Consumer, indirect	26	454	454	420
Consumer, direct	5	27	27	18
Consumer	31	481	481	438
Total originated loans	46	$1,917	$ 1,917	$ 1,871
Acquired loans:				
Commercial real estate, other	1	$50	$ 50	$ 47
Residential real estate	15	1,258	1,258	1,244
Home equity lines of credit	5	140	140	139
Total acquired loans	21	$1,448	$ 1,448	$ 1,430
September 30, 2017				
Originated loans:				
Commercial real estate, other	1	$14	$ 14	$ 14
Commercial and industrial	3	174	174	123
Residential real estate	7	483	483	478
Home equity lines of credit	6	291	291	286
Consumer, indirect	11	127	127	86
Consumer, direct	3	10	10	10
Consumer	14	137	137	96
Total originated loans	31	$1,099	$ 1,099	$ 997
Acquired loans:				
Commercial real estate, other	2	$271	$ 271	$ 265
Residential real estate	8	264	264	263
Home equity lines of credit	5	328	328	323
Consumer, direct	2	10	10	9
Total acquired loans	17	$873	$ 873	$ 860

(a) The amounts shown are inclusive of all partial paydowns and charge-offs. Loans modified in a TDR that were fully paid down, charged-off or foreclosed upon by period end are not reported.

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The following table presents those acquired loans modified in a TDR during the year that subsequently defaulted (i.e., are 90 days or more past due following a modification) during the nine-month periods ended September 30:

(Dollars in thousands)	September 30, 2018 Number of Contracts	Recorded Investment (a)	Impact on the Allowance for Loan Losses	September 30, 2017 Number of Contracts	Recorded Investment (a)	Impact on the Allowance for Loan Losses
Acquired loans:						
Residential real estate	—	$ —	$ —	1	$ 44	$ —
Home equity lines of credit	1	10	—	—	—	—
Consumer, other	—	—	—	1	8	—
Total	1	$ 10	$ —	2	$ 52	$ —

(a) The amounts shown are inclusive of all partial paydowns and charge-offs.

Loans modified in a TDR that were fully paid down, charged-off or foreclosed upon by period end are not reported.

Peoples did not have any originated loans that were modified as a TDR during the last twelve months that subsequently defaulted. Peoples had no commitments to lend additional funds to the related debtors whose terms have been modified in a TDR.

Allowance for Originated Loan Losses

Changes in the allowance for originated loan losses for the nine months ended September 30 were as follows:

(Dollars in thousands)	Commercial Real Estate	Commercial and Industrial	Residential Real Estate	Home Equity Lines of Credit	Consumer Indirect	Consumer Direct	Deposit Account Overdrafts	Total
Balance, January 1, 2018	$ 7,797	$ 5,813	$ 904	$ 693	$ 2,944	$ 464	$ 70	$ 18,685
Charge-offs	(849)	(38)	(293)	(67)	(1,967)	(297)	(731)	(4,242)
Recoveries	58	10	98	12	403	114	160	855
Net charge-offs	(791)	(28)	(195)	(55)	(1,564)	(183)	(571)	(3,387)
Provision for loan losses	960	353	290	70	2,043	114	596	4,426
Balance, September 30, 2018	$ 7,966	$ 6,138	$ 999	$ 708	$ 3,423	$ 395	$ 95	$ 19,724
Period-end amount allocated to:								
Loans individually evaluated for impairment	$ 91	$ 191	$ 40	$ 83	$ 140	$ 32	$ —	$ 577
Loans collectively evaluated for impairment	7,875	5,947	959	625	3,283	363	95	19,147
Ending balance	$ 7,966	$ 6,138	$ 999	$ 708	$ 3,423	$ 395	$ 95	$ 19,724
Balance, January 1, 2017	$ 7,172	$ 6,353	$ 982	$ 688	$ 2,312	$ 518	$ 171	$ 18,196
Charge-offs	(25)	(165)	(451)	(100)	(1,493)	(275)	(767)	(3,276)
Recoveries	135	1	128	9	598	152	159	1,182
Net recoveries (charge-offs)	110	(164)	(323)	(91)	(895)	(123)	(608)	(2,094)
Provision for loan losses	252	226	265	82	1,397	46	507	2,775
Balance, September 30, 2017	$ 7,534	$ 6,415	$ 924	$ 679	$ 2,814	$ 441	$ 70	$ 18,877
Period-end amount allocated to:								
	$ 136	$ 424	$ 151	$ 13	$ 2	$ 21	$ —	$ 747

Loans individually evaluated for impairment								
Loans collectively evaluated for impairment	7,398	5,991	773	666	2,812	420	70	18,130
Ending balance	$ 7,534	$ 6,415	$ 924	$ 679	$ 2,814	$ 441	$ 70	$ 18,877

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Allowance for Loan Losses for Acquired Loans

Acquired loans are recorded at their fair value as of the acquisition date with no valuation allowance, and monitored for changes in credit quality and subsequent increases or decreases in expected cash flows. Decreases in expected cash flows of acquired purchased credit impaired loans are recognized as an impairment, with the amount of the expected loss included in management's evaluation of the appropriateness of the allowance for loan losses. The methods utilized to estimate the required allowance for loan losses for nonimpaired acquired loans are similar to those utilized for originated loans; however, Peoples records a provision for loan losses only when the computed allowance exceeds the remaining fair value adjustment.

The following table presents activity in the allowance for loan losses for acquired loans:

(Dollars in thousands)	Three Months Ended September 30, 2018	Three Months Ended September 30, 2017	Nine Months Ended September 30, 2018	Nine Months Ended September 30, 2017
Purchased credit impaired loans:				
Balance, beginning of period	$ 108	$ 90	$ 108	$ 233
Provision for (recovery of) loan losses	47	25	47	(118)
Balance, September 30	$ 155	$ 115	$ 155	$ 115

Note 5 Long-Term Borrowings

The following table summarizes Peoples' long-term borrowings:

(Dollars in thousands)	September 30, 2018 Balance	September 30, 2018 Weighted-Average Rate	December 31, 2017 Balance	December 31, 2017 Weighted-Average Rate
FHLB putable, non-amortizing, fixed-rate advances	$85,000	2.05 %	$115,000	1.86 %
FHLB amortizing, fixed-rate advances	18,860	2.09 %	21,939	2.02 %
Junior subordinated debt securities	7,239	7.34 %	7,107	6.51 %
Unamortized debt issuance costs	—	— %	(27)	— %
Total long-term borrowings	$111,099	2.40 %	$144,019	2.11 %

Peoples continually evaluates its overall balance sheet position given the interest rate environment. During the first nine months of 2018, no additional borrowings were entered into, and two long-term FHLB non-amortizing advances in the aggregate amount of $30.0 million were reclassified to short-term borrowings as the maturity became less than one year.

As of September 30, 2018, Peoples' had one remaining FHLB putable option-based advance. The FHLB has the option, at its sole discretion, to terminate the advance after the initial fixed rate period of three months, requiring full repayment of the advance by Peoples, prior to the stated maturity. If the advance is terminated prior to maturity, the FHLB will offer Peoples replacement funding at the then-prevailing rate on an advance product then offered by the FHLB, subject to normal FHLB credit and collateral requirements. Peoples is required to make quarterly interest payments.

The amortizing, fixed-rate FHLB advances have a fixed rate for the term of each advance, with maturities ranging from two to thirteen years. These advances require monthly principal and interest payments, with some having a constant prepayment rate requiring an additional principal payment annually. These advances are not eligible for optional prepayment prior to maturity.

Peoples maintains a multi-year unsecured $15.0 million revolving credit facility (the "Credit Facility") with Raymond James Bank, N.A. that matures on March 4, 2019. Borrowings under the Credit Facility may be used: (i) to make acquisitions; (ii) to make stock repurchases; (iii) for working capital needs; and (iv) for other general corporate purposes. Each loan under the Credit Facility will bear interest per annum at a rate equal to 3.00% plus the one-month LIBOR rate, which rate will reset monthly. As of September 30, 2018, there were no borrowings outstanding under the Credit Facility. Additional information regarding the Credit Facility can be found in Note 9 of the Notes to the

Consolidated Financial Statements included in Peoples' 2017 Form 10-K.

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The aggregate minimum annual retirements of long-term borrowings in future periods are as follows:

(Dollars in thousands)	Balance	Weighted-Average Rate	
Three months ending December 31, 2018	$1,455	1.97	%
Year ending December 31, 2019	3,512	1.56	%
Year ending December 31, 2020	25,564	1.83	%
Year ending December 31, 2021	21,979	1.74	%
Year ending December 31, 2022	16,521	1.95	%
Thereafter	42,068	3.35	%
Total long-term borrowings	$111,099	2.40	%

Note 6 Stockholders' Equity

The following table details the progression in Peoples' common shares and treasury stock during the nine months ended September 30, 2018:

	Common Shares	Treasury Stock	
Shares at December 31, 2017	18,952,385	702,449	
Changes related to stock-based compensation awards:			
Release of restricted common shares	—	30,808	
Cancellation of restricted common shares	—	1,961	
Exercise of stock appreciation rights	—	(102	)
Grant of restricted common shares	—	(103,605	)
Grant of common shares	—	(16,544	)
Changes related to deferred compensation plan for Boards of Directors:			
Purchase of treasury stock	—	4,646	
Disbursed out of treasury stock	—	(2,089	)
Common shares issued under dividend reinvestment plan	14,098	—	
Common shares issued under compensation plan for Boards of Directors	—	(3,088	)
Common shares issued under employee stock purchase plan	—	(5,186	)
Issuance of common shares related to the acquisition of ASB Financial Corp.	1,152,711	—	
Shares at September 30, 2018	20,119,194	609,250	

Under its Amended Articles of Incorporation, Peoples is authorized to issue up to 50,000 preferred shares, in one or more series, having such voting powers, designations, preferences, rights, qualifications, limitations and restrictions as determined by Peoples' Board of Directors. At September 30, 2018, Peoples had no preferred shares issued or outstanding.

The following table details the cash dividends declared per common share during the nine months ended September 30:

	2018	2017
First Quarter	$0.26	$0.20
Second Quarter	0.28	0.20
Third Quarter	0.28	0.22
Total dividends declared	$0.82	$0.62

Accumulated Other Comprehensive Loss

The following table details the change in the components of Peoples' accumulated other comprehensive loss for the nine months ended September 30, 2018:

(Dollars in thousands)

	Unrealized Loss on Securities	Unrecognized Net Pension and Postretirement Costs	Unrealized Gain on Cash Flow Hedge	Accumulated Other Comprehensive Loss
Balance, December 31, 2017	$ (2,088)	$ (4,256)	$ 1,129	$ (5,215)
Reclassification adjustments to net income:				
Realized gain on sale of securities, net of tax	115	—	—	115
Realized loss due to settlement and curtailment, net of tax	—	139	—	139
Amounts reclassified out of accumulated other comprehensive loss per ASU 2016-01	(5,020)	—	—	(5,020)
Other comprehensive (loss) income, net of reclassifications and tax	(13,629)	993	2,027	(10,609)
Balance, September 30, 2018	$ (20,622)	$ (3,124)	$ 3,156	$ (20,590)

Note 7 Employee Benefit Plans

Peoples sponsors a noncontributory defined benefit pension plan that covers substantially all employees hired before January 1, 2010. The plan provides retirement benefits based on an employee's years of service and compensation. For employees hired before January 1, 2003, the amount of postretirement benefit is based on the employee's average monthly compensation over the highest five consecutive years out of the employee's last ten years with Peoples while an eligible employee. For employees hired on or after January 1, 2003, the amount of postretirement benefit is based on 2% of the employee's annual compensation during the years 2003 through 2009, plus accrued interest. Effective January 1, 2010, the pension plan was closed to new entrants. Effective March 1, 2011, the accrual of pension plan benefits for all participants was frozen. Peoples recognized this freeze as a curtailment as of December 31, 2010 and March 1, 2011, under the terms of the pension plan.

Peoples also provides post-retirement health and life insurance benefits to former employees and directors. Only those individuals who retired before January 27, 2012 were eligible for life insurance benefits. As of January 1, 2011, all retirees who desire to participate in Peoples medical plan do so by electing COBRA, which provides up to 18 months of coverage; retirees over the age of 65 also have the option to pay to participate in a group Medicare supplemental plan. Peoples' policy is to fund the cost of the health benefits as they arise.

The following tables detail the components of the net periodic cost for the plans:

	Pension Benefits			
	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in thousands)	2018	2017	2018	2017
Interest cost	$ 104	$ 112	$ 314	$ 338
Expected return on plan assets	(147)	(138)	(440)	(415)
Amortization of net loss	29	26	84	77
Settlement of benefit obligation	176	—	—	—
Net periodic cost	$ 162	$ —	$ (42)	$ —

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	Postretirement Benefits			
	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
(Dollars in thousands)	2018	2017	2018	2017
Interest cost	$—	$ 1	$ 2	$ 3
Amortization of net gain	(1)	(1)	(4)	(5)
Net periodic cost	$(1)	$ —	$ (2)	$ (2)

Under US GAAP, Peoples is required to recognize a settlement gain or loss when the aggregate amount of lump-sum distributions to participants equals or exceeds the sum of the service and interest cost components of the net periodic pension cost. The amount of settlement gain or loss recognized is the pro rata amount of the unrealized gain or loss existing immediately prior to the settlement. In general, both the projected benefit obligation and the fair value of plan assets are required to be remeasured in order to determine the settlement gain or loss.

During the third quarter 2018, the total lump-sum distributions made to participants caused the total settlements to exceed the recognition threshold for settlement gain or losses. As a result, Peoples recorded settlement charges of $176,000 in the three and nine months ended September 30, 2018. There were no settlement charges recorded during the three or nine months ended September 30, 2017 under the noncontributory defined benefit pension plan.

The following table summarizes the change in projected benefit obligation and funded status as a result of the remeasurement and the aggregate settlements for the three months ended September 30, 2018:

(Dollars in thousands)	As of December 31,	September 30, 2018		
Funded status:	2017	Before Settlements	Impact of Settlement	After Settlement
Projected benefit obligation	$12,991	$12,006	$ (510)	$11,496
Fair value of plan assets	8,493	12,006	(510)	11,496
Funded status	$(4,498)	$—	$ —	$—
Gross unrealized loss	$5,458	$4,196	$ 176	$4,020
Assumptions:				
Discount rate	3.40 %	4.00 %		4.00 %
Expected return on plan assets	7.50 %	7.50 %		7.50 %

In 2018, Peoples contributed $3.2 million to the defined benefit pension plan. This contribution was reported on the 2017 federal income tax return and recognized as a deduction for tax purposes at the 35% statutory federal corporate income tax rate.

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Note 8 Earnings Per Common Share

The calculations of basic and diluted earnings per common share were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in thousands, except per common share data)	2018	2017	2018	2017
Distributed earnings allocated to common shareholders	$5,409	$ 3,972	$15,532	$ 11,184
Undistributed earnings allocated to common shareholders	7,246	6,865	16,638	18,134
Net earnings allocated to common shareholders	$12,655	$ 10,837	$32,170	$ 29,318
Weighted-average common shares outstanding	19,325,458	17,056,202	18,875,291	19,043,692
Effect of potentially dilutive common shares	141,408	157,331	128,797	156,267
Total weighted-average diluted common shares outstanding	19,466,866	17,213,533	19,004,088	19,199,959
Earnings per common share:				
Basic	$0.65	$ 0.60	$1.70	$ 1.62
Diluted	$0.65	$ 0.60	$1.69	$ 1.61
Anti-dilutive shares excluded from calculation:				
Restricted shares, stock options and stock appreciation rights	5,541	163	2,193	270

Note 9 Financial Instruments with Off-Balance Sheet Risk

Derivatives and Hedging Activities - Risk Management Objective of Using Derivatives

Peoples is exposed to certain risks arising from both its business operations and economic conditions. Peoples principally manages its exposures to a wide variety of business and operational risks through management of its core business activities. Peoples manages economic risks, including interest rate, liquidity, and credit risks, primarily by managing the amount, sources, and duration of its assets and liabilities and through the use of derivative financial instruments. Specifically, Peoples enters into derivative financial instruments to manage exposures that arise from business activities that result in the receipt or payment of future known or expected cash amounts, the value of which are determined by interest rates. Peoples’ derivative financial instruments are used to manage differences in the amount, timing, and duration of Peoples' known or expected cash receipts and its known or expected cash payments principally related to certain variable rate borrowings. Peoples also has interest rate derivatives that result from a service provided to certain qualifying customers and, therefore, are not used to manage interest rate risk in Peoples' assets or liabilities. Peoples manages a matched book with respect to customer-related derivative financial instruments in order to minimize its net risk exposure resulting from such transactions.

Fair Values of Derivative Instruments on the Balance Sheet

Peoples' fair value of the derivative financial instruments was $8.8 million in an asset position and $4.9 million in a liability position at September 30, 2018, and there was $4.6 million in an asset position and $3.2 million in a liability position at December 31, 2017. The amounts are recorded in Other assets, and Accrued expenses and other liabilities on the Consolidated Balance Sheet at the date indicated.

Cash Flow Hedges of Interest Rate Risk

Peoples' objectives in using interest rate derivatives are to add stability to interest income and expense, and to manage its exposure to interest rate movements. To accomplish these objectives, Peoples has entered into interest rate swaps as part of its interest rate risk management strategy. These interest rate swaps are designated as cash flow hedges and involve the receipt of variable rate amounts from a counterparty in exchange for Peoples making fixed payments. Peoples acquired three interest rate swaps with the ASB acquisition in the second quarter of 2018, which had an aggregate notional value of $7.0 million, and all of which matured in July 2018. As of September 30, 2018, Peoples had entered into twelve interest rate swap contracts, ten of which were effective with an aggregate notional value of $100.0 million. The remaining two became effective in October 2018 with an aggregate notional value of $10.0 million. Peoples will pay a fixed rate of interest for up to ten years while receiving a floating rate component of interest equal to the three-month LIBOR rate. The interest received on the floating rate component is intended to offset the rate on the rolling three-month FHLB advances. Amounts reported in accumulated other comprehensive loss ("AOCL"), related to derivatives will be reclassified to interest income or expense as interest payments are made or received on Peoples' variable-rate assets or liabilities. During the three and nine months ended September 30, 2018, and September 30, 2017, Peoples had minimal reclassifications to interest expense. During the next twelve months, Peoples estimates that minimal interest expense amount will be reclassified.

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For derivatives designated as cash flow hedges, the effective portion of changes in the fair value of each derivative is reported in AOCL (outside of earnings), net of tax, and subsequently reclassified to earnings when the hedged transaction affects earnings, and the ineffective portion of changes in the fair value of the derivative is recognized directly in earnings. Peoples assesses the effectiveness of each hedging relationship by comparing the changes in cash flows of the derivative hedging instrument with the changes in cash flows of the designated hedged transaction. The reset dates and the payment dates on the 90-day advances used to fund the swaps are matched to the reset dates and payment dates on the receipt of the 3-month LIBOR floating portion of the swaps to ensure effectiveness of the cash flow hedge. Effectiveness is measured by ensuring that reset dates and payment dates are matched.

The amount of accumulated other comprehensive pre-tax income for Peoples' cash flow hedges was $4.0 million at September 30, 2018. There were no pre-tax net losses recorded for the nine months ended September 30, 2018. Additionally, Peoples had no reclassifications to earnings in the three or nine months ended September 30, 2018 or September 30, 2017.

Non-Designated Hedges

Peoples maintains an interest rate protection program for commercial loan customers, which was established in 2010. Under this program, Peoples provides its customer with a fixed-rate loan while creating a variable-rate asset for Peoples by the customer entering into an interest rate swap with Peoples on terms that match the loan. Peoples offsets its risk exposure by entering into an offsetting interest rate swap with an unaffiliated institution. These interest rate swaps do not qualify as designated hedges; therefore, each swap is accounted for as a standalone derivative. Peoples had interest rate swaps associated with commercial loans with an aggregate notional value of $449.3 million and fair value of $5.6 million of equally offsetting assets and liabilities at September 30, 2018, and an aggregate notional value of $363.3 million and fair value of $3.0 million of equally offsetting assets and liabilities at December 31, 2017. These interest rate swaps did not have a material impact on Peoples' results of operation or financial condition.

Note 10 Stock-Based Compensation

Under the Peoples Bancorp Inc. Third Amended and Restated 2006 Equity Plan (the "2006 Equity Plan"), Peoples may grant, among other awards, nonqualified stock options, incentive stock options, restricted stock awards, stock appreciation rights ("SARs") and unrestricted share awards to employees and non-employee directors. The total number of common shares currently available under the 2006 Equity Plan is 891,340. The maximum number of common shares that can be issued for incentive stock options is 500,000 common shares. Prior to 2007, Peoples granted nonqualified and incentive stock options to employees and nonqualified stock options to non-employee directors under the 2006 Equity Plan and predecessor plans. Since 2009, Peoples has granted restricted common shares to employees and restricted common shares to non-employee directors subject to the terms and conditions prescribed by the 2006 Equity Plan. In 2018, the Board of Directors granted unrestricted common shares to non-employee directors and to all full-time and part-time employees who did not already participate in the 2006 Equity Plan. In general, common shares issued in connection with stock-based awards are issued from treasury shares to the extent available. If no treasury shares are available, common shares are issued from authorized but unissued common shares.

Stock Appreciation Rights

SARs granted to employees have an exercise price equal to the fair market value of Peoples’ common shares on the date of grant and will be settled using common shares of Peoples. Additionally, the SARs granted to employees vested three years after the respective grant dates and expired ten years from the respective date of grant. The most recent grant of SARs occurred in 2008 and these SARs were exercised immediately prior to their expiration on February 20, 2018. The following table summarizes the changes to Peoples' SARs for the nine months ended September 30, 2018:

	Number of Common Shares Subject to	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life	Aggregate Intrinsic Value

	SARs				
Outstanding at January 1	314	$ 23.77			
Exercised	314	23.77			
Outstanding at September 30	—	$ —	—	$	—
Exercisable at September 30	—	$ —	—	$	—

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Restricted Common Shares

Under the 2006 Equity Plan, Peoples may award restricted common shares to officers, key employees and non-employee directors. Beginning in 2018, common shares awarded to non-employee directors vest immediately upon grant with no restrictions. Restrictions on restricted common shares awarded to employees expire after periods ranging from one to three years. In the first nine months of 2018, Peoples granted an aggregate of 84,876 restricted common shares subject to performance-based vesting to officers and key employees with restrictions that will lapse three years after the grant date provided that in order for the restricted common shares to vest in full, Peoples must have reported positive net income and maintained a well capitalized status by regulatory standards for each of the three fiscal years preceding the vesting date. During the first nine months of 2018, Peoples granted, to certain key employees, an aggregate of 18,729 restricted common shares subject to time-based vesting with restrictions that will lapse after periods ranging from immediate grant date vesting to vesting three years after the grant date.

The following table summarizes the changes to Peoples' restricted common shares for the nine months ended September 30, 2018:

	Time-Based Vesting		Performance-Based Vesting	
	Number of Common Shares	Weighted-Average Grant Date Fair Value	Number of Common Shares	Weighted-Average Grant Date Fair Value
Outstanding at January 1	33,082	$ 22.85	176,218	$ 25.50
Awarded	18,729	36.70	84,876	35.43
Released	7,000	24.49	83,311	23.62
Forfeited	—	—	1,961	34.39
Outstanding at September 30	44,811	$ 28.38	175,822	$ 31.09

For the nine months ended September 30, 2018, the total intrinsic value for restricted common shares released was $3.2 million compared to $0.9 million for the nine months ended September 30, 2017.

Stock-Based Compensation

Peoples recognizes stock-based compensation expense based on the estimated fair value of the awards on the grant date. The following table summarizes the amount of stock-based compensation expense and related tax benefit recognized for each period:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in thousands)	2018	2017	2018	2017
Total stock-based compensation expense	$ 564	$ 351	$ 2,174	$ 1,362
Recognized tax benefit	(119)	(123)	(457)	(477)
Net expense recognized	$ 445	$ 228	$ 1,717	$ 885

Total unrecognized stock-based compensation expense related to unvested awards was $2.7 million at September 30, 2018, which will be recognized over a weighted-average period of 1.9 years. On January 31, 2018, Peoples granted, to non-employee directors, an aggregate of 3,600 unrestricted common shares, which resulted in an additional $128,000 of stock-based compensation expense being recognized. On February 14, 2018, an aggregate of 11,112 unrestricted common shares were granted as a one-time special award to all full-time and part-time employees who did not already participate in the 2006 Equity Plan, which resulted in an additional $388,000 of stock-based compensation expense being recognized in the first quarter of 2018.

Performance Unit Awards

Under the 2006 Equity Plan, Peoples may award performance unit awards to officers, key employees and non-employee directors. On July 26, 2017, Peoples granted a total of seven performance unit awards to officers with a maximum aggregate dollar amount of $1.3 million represented by the performance units subject to such awards, with each performance unit representing $1.00. The performance unit awards granted are for the performance period beginning January 1, 2018 and ending on December 31, 2019, and will be subject to two performance goals. Twenty-five percent of the performance units subject to each award will vest if, but only if, the related target performance goal is achieved. The remaining 75% of the performance units subject to each award will vest based on the relative performance (measured by percentile ranking) with

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respect to the related maximum performance goal. If for the performance period, the target level of achievement for the first performance goal and/or the maximum level of achievement for the second performance goal is not reached, the dollar amount represented by the performance units associated with each performance goal will be adjusted to reflect the level of performance achieved. After the vesting date, the participant will receive that number of common shares of Peoples equal to (i) the aggregate number of participant's performance units (and dollar value of such performance units) that vested based on the performance achieved under both performance goals (ii) divided by the fair market value of a common share of Peoples on the date of such vesting and rounded down to the nearest whole common share.

Note 11 Revenue

As of January 1, 2018, Peoples adopted ASU 2014-09 - Revenue from Contracts with Customers (Topic 606), and all subsequent updates that modified ASC 606. Peoples elected to adopt this new accounting guidance using the modified retrospective approach. The modified retrospective approach uses a cumulative-effect adjustment to retained earnings to reflect uncompleted contracts in the initial application of the guidance. As of January 1, 2018, Peoples recorded a cumulative-effect adjustment for uncompleted contracts, which resulted in a reduction to Retained earnings and an increase in Accrued expenses and other liabilities of $3.1 million, which is net of federal income taxes. The impact during the third quarter of 2018 was an increase in insurance income and a decrease in retained earnings of $101,000 as a result of applying ASC 606. During the first nine months of 2018, the impact of ASC 606 resulted in an increase in insurance income and a decrease in retained earnings of $146,000. Prior period amounts are not adjusted and continue to be reported under the accounting standards in effect for those respective periods.

Peoples recognizes revenues as they are earned based on contractual terms, or as services are provided and collectability is reasonably assured. Estimates of variable consideration are included in revenue to the extent that it is probable that a significant reversal of cumulative revenue will not occur, once the uncertainty is resolved. Peoples contracts with customers are short-term in nature, and are recognized under the following revenue streams:

Insurance Income: Insurance income generally consists of commissions and fees from the sale of insurance policies, third-party administration services and performance-based commissions from insurance companies.

Peoples recognizes commission income from the sale of insurance policies when it acts as an agent between the insurance carrier and policyholder, arranging for the insurance carrier to provide policies to policyholders, and acts on behalf of the insurance carrier by providing customer service to the policyholders during the respective policy periods. Commission income is recognized over time, using the output method of time elapsed, which corresponds with the underlying insurance policy period, for which Peoples is obligated to perform under contract with the insurance carrier. Commission income is variable, as it is comprised of a certain percentage of the underlying policy premium. Peoples estimates the variable consideration based upon the "most likely amount" method, and does not expect or anticipate a significant reversal of revenue in future periods, based upon historical experience. Payment is due from the insurance carrier for commission income once the insurance policy has been sold. Peoples has elected to apply a practical expedient related to capitalizable costs, which are the commissions paid to insurance producers, and will expense these commissions paid to insurance producers as incurred, as these costs are related to the commission income and would have been amortized within one year or less if they had been capitalized, the same period over which the commission income was earned.

Fees related to third-party administration services performed are recognized over time, during the period in which services have been provided, and are recognized monthly in the month the services were performed.

Performance-based commissions from insurance companies are recognized at a point in time, when received, and no contingencies remain.

Trust and Investment Income: Trust and investment income consists of revenue from fiduciary and brokerage activities, which includes fees for services such as asset management, record keeping, retirement services and estate management, and investment commissions and fees related to the sale of investments. Trust and investment income is recognized over time which reflects the duration of the contract period for which services have been provided. Trust and investment income is variable as it is based on the value of assets under administration and management, and specific transactions. Peoples estimates the variable consideration based upon the most likely amount method, and does not expect or anticipate a significant reversal of revenue in future periods. Payment is due from the customer when billed, which is typically a monthly or quarterly billing for services rendered in the most recent period, for which the performance obligation has been satisfied. Peoples has elected to apply a practical expedient of right to invoice when recognizing trust and investment income, as Peoples has fulfilled the performance

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obligation, the customer has consumed the service, and Peoples has a right to the related income. Peoples has also elected to apply a practical expedient related to capitalizable costs, which are the commissions paid to financial advisors, and will expense these commissions paid to financial advisors as incurred, as these costs are related to the trust and investment income and would have been amortized within one year or less if they had been capitalized, the same period over which the income was earned.

Electronic Banking Income: Electronic banking income consists of two revenue streams related to interchange income and promotional and usage income.

Peoples recognizes interchange income over time, on a monthly basis, which is based on the transactional volume of debit card activity completed by its customers during the month in which income is recognized. Peoples is obligated to certain debit card activity being performed by its customers over a certain period of time. Interchange income is variable as it is based on the transaction volume of debit card activity completed by Peoples' customers. Peoples estimates the variable consideration based upon the most likely amount method, and does not expect or anticipate a significant reversal of revenue in future periods. Payment is due from the vendor within one month of the completed customer debit card activity. Peoples has elected to apply a practical expedient of right to invoice when recognizing interchange income, as Peoples has fulfilled the required performance obligations, the vendor has consumed the service, and Peoples has a right to the related income.

Peoples also recognizes promotional and usage income over time, on a monthly basis, which is related to branding of debit cards and promotion or use of certain services provided by third-party vendors. Peoples is obligated to brand its debit cards in a certain manner, and promote and use services provided by third-party vendors. Promotional and usage income is variable as it is based on certain metrics achieved for promotion and usage of services provided by the third-party vendors. Peoples estimates the variable consideration based upon the most likely amount method, and does not expect or anticipate a significant reversal of revenue in future periods. Payment is due from the third-party vendors within 45 days of the monthly fulfillment of Peoples' performance obligation. Peoples has elected to apply a practical expedient of right to invoice when recognizing promotional and usage income, as Peoples has fulfilled the required performance obligations, the vendor has consumed the service, and Peoples has a right to the related income.

Deposit Account Service Charges: Deposit account service charges consist of two revenue streams related to ongoing maintenance fees for deposit accounts and certain transactional-based fees.

Ongoing maintenance fees are recognized on a monthly basis, generally with the monthly period beginning on the day of the month on which the account was opened. Ongoing maintenance fee income is variable as these fees can be reduced if a customer meets certain qualifying metrics. Peoples estimates the variable consideration based upon the most likely amount method, and does not expect or anticipate a significant reversal of revenue in future periods. For accounts that are assessed maintenance fees through the account analysis process, payment is due from the customer within one month of the monthly period in which the account was open. For all other accounts, monthly maintenance fees are assessed to the account on the last day of the monthly period. Peoples has elected to apply a practical expedient of right to invoice when recognizing ongoing maintenance fees for deposit accounts, as Peoples has fulfilled the required performance obligations, the customer has consumed the service, and Peoples has a right to the related income.

Transactional-based deposit account fees are recognized at a point in time, which is at the completion of the relevant transaction. Peoples is obligated to perform certain transactions as requested by its consumer and business deposit account customers, which are outside of the normal maintenance requirements. Transactional-based deposit account fee income is variable as these fees are directly related to a service request from the customer. Peoples estimates the variable consideration based upon the most likely amount method, and does not expect or anticipate a significant reversal of revenue in future periods. Payment is due from the customer at the time of completion of the requested transaction.

Commercial Loan Swap Fees: Commercial loan swap fees consist of income related to transactions in which Peoples acts as an agent between a third-party vendor and certain Peoples commercial loan customers for which an interest rate swap occurs. Commercial loan swap fees are recognized at a point in time, when the transaction has been completed, and there is no recourse or further performance obligation required of Peoples. Commercial loan swap fee income is variable as these fees are a certain percentage of the total swap fee collected on a completed transaction.

Peoples estimates the variable consideration based upon the most likely amount method, and does not expect or anticipate a significant reversal of revenue in future periods. Payment is due from the customer at the time of completion of the requested transaction.

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Other Non-Interest Income: Other non-interest income includes certain revenues that are transactional-based, such as wire transfer fees, money order fees and other ancillary fees or services. These transactional-based fees are recognized as income at a point in time, at the completion of the relevant transaction. Transactional-based other non-interest income is variable as these fees are directly related to a service request from the customer. Peoples estimates the variable consideration based upon the most likely amount method, and does not expect or anticipate a significant reversal of revenue in future periods. Payment is due from the customer at the time of completion of the requested transaction.

The following table details Peoples' revenue from contracts with customers for the three and nine months ended September 30, 2018:

(Dollars in thousands)	Three Months Ended September 30, 2018	Nine Months Ended September 30, 2018
Insurance income:		
Commission and fees from sale of insurance policies (a)	$ 3,159	$ 9,541
Fees related to third-party administration services (a)	131	423
Performance-based commissions (b)	98	1,448
Trust and investment income (a)	3,110	9,410
Electronic banking income:		
Interchange income (a)	2,464	7,248
Promotional and usage income (a)	426	1,212
Deposit account service charges:		
Ongoing maintenance fees for deposit accounts (a)	691	2,012
Transactional-based fees (b)	1,961	5,148
Commercial loan swap fees (b)	355	617
Other non-interest income transactional-based fees (b)	228	772
Total	$ 12,623	$ 37,831
Timing of revenue recognition:		
Services transferred over time	$ 9,981	$ 29,846
Services transferred at a point in time	2,642	7,985
Total	$ 12,623	$ 37,831

(a) Services transferred over time.
(b) Services transferred at a point in time.

Peoples records contract liabilities for payments received for commission income related to the sale of insurance policies, for which the performance obligations have not yet been fulfilled. The contract liabilities are recognized as income over time, during the period in which the performance obligations are fulfilled, which is over the insurance policy period. The following table details the change in Peoples' contract liabilities for the period ended September 30, 2018:

(Dollars in thousands)	Contract Liabilities
Balance, January 1, 2018 (a)	$ 4,700
Additional deferred income	4,362
Recognition of income previously deferred	(4,508)

Balance, September 30, 2018	$	4,554

(a) The amount of $3.1 million reported elsewhere throughout this Form 10-Q is the $4.7 million noted above, net of federal corporate income taxes.

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The following table details the impact of the adoption of ASU 2014-09 to Peoples' Consolidated Statements of Income and Balance Sheets, compared to amounts that would have been recognized under previous guidance:

(Dollars in thousands)	At or For the Three Months Ended September 30, 2018			At or For the Nine Months Ended September 30, 2018		
	As Reported	Impact of ASC 606	Amounts Recognized Under Previous Guidance	As Reported	Impact of ASC 606	Amounts Recognized Under Previous Guidance
Non-interest income:						
Insurance income	$3,388	$101	$ 3,287	$11,412	$146	$ 11,266
Liabilities:						
Accrued expenses and other liabilities	49,747	2,940	46,807	49,747	2,940	46,807
Stockholders' equity:						
Retained earnings	152,976	(2,940)	155,916	152,976	(2,940)	155,916

Note 12 Acquisitions

On October 29, 2018, Peoples entered into an Agreement and Plan of Merger (The "First Prestonsburg Merger Agreement") with First Prestonsburg Bancshares Inc. ("First Prestonsburg"), that calls for First Prestonsburg to merge into Peoples (the "Merger"). First Prestonsburg is the parent company of First Commonwealth Bank of Prestonsburg, Inc. ("First Commonwealth"), which operates eight full service branches located in eastern Kentucky, with an additional branch to open by the end of 2018. First Commonwealth will merge into Peoples Bank following the merger of First Prestonsburg into Peoples. The merger transactions are expected to close during the second quarter of 2019, subject to the satisfaction of customary closing conditions, including receipt of applicable regulatory approvals and the approval of the shareholders of First Prestonsburg. As of September 30, 2018, First Prestonsburg had, on a consolidated basis, approximately $310 million in total assets, which included approximately $139 million in total loans, and approximately $244 million in total deposits. Under the terms of the First Prestonsburg Merger Agreement, shareholders of First Prestonsburg will receive 12.512 Peoples' common shares for each share of First Prestonsburg common stock. In addition, immediately prior to the closing of the Merger, First Prestonsburg will pay a special aggregate cash distribution of $11.275 million to its shareholders based upon the twenty day volume-weighted average closing price of Peoples' common stock through October 26, 2018. The stock consideration plus the special dividend have a combined transaction value of $45.4 million to the holders of First Prestonsburg's common stock.
On April 13, 2018, Peoples completed its acquisition of ASB for total consideration of $41.5 million, which reflected the conversion of each of the 1,979,034 outstanding ASB common shares into $20.00 in cash or 0.592 in Peoples' common shares. ASB merged into Peoples, and ASB's wholly-owned subsidiary, American Savings Bank, fsb, which operated seven full-service branches in southern Ohio and northern Kentucky, merged into Peoples Bank. Per the applicable accounting guidance for business combinations, the acquisition date fair values of the assets purchased, liabilities assumed and related identifiable intangible assets are preliminary and subject to refinement for up to one year after the closing date of the acquisition as additional information relative to closing date fair values becomes available.

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The following table provides the preliminary purchase price calculation as of the date of acquisition for the ASB acquisition, and the assets acquired and liabilities assumed at their estimated fair values.

(Dollars in thousands, except per share data)	ASB
Purchase Price	
Common shares electing cash consideration	31,763
Cash purchase price per share	$20.00
Cash consideration	$635
Common shares electing stock consideration	1,947,271
Number of common shares of Peoples issued for each common share of acquired company	0.592
Price per Peoples common share, based on closing date	$35.48
Common share consideration	$40,898
Cash in lieu of fractional common shares of Peoples	$2
Total consideration	$41,535
Net Assets at Fair Value	
Assets	
Total cash and cash equivalents	$5,332
Available-for-sale investment securities	18,155
Held-to-maturity investment securities	649
Other investment securities	1,596
Total investment securities	20,400
Loans, net of deferred fees and costs	236,628
Loans held for sale	2,539
Net loans	239,167
Bank premises and equipment, net of accumulated depreciation	3,320
Bank owned life insurance	4,803
Other intangible assets	2,639
Other assets	3,481
Total assets	$279,142
Liabilities	
Deposits:	
Non-interest-bearing	$29,487
Interest-bearing	169,142
Total deposits	198,629
Short-term borrowings	54,824
Accrued expenses and other liabilities	2,716
Total liabilities	$256,169
Net assets	$22,973
Goodwill	$18,562

The estimated fair values presented in the above table reflect additional information that was obtained during the three months ended September 30, 2018, which resulted in changes to certain fair value estimates made as of the date of acquisition. Adjustments to acquisition date estimated fair values are recorded during the period in which they occur and, as a result, previously recorded results have changed. After considering the additional information, the estimated fair value of loans decreased $481,000; bank premises and equipment, net of accumulated depreciation, increased $355,000; other assets

increased $34,000; and accrued expenses and other liabilities increased $158,000, in each case from balances reported as of June 30, 2018. These revised fair value estimates resulted in a net increase to goodwill of $250,000 from $18.3 million reported as of June 30, 2018, to $18.6 million which was recognized in the September 30, 2018 Consolidated Balance Sheet.

Acquired loans are reported net of the unamortized fair value adjustment. The following table details the preliminary fair value adjustment for acquired loans as of the acquisition date:

(Dollars in thousands, except per share data)	ASB
Nonimpaired Loans	
Contractual cash flows	$342,087
Nonaccretable difference	59,967
Expected cash flows	282,120
Accretable yield	54,029
Fair value	$228,091
Credit Impaired Loans	
Contractual cash flows	$19,031
Nonaccretable difference	5,908
Expected cash flows	13,123
Accretable yield	2,047
Fair value	$11,076

Peoples recorded non-interest expense related to acquisitions of $675,000 and $6.9 million for the three and nine months ended September 30, 2018, respectively. Total non-interest income declined due to losses of $203,000 associated with the ASB acquisition. Salaries and employee benefit costs contained $466,000 and $2.4 million, for the three and nine months ended September 30, 2018, respectively, related to change in control agreements, retention and severance bonuses, and regular payroll and taxes after conversion. Professional fees contained $31,000 and $742,000 for the three and nine months ended September 30, 2018, respectively. Data processing expenses contained none and $59,000 for the three and nine months ended September 30, 2018. Marketing expense included $16,000 and $107,000 for the three and nine months ended September 30, 2018, respectively, and other non-interest expense contained $162,000 and $3.6 million for the three and nine months ended September 30, 2018, respectively.

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ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
SELECTED FINANCIAL DATA
The following data should be read in conjunction with the Unaudited Consolidated Financial Statements and Management's Discussion and Analysis that follows:

	At or For the Three Months Ended September 30,		At or For the Nine Months Ended September 30,	
	2018	2017	2018	2017
Per Common Share Data (a)				
Earnings per common share – basic	$0.65	$0.60	$1.70	$1.62
Earnings per common share – diluted	0.65	0.60	1.69	1.61
Cash dividends declared per common share	0.28	0.22	0.82	0.62
Book value per common share (b)	25.79	25.02	25.79	25.02
Tangible book value per common share (b)(c)	$17.44	$17.15	$17.44	$17.15
Weighted-average number of common shares outstanding – basic	19,325,457	18,056,202	18,875,290	18,043,692
Weighted-average number of common shares outstanding – diluted	19,466,865	18,213,533	19,004,087	18,199,959
Common shares outstanding at end of period	19,550,014	18,281,194	19,550,014	18,281,194
Closing stock price at end of period	$35.03	$33.59	$35.03	$33.59
Significant Ratios (a)				
Return on average stockholders' equity (d)	10.06 %	9.47 %	8.97 %	8.80 %
Return on average tangible stockholders' equity (d)(e)	15.73 %	14.58 %	14.09 %	13.77 %
Return on average assets (d)	1.26 %	1.22 %	1.13 %	1.13 %
Average stockholders' equity to average assets	12.55 %	12.88 %	12.58 %	12.81 %
Average loans to average deposits	90.47 %	86.69 %	89.11 %	86.09 %
Net interest margin (d)(f)	3.68 %	3.67 %	3.69 %	3.61 %
Efficiency ratio (g)	62.58 %	60.74 %	66.48 %	62.24 %
Pre-provision net revenue to total average assets (d)(h)	1.67 %	1.71 %	1.52 %	1.65 %
Dividend payout ratio	43.00 %	36.90 %	48.55 %	38.34 %
Total investment securities as percentage of total assets (b)	21.84 %	24.70 %	21.84 %	24.70 %
Asset Quality Ratios (a)				
Nonperforming loans as a percent of total loans (b)(i)	0.67 %	0.85 %	0.67 %	0.85 %
Nonperforming assets as a percent of total assets (b)(i)	0.46 %	0.56 %	0.46 %	0.56 %
Nonperforming assets as a percent of total loans and other real estate owned ("OREO") (b)(i)	0.67 %	0.86 %	0.67 %	0.86 %
Criticized loans as a percent of total loans (b)(j)	4.38 %	4.15 %	4.38 %	4.15 %
Classified loans as a percent of total loans (b)(k)	1.81 %	1.77 %	1.81 %	1.77 %
Allowance for loan losses as a percent of total loans (b)	0.73 %	0.82 %	0.73 %	0.82 %
Allowance for loan losses as a percent of nonperforming loans (b)(i)	109.71 %	96.11 %	109.71 %	96.11 %
Provision for loan losses as a percent of average total loans	0.19 %	0.19 %	0.23 %	0.16 %
Net charge-offs as a percentage of average total loans (d)	0.10 %	0.16 %	0.18 %	0.12 %
Capital Information (b)				
Common equity tier 1 capital ratio (l)	13.31 %	13.31 %	13.31 %	13.31 %
Tier 1 risk-based capital ratio	13.58 %	13.60 %	13.58 %	13.60 %
Total risk-based capital ratio (tier 1 and tier 2)	14.30 %	14.49 %	14.30 %	14.49 %
Leverage ratio	9.71 %	9.81 %	9.71 %	9.81 %

Common equity tier 1 capital	$368,195	$326,966	$368,195	$326,966
Tier 1 capital	375,433	334,027	375,433	334,027
Total capital (tier 1 and tier 2)	395,313	355,951	395,313	355,951
Total risk-weighted assets	$2,765,328	$2,456,797	$2,765,328	$2,456,797
Tangible equity to tangible assets (c)	8.88 %	9.20 %	8.88 %	9.20 %

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(a) Reflects the impact of the acquisition of ASB beginning April 13, 2018.
(b) Data presented as of the end of the period indicated.
(c) These amounts represent non-GAAP financial measures since they exclude goodwill and other intangible assets. Additional information regarding the calculation of these non-GAAP financial measures can be found under the caption “Capital/Stockholders’ Equity.”
(d) Ratios are presented on an annualized basis.
(e) These amounts represent non-GAAP financial measures since they exclude the after-tax impact of amortization of other intangible assets from earnings and exclude the balance sheet impact of goodwill and other intangible assets acquired through acquisitions on stockholders' equity. Additional information regarding the calculation of these non-GAAP financial measures can be found under the caption “Return on Average Tangible Stockholders' Equity Ratio.”
(f) Information presented on a fully tax-equivalent basis.
(g) These amounts represent non-GAAP financial measures and include total non-interest expense (less amortization of other intangible assets) as a percentage of fully tax-equivalent net interest income plus total non-interest income (excluding all gains and all losses). Additional information regarding the calculation of these non-GAAP financial measures can be found under the caption “Efficiency Ratio.”
(h) These amounts represent non-GAAP financial measures since they exclude the provision for (recovery of) loan losses and all gains and losses included in earnings. Additional information regarding the calculation of these non-GAAP financial measures can be found under the caption “Pre-Provision Net Revenue.”
(i) Nonperforming loans include loans 90 days past due and accruing, renegotiated loans and nonaccrual loans. Nonperforming assets include nonperforming loans and other real estate owned.
(j) Includes loans categorized as special mention, substandard and doubtful.
(k) Includes loans categorized as substandard and doubtful.
(l) Peoples' capital conservation buffer was 6.30% at September 30, 2018 and 6.49% at September 30, 2017, compared to 2.50% for the fully phased-in capital conservation buffer required by January 1, 2019.

Forward-Looking Statements

Certain statements in this Form 10-Q, which are not historical fact, are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, Section 21E of the Securities Exchange Act of 1934, as amended, and the Private Securities Litigation Reform Act of 1995. These forward-looking statements are identified by the fact they are not historical facts and include words such as "anticipate," "estimate," "may," "feel," "expect," "believe," "plan," "will," "would," "should," "could," "project," "goal," "target," "potential," "seek," "intend," and similar expressions.

These forward-looking statements reflect management's current expectations based on all information available to management and its knowledge of Peoples' business and operations. Additionally, Peoples' financial condition, results of operations, plans, objectives, future performance and business are subject to risks and uncertainties that may cause actual results to differ materially. These factors include, but are not limited to:

(1) the success, impact, and timing of the implementation of Peoples' business strategies, including the successful integration of the recently completed acquisition of ASB and the expansion of consumer lending activity;
(2) Peoples' ability to integrate future acquisitions, including the pending merger with First Prestonsburg, which may be unsuccessful, or may be more difficult, time-consuming or costly than expected;
(3) competitive pressures among financial institutions, or from non-financial institutions, which may increase significantly, including product and pricing pressures, changes to third-party relationships and revenues, and Peoples' ability to attract, develop and retain qualified professionals;
(4) changes in the interest rate environment due to economic conditions and/or the fiscal policies of the United States ("U.S.") government and the Board of Governors of the Federal Reserve System (the "Federal Reserve Board"), which may adversely impact interest rates, interest margins, loan demand and interest rate sensitivity;
(5) uncertainty regarding the nature, timing, cost and effect of legislative or regulatory changes or actions, promulgated and to be promulgated by governmental and regulatory agencies in the State of Ohio, the Federal Deposit Insurance Corporation, the Federal Reserve Board and the Consumer Financial Protection Bureau, which

may subject Peoples, its subsidiaries, or one or more acquired companies to a variety of new and more stringent legal and regulatory requirements which adversely affect their respective businesses, including in particular the rules and regulations promulgated and to be promulgated under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, and the Basel III regulatory capital reform;

(6) the effects of easing restrictions on participants in the financial services industry;

(7) uncertainties in Peoples' preliminary review of, and additional analysis of, the impact of the Tax Cuts and Jobs Act;

(8) local, regional, national and international economic conditions (including the impact of tariffs, a U.S. withdrawal from or significant renegotiation of trade agreements, trade wars and other changes in trade regulations) and the impact these conditions may have on Peoples, its customers and its counterparties, and Peoples' assessment of the impact, which may be different than anticipated;

(9) the existence or exacerbation of general geopolitical instability and uncertainty;

(10) changes in policy, other regulatory and legal developments, including the Tax Cuts and Jobs Act, and uncertainty or speculation pending the enactment of such changes;

(11) Peoples may issue equity investment securities in connection with future acquisitions, which could cause ownership and economic dilution to Peoples' current shareholders;

(12) changes in prepayment speeds, loan originations, levels of nonperforming assets, delinquent loans and charge-offs, which may be less favorable than expected and adversely impact the amount of interest income generated;

(13) adverse changes in economic conditions and/or activities, including, but not limited to, potential or imposed tariffs, continued economic uncertainty in the U.S., the European Union (including the uncertainty surrounding the actions to be taken to implement the referendum by British voters to exit the European Union), Asia and other areas, which could decrease sales volumes, add volatility to the global stock markets and increase loan delinquencies and defaults;

(14) slowing or reversal of the current U.S. economic expansion;

(15) deterioration in the credit quality of Peoples' loan portfolio, which may adversely impact the provision for loan losses;

(16) changes in accounting standards, policies, estimates or procedures which may adversely affect Peoples' reported financial condition or results of operations;

(17) Peoples' assumptions and estimates used in applying critical accounting policies, which may prove unreliable, inaccurate or not predictive of actual results;

(18) adverse changes in the conditions and trends in the financial markets, including political developments, which may adversely affect the fair value of securities within Peoples' investment portfolio, the interest rate sensitivity of Peoples' consolidated balance sheet, and the income generated by Peoples' trust and investment activities;

(19) Peoples' ability to receive dividends from its subsidiaries;

(20) Peoples' ability to maintain required capital levels and adequate sources of funding and liquidity;

(21) the impact of minimum capital thresholds established as a part of the implementation of Basel III;

(22) the impact of larger or similar-sized financial institutions encountering problems, which may adversely affect the banking industry and/or Peoples' business generation and retention, funding and liquidity;

(23) the costs and effects of new federal and state laws, and other regulatory and legal developments, including the outcome of potential regulatory or other governmental inquiries and legal proceedings and results of regulatory examinations;

(24) Peoples' ability to secure confidential information through the use of computer systems and telecommunications networks, including those of Peoples' third-party vendors and other service providers, which may prove inadequate, and could adversely affect customer confidence in Peoples and/or result in Peoples incurring a financial loss;

(25) Peoples' reliance on, and the potential failure of, a number of third-party vendors to perform as expected, including its primary core banking system provider;

(26) Peoples' ability to anticipate and respond to technological changes which can impact Peoples' ability to respond to customer needs and meet competitive demands;

(27) operational issues stemming from and/or capital spending necessitated by the potential need to adapt to industry changes in information technology systems on which Peoples and its subsidiaries are highly dependent;

(28) changes in consumer spending, borrowing and saving habits, whether due to tax reform legislation, changes in business and economic conditions, legislative or regulatory initiatives, or other factors, which may be different than anticipated;

(29) the adequacy of Peoples' risk management program in the event of changes in market, economic, operational, asset/liability repricing, liquidity, credit and interest rate risks associated with Peoples' business;

(30) the impact on Peoples' businesses, as well as on the risks described above, of various domestic or international widespread natural or other disasters, pandemics, cyber attacks, civil unrest, military or terrorist activities or international conflicts;

(31) significant changes in the tax laws, which may adversely affect the fair values of deferred tax assets and obligations of states and political subdivisions held in Peoples' investment securities portfolio;

(32) Peoples' continued ability to grow deposits; and

(33) other risk factors relating to the banking industry or Peoples as detailed from time to time in Peoples' reports filed with the Securities and Exchange Commission (the "SEC"), including those risk factors included in the disclosures under the heading "ITEM 1A. RISK FACTORS" of Peoples' Annual Report on Form 10-K for the fiscal year ended December 31, 2017 and under the heading "ITEM 1A. RISK FACTORS" in Part II of this Form 10-Q.

All forward-looking statements speak only as of the filing date of this Form 10-Q and are expressly qualified in their entirety by the cautionary statements. Although management believes the expectations in these forward-looking statements are based on reasonable assumptions within the bounds of management's knowledge of Peoples' business and operations, it is possible that actual results may differ materially from these projections. Additionally, Peoples undertakes no obligation to update these forward-looking statements to reflect events or circumstances after the filing date of this Form 10-Q or to reflect the occurrence of unanticipated events except as may be required by applicable legal requirements. Copies of documents filed with the SEC are available free of charge at the SEC's website at www.sec.gov and/or from Peoples' website – www.peoplesbancorp.com under the "Investor Relations" section.

This discussion and analysis should be read in conjunction with the audited Consolidated Financial Statements, and Notes thereto, contained in Peoples' 2017 Form 10-K, as well as the Unaudited Consolidated Financial Statements, Notes to the Unaudited Consolidated Financial Statements, ratios, statistics and discussions contained elsewhere in this Form 10-Q.

Business Overview

The following discussion and analysis of Peoples' Unaudited Consolidated Financial Statements is presented to provide insight into management's assessment of the financial condition and results of operations.

Peoples offers diversified financial products and services through 82 locations, including 72 full-service bank branches, and 78 Automated Teller Machines ("ATMs") in northeastern, central, southwestern and southeastern Ohio, west central West Virginia and northeastern Kentucky through its financial service units – Peoples Bank and Peoples Insurance Agency, LLC ("Peoples Insurance"), a subsidiary of Peoples Bank. Peoples Bank is subject to regulation and examination primarily by the Ohio Division of Financial Institutions (the "ODFI"), the Federal Reserve Bank of Cleveland and the Federal Deposit Insurance Corporation (the "FDIC"). Peoples Bank is also subject to regulations of the Consumer Financial Protection Bureau (the "CFPB") which regulates consumer financial products and services and certain financial services providers. Peoples Insurance is subject to regulation by the Ohio Department of Insurance and the state insurance regulatory agencies of those states in which Peoples Insurance may do business.

Peoples' products and services include traditional banking products, such as deposit accounts, lending products and trust services. Peoples provides services through traditional offices, ATMs, mobile banking and telephone and internet-based banking. Peoples also offers a complete array of insurance products and makes available custom-tailored fiduciary, employee benefit plan and asset management services. Brokerage services are offered by Peoples exclusively through an unaffiliated registered broker-dealer located at Peoples Bank's offices.

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Critical Accounting Policies

The accounting and reporting policies of Peoples conform to US GAAP and to general practices within the financial services industry. The preparation of the financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could materially differ from those estimates. Management has identified the accounting policies that, due to the judgments, estimates and assumptions inherent in those policies, are critical to understanding Peoples' Unaudited Consolidated Financial Statements, and Management's Discussion and Analysis at September 30, 2018, which were unchanged from the policies disclosed in Peoples' 2017 Form 10-K.

Summary of Recent Transactions and Events

The following is a summary of recent transactions and events that have impacted or are expected to impact Peoples' results of operations or financial condition:

On October 29, 2018, Peoples entered into a merger agreement with First Prestonsburg Bancshares Inc. ("First Prestonsburg"), which calls for First Prestonsburg to merge into Peoples. First Prestonsburg is the parent company of The First Commonwealth Bank of Prestonsburg, Inc. ("First Commonwealth"), which operates eight full service branches located in eastern Kentucky, with an additional branch to open by the end of this year. Following the merger of First Prestonsburg into Peoples, First Commonwealth will merge into Peoples Bank. This transaction is expected to close during the second quarter of 2019, subject to the satisfaction of customary closing conditions, including receipt of applicable regulatory approvals and the approval of the shareholders of First Prestonsburg. Refer to Note 12 of the Notes to the Unaudited Consolidated Financial Statements for additional information.

On July 31, 2018, Peoples entered into five $10.0 million interest rate swaps, which will mature between 2021 and 2028, with interest rates ranging from 2.94% to 3.03%. Additionally, the three interest rate swaps acquired with the ASB acquisition matured in July of 2018. For additional information regarding Peoples' interest rate swaps, refer to Note 9 of the Notes to the Unaudited Consolidated Financial Statements.

In 2018, Peoples contributed $3.2 million to Peoples' defined benefit pension plan. This contribution was reported in the 2017 federal income tax return. In accordance with the Tax Cuts and Jobs Act, Peoples recognized the contribution as a deduction for tax purposes at the 35% statutory federal corporate income tax rate for 2017.

In the third quarter of 2018, Peoples incurred $674,000 of acquisition-related costs, which include gains and losses, compared to $6.3 million in the second quarter of 2018, $149,000 in the first quarter of 2018 and none in the third quarter of 2017. For the nine months ended September 30, 2018, Peoples incurred $6.9 million of acquisition-related costs compared to none for the same period in 2017. The acquisition-related costs incurred in 2018 were primarily related to fees associated with early termination of contracts, severance costs and write-offs associated with assets acquired.

At the close of business on April 13, 2018, Peoples completed the acquisition of ASB Financial Corp. ("ASB"). ASB merged into Peoples, and ASB's wholly-owned subsidiary, American Savings Bank, fsb, which operated seven full-service bank branches and two loan production offices in southern Ohio and northern Kentucky, merged into Peoples Bank. Under the terms of the merger agreement, Peoples paid total consideration of $41.5 million. The acquisition added $239.2 million of net loans and $198.6 million of total deposits at the acquisition date, after preliminary acquisition accounting adjustments. Refer to Note 12 of the Notes to the Unaudited Consolidated Financial Statements for additional information.

In the second quarter of 2018, Peoples released a valuation allowance which reduced income tax expense by $0.8 million. The valuation allowance was related to a historical tax credit that Peoples had invested in during 2015. Peoples sold $6.7 million of equity investment securities in the second quarter of 2018, which resulted in a capital gain for tax purposes. This capital gain was large enough to offset an anticipated future capital loss, which is expected to be recognized due to the structure of the historical tax credit investment, resulting in the release of the valuation allowance.

During the second half of 2017, Peoples reduced its position in certain equity investment securities. This action was taken as a result of the high appreciation in the market value of these securities. The sales completed resulted in a net gain on investment securities of $1.9 million in the second half of 2017. On January 1, 2018, Peoples adopted ASU 2016-01, resulting in the reclassification of equity investment securities from available-for-sale investment securities to other investment securities which also resulted in changes in the fair value of the equity investment securities being recorded in non-interest income.

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As of December 31, 2017, Peoples recorded a revaluation of its deferred tax assets and liabilities in light of the applicable provisions of the Tax Cuts and Jobs Act. Previously, Peoples had recognized its deferred tax assets and deferred tax liabilities at a federal corporate income tax rate of 35%, and the new law required the use of a 21% federal corporate income tax rate. As a result, Peoples wrote down its net deferred tax assets by $0.9 million in the fourth quarter of 2017, which had a direct impact on income tax expense recorded during that period. Beginning on January 1, 2018, in accordance with the Tax Cuts and Jobs Act, Peoples began recognizing income tax expense at the 21% statutory federal corporate income tax rate, which has resulted in lower income tax expense for 2018, compared to the 35% statutory federal corporate income tax rate for 2017.

On October 2, 2017, Peoples Insurance acquired a property and casualty focused independent insurance agency with annual net revenue of $0.8 million located in the Cleveland, Ohio area. The acquisition did not materially impact Peoples' financial position, results of operations, or cash flows.

During the second quarter of 2017, Peoples borrowed an additional $45.0 million of long-term FHLB non-amortizing advances, which have interest rates ranging from 1.74% to 2.03% and mature between 2020 and 2022.

During the first quarter of 2017, Peoples borrowed an additional $30.0 million of long-term FHLB non-amortizing advances, which have interest rates ranging from 1.20% to 1.46% and mature between 2018 and 2019.

During 2017, Peoples closed six full-service bank branches, four located in Ohio, and two located in West Virginia. Peoples continues to evaluate its bank branch network in an effort to optimize efficiency.

On January 31, 2017, Peoples Insurance acquired a third-party insurance administration company located in Piketon, Ohio for total cash consideration of $0.5 million, and recorded $0.5 million of customer relationship intangibles. The acquisition did not materially impact Peoples' financial position, results of operations or cash flows.

On January 27, 2017, Peoples entered into two $10.0 million forward starting interest rate swaps, which became effective in January and April of 2018 and mature between 2025 and 2027, with interest rates ranging from 2.47% to 2.53%. For additional information regarding Peoples' interest rate swaps, refer to Note 9 of the Notes to the Unaudited Consolidated Financial Statements.

The Federal Reserve Board began tightening monetary policy in December 2015 by raising the benchmark Federal Funds Target Rate. Since then, the rate has increased seven times from a range of 0.25% - 0.50% to its current range of 2.00% - 2.25%. Expectations are for one more rate hike in 2018 and three in 2019. The Federal Reserve Board has also begun to reduce the size of its $4.5 trillion balance sheet, which could result in higher interest rates as well. However, there has been no indication that the Federal Reserve Board would alter its current posture of tightening monetary policy at future meetings. Peoples is closely monitoring interest rates, both foreign and domestic; and potential impacts of changes in interest rates to Peoples Bank's operations.

The impact of these transactions and events, where material, is discussed in the applicable sections of this Management’s Discussion and Analysis of Results of Operations and Financial Condition.

EXECUTIVE SUMMARY

Peoples recorded net income of $12.7 million for the third quarter of 2018, representing earnings per diluted share of $0.65, compared to $7.9 million, or $0.41 per diluted share, for the second quarter of 2018, and $10.9 million, or $0.60 per diluted share, for the third quarter of 2017. During the third quarter of 2018, earnings per diluted share were negatively impacted by $0.03 per share for acquisition-related costs, which include gains and losses, and $0.01 per share for pension settlement charges, compared to the negative impact of $0.25 per share in acquisition-related costs, offset partially by the positive impact of $0.04 per share due to the release of a tax valuation allowance, in the second quarter of 2018. During the third quarter of 2017, earnings per diluted common share were positively impacted by $0.07 per share due to the recognized gain on investment securities of $1.9 million.

For the first nine months of 2018, net income was $32.4 million, or $1.69 per diluted share, compared to $29.5 million, or $1.61 per diluted share, for the same period in 2017. Earnings per diluted common share for the first nine months of 2018 were negatively impacted by $0.28 per share for acquisition-related costs and $0.01 per share for pension settlement charges. The increased earnings were primarily due to increases in net interest income, mortgage banking income, trust and investment income, electronic banking income, and other non-interest income. These increases were partially offset by increased salaries and employee benefit costs, professional fees and other fees related to acquisition-related expenses which were primarily related to fees associated with early termination of contracts, in 2018, compared to 2017.

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Net interest income grew to $33.3 million for the third quarter of 2018, an increase of 2%, compared to $32.8 million for the second quarter of 2018, and 14% compared to $29.2 million for the third quarter of 2017. Net interest margin was 3.68% for the third quarter of 2018, a decrease from 3.74% for the second quarter of 2018, and an increase from 3.67% for the third quarter of 2017. The increase in net interest income compared to both the linked quarter and the third quarter of 2017 was largely due to loan growth and the recent ASB acquisition, which were tempered by lower income on investment securities, higher deposit costs and increased borrowing costs. In addition, during the third quarter of 2017, net interest income was impacted by proceeds of $611,000, received on an investment security for which an other-than-temporary-impairment had previously been recorded.

Net interest margin experienced a decline for the third quarter of 2018, compared to the linked quarter, due to increases in both deposit costs and borrowings costs, while loan yields only rose slightly given the relatively flat LIBOR rates in the third quarter of 2018. Although deposit rates remain relatively low, competition for deposits is increasing, resulting in higher deposit rates being offered to clients. The second quarter of 2018, and the third quarter of 2017, included proceeds received on a security for which an other-than-temporary-impairment had previously been recorded, which added 3 basis points and 8 basis points, respectively, to net interest margin for those periods. Compared to the third quarter of 2017, net interest margin has increased primarily due to higher loan yields, which have been partially offset by higher deposit costs and increased borrowing costs.

Compared to the first nine months of 2017, net interest income grew $11.2 million, or 13%, while net interest margin increased 8 basis points. Net interest income for 2018 benefited from the acquisition of ASB, coupled with organic loan growth. Net interest margin for the first nine months of 2018 was 3.69%, compared to 3.61% for the same period in 2017. Loan yields have benefited from higher LIBOR rates since the end of 2017, while deposit costs were relatively controlled, which caused the improvement compared to 2017. During 2017, the net interest margin improved due to proceeds of $0.8 million that were received on an investment security for which an other-than-temporary-impairment had previously been recorded, which added 10 basis points to net interest margin. During 2018, the net interest margin improved due to proceeds of $0.6 million, that were received on an investment security for which an other-than-temporary-impairment had previously been recorded, which added 2 basis points to net interest margin.

For the third quarter of 2018, accretion income from acquisitions, net of amortization expense, was $612,000, compared to $523,000 for the second quarter of 2018 and $816,000 for the third quarter of 2017, which added 7 basis points, 6 basis points, and 10 basis points, respectively, to net interest margin. Accretion income, net of amortization expense, from the ASB acquisition was $238,000 for the third quarter of 2018, and exceeded the amortization of the fair value adjustment to time deposits of $218,000. The preliminary accounting for the fair value adjustments for the ASB acquisition may be refined for up to one year after the acquisition, which could result in changes to accretion income and amortization expense in future periods.

For the first nine months of 2018, accretion income, net of amortization expense, was $1.7 million, compared to $2.4 million during the same period in 2017. The accretion income, net of amortization expense added 7 basis points to net interest margin during the first nine months of 2018, compared to 10 basis points in 2017.

During the third quarter of 2018, provision for loan losses was $1.3 million, compared to $1.2 million for the second quarter of 2018 and $1.1 million for the third quarter of 2017. Provision for loan losses during the first nine months of 2018 was $4.5 million compared to $2.7 million for the same period in 2017. Organic loan growth has driven the higher provision for loan losses during 2018, while asset quality metrics were stable.

For the third quarter of 2018, total non-interest income increased $1.1 million, or 8%, compared to the second quarter of 2018 and decreased $93,000, or 1%, from the third quarter of 2017. The increase in total non-interest income from the second quarter of 2018 was largely due to increased deposit account service charges coupled with higher commercial loan swap fees and mortgage banking income. The decrease in total non-interest income from the third quarter of 2017 was due primarily to net gains on investment securities recognized in 2017 as a result of the sale of bank equity investment securities. The decrease in net gains on investment securities were partially offset by higher mortgage banking income related to the mortgage origination operations acquired in the ASB transaction, coupled with increases in trust and investment income, and electronic banking income.

For the first nine months of 2018, total non-interest income grew $743,000, or 2%, compared to 2017. The increase was led by higher income from mortgage banking, trust and investment, electronic banking and insurance. In addition, other non-interest income grew during the first nine months of 2018, as a result of higher gains on sale of Small Business Administration ("SBA") loans, coupled with the change in fair value of equity investment securities during 2018. The majority of these investment securities were liquidated during 2018, and the fair value change in future periods should be minimal. Additionally, year-over-year, mortgage banking income increased as the mortgage origination operations acquired from ASB, provided additional income.

Total non-interest expense decreased $5.1 million, or 14%, in the third quarter of 2018 compared to the second quarter of 2018 and grew $4.3 million, or 16%, compared to the third quarter of 2017. The decrease compared to the linked quarter was primarily due to the $5.4 million reduction in acquisition-related expenses. Excluding acquisition-related expenses, total non-interest expense was relatively flat compared to the linked quarter. The growth in non-interest expense compared to the third quarter of 2017 was led by higher salaries and employee benefit costs, mainly due to the ASB acquisition, coupled with $176,000 of pension settlement charges, as well as acquisition-related expenses of $675,000 and the ongoing increased operating costs resulting from running the ASB franchise.

During the first nine months of 2018, total non-interest expense increased 18% compared to 2017. This increase was driven by $6.9 million of acquisition-related expenses during 2018, compared to none in 2017, coupled with growth in salaries and employee benefit costs and other ongoing increased operating costs resulting from the ASB acquisition.

Peoples' efficiency ratio, calculated as total non-interest expense less amortization of other intangible assets divided by fully tax-equivalent ("FTE") net interest income, plus total non-interest income, excluding all gains and losses, for the third quarter of 2018 was 62.6%, compared to 75.0% for the second quarter of 2018 and 60.7% for the third quarter of 2017. The efficiency ratio, when adjusted for non-core expenses, was 60.8% for the third quarter of 2018, compared to 62.0% for the second quarter of 2018 and 60.7% for the third quarter of 2017. The decline in the efficiency ratio compared to the linked quarter was primarily due to the acquisition-related expenses recognized during the second quarter of 2018, while the increase compared to the third quarter of 2017 was mostly due to higher total non-interest expense. During the first nine months of 2018, the efficiency ratio was 66.5%, compared to 62.2% for the same period in 2017. The efficiency ratio for the first nine months of 2018, when adjusted for non-core expenses in the form of acquisition-related expenses and pension settlement charges, was 61.4% and was 62.2% for the first nine months of 2017.

During the third quarter of 2018, income tax expense was $2.8 million, compared to $1.0 million for the linked quarter and $5.1 million for the third quarter of 2017. The increase in income tax expense compared to the linked quarter was due to higher pre-tax income as a result of reduced acquisition-related expenses, coupled with a release of a valuation allowance during the second quarter of 2018 of $0.8 million. This valuation allowance was related to a historical tax credit that Peoples invested in during 2015. The decline in income tax expense compared to the third quarter of 2017 was directly related to the reduction in the federal corporate income tax rate from 35% to 21% due to the Tax Cuts and Jobs Act.

For the first nine months of 2018, income tax expense totaled $6.2 million compared to $13.4 million in 2017. The reduction in income tax expense compared to 2017 was largely a result of the Tax Cuts and Jobs Act enacted in December 2017, coupled with the release of the valuation allowance of $0.8 million during the second quarter of 2018.

At September 30, 2018, total assets were $4.00 billion, compared to $3.58 billion at December 31, 2017. The 12% increase compared to December 31, 2017 was primarily due to the ASB acquisition, which added $279.1 million of assets, after preliminary fair value adjustments, coupled with organic loan growth. Excluding the impact of the ASB acquisition, period-end loan balances, net of deferred fees and costs, grew $133.9 million, or 8% annualized. Commercial loan balances increased $73.0 million, mostly driven by higher commercial and industrial loans, while consumer loans grew $60.9 million, with consumer indirect lending providing most of the increase.

Total liabilities were $3.50 billion at September 30, 2018, up $375.7 million, or 12%, since December 31, 2017. The increase in liabilities during the first nine months of 2018 was primarily due to an increase in deposits of $310.8 million, while borrowings increased $54.4 million. The growth in deposits compared to December 31, 2017 was mostly due to acquired ASB deposit balances.

At September 30, 2018, total stockholders' equity was $504.3 million, an increase of $45.7 million, compared to December 31, 2017. The increase in total stockholders' equity was mostly due to the $40.9 million of common shares issued in connection with the ASB acquisition. In addition, net income earned for the first nine months of 2018 exceeded dividends, but was offset partially by an increase in accumulated other comprehensive loss.

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RESULTS OF OPERATIONS

Net Interest Income

Net interest income, the amount by which interest income exceeds interest expense, remains Peoples' largest source of revenue. The amount of net interest income earned by Peoples each quarter is affected by various factors, including changes in market interest rates due to the Federal Reserve Board’s monetary policy, the level and degree of pricing competition for both loans and deposits in Peoples’ markets, and the amount and composition of Peoples' earning assets and interest-bearing liabilities.

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The following tables detail Peoples' average balance sheets for the periods presented:

	For the Three Months Ended								
	September 30, 2018			June 30, 2018			September 30, 2017		
(Dollars in thousands)	Average Balance	Income/ Expense	Yield/Cost	Average Balance	Income/ Expense	Yield/Cost	Average Balance	Income/ Expense	Yield/Cost
Short-term investments	$23,057	$86	1.48 %	$10,815	$54	2.00 %	$12,812	$42	1.30 %
Investment securities (a)(b):									
Taxable	787,081	5,615	2.85 %	793,497	5,868	2.96 %	780,667	5,661	2.90 %
Nontaxable	93,958	777	3.31 %	96,991	804	3.32 %	105,077	1,078	4.10 %
Total investment securities	881,039	6,392	2.90 %	890,488	6,672	3.00 %	885,744	6,739	3.04 %
Loans (b)(c):									
Commercial real estate, construction	123,939	1,573	4.97 %	118,206	1,438	4.81 %	118,208	1,337	4.43 %
Commercial real estate, other	852,675	10,934	5.02 %	840,677	10,434	4.91 %	750,260	8,890	4.64 %
Commercial and industrial	526,316	6,844	5.09 %	503,364	6,216	4.89 %	438,524	5,196	4.64 %
Residential real estate (d)	614,914	7,010	4.56 %	600,799	6,749	4.49 %	507,906	5,468	4.31 %
Home equity lines of credit	135,626	1,860	5.44 %	131,970	1,701	5.17 %	110,741	1,291	4.63 %
Consumer, indirect	387,559	3,872	3.96 %	359,941	3,498	3.90 %	322,072	2,955	3.64 %
Consumer, direct	76,171	1,281	6.67 %	72,820	1,230	6.77 %	70,204	1,270	7.18 %
Total loans	2,717,200	33,374	4.84 %	2,627,777	31,266	4.73 %	2,317,915	26,407	4.49 %
Less: Allowance for loan losses	(19,584)			(19,071)			(18,869)		
Net loans	2,697,616	33,374	4.88 %	2,608,706	31,266	4.77 %	2,299,046	26,407	4.53 %
Total earning assets	3,601,712	39,852	4.37 %	3,510,009	37,992	4.31 %	3,197,602	33,188	4.10 %
Intangible assets	163,615			161,600			144,267		
Other assets	232,927			226,348			199,351		
Total assets	$3,998,254			$3,897,957			$3,541,220		
Deposits:									
Savings accounts	$476,127	$84	0.07 %	$477,167	$69	0.06 %	$443,599	$65	0.06 %
Governmental deposit accounts	328,806	507	0.61 %	312,999	273	0.35 %	309,623	200	0.26 %
Interest-bearing demand accounts	551,291	157	0.11 %	581,600	202	0.14 %	320,788	133	0.16 %
Money market accounts	395,477	365	0.37 %	393,580	323	0.33 %	389,292	253	0.26 %
Retail certificates of deposit	402,379	1,372	1.35 %	395,304	1,242	1.26 %	348,047	760	0.87 %
Brokered certificates of deposit	256,780	1,533	2.37 %	187,387	992	2.13 %	106,448	454	1.69 %
Total interest-bearing deposits	2,410,860	4,018	0.66 %	2,348,037	3,101	0.53 %	1,917,797	1,865	0.39 %
Borrowed funds:									
Short-term FHLB advances	258,742	1,475	2.26 %	225,635	966	1.72 %	96,760	336	1.38 %
	74,174	142	0.77 %	85,188	209	0.98 %	77,706	33	0.17 %

Retail repurchase agreements												
Total short-term borrowings	332,916	1,617	1.93	%	310,823	1,175	1.52	%	174,466	369	0.84	%
Long-term FHLB advances	104,026	537	2.05	%	114,287	559	1.96	%	153,070	788	2.04	%
Wholesale repurchase agreements	—	—	—	%	—	—	—	%	40,000	371	3.71	%
Other borrowings	7,217	135	7.48	%	7,766	126	6.49	%	7,003	115	6.57	%
Total long-term borrowings	111,243	672	2.40	%	122,053	685	2.25	%	200,073	1,274	2.53	%
Total borrowed funds	444,159	2,289	2.05	%	432,876	1,860	1.72	%	374,539	1,643	1.74	%
Total interest-bearing liabilities	2,855,019	6,307	0.88	%	2,780,913	4,961	0.71	%	2,292,336	3,508	0.61	%
Non-interest-bearing deposits	592,709				585,800				756,098			
Other liabilities	48,741				41,368				36,588			
Total liabilities	3,496,469				3,408,081				3,085,022			
Total stockholders' equity	501,785				489,876				456,198			
Total liabilities and stockholders' equity	$3,998,254				$3,897,957				$3,541,220			
Interest rate spread (b)		$33,545	3.49	%		$33,031	3.60	%		$29,680	3.49	%
Net interest margin (b)			3.68	%			3.74	%			3.67	%

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	For the Nine Months Ended					
	September 30, 2018			September 30, 2017		
(Dollars in thousands)	Average Balance	Income/ Expense	Yield/Cost	Average Balance	Income/ Expense	Yield/Cost
Short-term investments	$15,379	$192	1.67 %	$10,854	$83	1.02 %
Investment securities (a)(b):						
Taxable	785,454	17,169	2.91 %	766,116	15,416	2.68 %
Nontaxable	96,016	2,395	3.33 %	109,921	3,473	4.21 %
Total investment securities	881,470	19,564	2.96 %	876,037	18,889	2.87 %
Loans (b)(c):						
Commercial real estate, construction	120,264	4,344	4.76 %	106,637	3,488	4.31 %
Commercial real estate, other	819,797	30,492	4.90 %	740,263	26,205	4.67 %
Commercial and industrial	503,328	18,631	4.88 %	434,976	14,599	4.43 %
Residential real estate (d)	569,593	19,068	4.46 %	519,989	16,801	4.31 %
Home equity lines of credit	125,505	4,832	5.15 %	111,012	3,683	4.44 %
Consumer, indirect	363,705	10,500	3.86 %	295,461	7,758	3.51 %
Consumer, other	72,499	3,673	6.77 %	69,914	3,718	7.11 %
Total loans	2,574,691	91,540	4.70 %	2,278,252	76,252	4.46 %
Less: Allowance for loan losses	(19,116)			(18,671)		
Net loans	2,555,575	91,540	4.75 %	2,259,581	76,252	4.47 %
Total earning assets	3,452,424	111,296	4.28 %	3,146,472	95,224	4.02 %
Intangible assets	156,540			144,950		
Other assets	223,590			201,350		
Total assets	$3,832,554			$3,492,772		
Deposits:						
Savings accounts	$468,810	$217	0.06 %	$442,559	$184	0.06 %
Governmental deposit accounts	311,223	997	0.43 %	298,321	499	0.22 %
Interest-bearing demand accounts	566,656	580	0.14 %	300,911	310	0.14 %
Money market accounts	385,768	914	0.32 %	393,944	637	0.22 %
Retail certificates of deposit	378,871	3,379	1.19 %	363,747	2,233	0.82 %
Brokered certificates of deposit	200,637	3,245	2.16 %	85,576	1,218	1.90 %
Total interest-bearing deposits	2,311,965	9,332	0.54 %	1,885,058	5,081	0.36 %
Borrowed funds:						
Short-term FHLB advances	209,980	3,104	1.98 %	104,703	757	0.97 %
Retail repurchase agreements	87,076	656	1.00 %	74,940	96	0.17 %
Total short-term borrowings	297,056	3,760	1.69 %	179,643	853	0.64 %
Long-term FHLB advances	112,381	1,660	1.97 %	136,570	2,140	2.10 %
Wholesale repurchase agreements	—	—	— %	40,000	1,100	3.67 %
Other borrowings	7,364	383	6.93 %	6,951	324	6.21 %
Total long-term borrowings	119,745	2,043	2.28 %	183,521	3,564	2.59 %
Total borrowed funds	416,801	5,803	1.86 %	363,164	4,417	1.62 %
Total interest-bearing liabilities	2,728,766	15,135	0.74 %	2,248,222	9,498	0.56 %
Non-interest-bearing deposits	577,461			761,308		
Other liabilities	44,189			35,650		
Total liabilities	3,350,416			3,045,180		
Total stockholders’ equity	482,138			447,592		

Total liabilities and stockholders' equity	$3,832,554				$3,492,772		
Interest rate spread (b)		$96,161	3.54	%		$85,726	3.46	%
Net interest margin (b)			3.69	%			3.61	%

(a) Average balances are based on carrying value.

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(b) Interest income and yields are presented on a fully tax-equivalent basis using a 21% federal corporate income tax rate for the 2018 reported periods and a 35% federal corporate income tax rate for the 2017 reported periods.

(c) Average balances include nonaccrual, impaired loans and loans held for sale. Interest income includes interest earned and received on nonaccrual loans prior to the loans being placed on nonaccrual status. Loan fees included in interest income were immaterial for all periods presented.

(d) Loans held for sale are included in the average loan balance listed. Related interest income on loans originated for sale prior to the loan being sold is included in loan interest income.

The following table provides an analysis of the changes in fully tax-equivalent ("FTE") net interest income:

	Three Months Ended September 30, 2018 Compared to						Nine Months Ended September 30, 2018 Compared to		
(Dollars in thousands)	June 30, 2018			September 30, 2017			September 30, 2017		
Increase (decrease) in:	Rate	Volume	Total (a)	Rate	Volume	Total (a)	Rate	Volume	Total (a)
INTEREST INCOME:									
Short-term investments	$(71)	$103	$32	$5	$39	$44	$64	$45	$109
Investment Securities (b):									
Taxable	(230)	(23)	(253)	(282)	236	(46)	1,660	93	1,753
Nontaxable	(2)	(25)	(27)	(195)	(106)	(301)	(59)	(1,019)	(1,078)
Total investment income	(232)	(48)	(280)	(477)	130	(347)	1,601	(926)	675
Loans (b):									
Commercial real estate, construction	54	81	135	169	67	236	385	471	856
Commercial real estate, other	303	197	500	768	1,276	2,044	1,374	2,913	4,287
Commercial and industrial	298	330	628	540	1,108	1,648	1,596	2,436	4,032
Residential real estate	101	160	261	337	1,205	1,542	623	1,644	2,267
Home equity lines of credit	103	56	159	250	319	569	633	516	1,149
Consumer, indirect	68	306	374	279	638	917	825	1,917	2,742
Consumer, direct	(103)	154	51	(410)	421	11	(40)	(5)	(45)
Total loan income	824	1,284	2,108	1,933	5,034	6,967	5,396	9,892	15,288
Total interest income	521	1,339	1,860	1,461	5,203	6,664	7,061	9,011	16,072
INTEREST EXPENSE:									
Deposits:									
Savings accounts	16	(1)	15	14	5	19	21	12	33
Governmental deposit accounts	219	15	234	294	13	307	475	23	498
Interest-bearing demand accounts	(35)	(10)	(45)	(223)	247	24	(4)	274	270
Money market accounts	40	2	42	108	4	112	299	(22)	277
Brokered certificates of deposit	127	414	541	238	841	1,079	187	1,840	2,027
Retail certificates of deposit	106	24	130	479	133	612	1,050	96	1,146
Total deposit cost	473	444	917	910	1,243	2,153	2,028	2,223	4,251
Borrowed funds:									
Short-term borrowings	308	134	442	434	814	1,248	635	2,272	2,907
Long-term borrowings	184	(197)	(13)	126	(728)	(602)	(614)	(907)	(1,521)
Total borrowed funds cost	492	(63)	429	560	86	646	21	1,365	1,386
Total interest expense	965	381	1,346	1,470	1,329	2,799	2,049	3,588	5,637
Net interest income	$(444)	$958	$514	$(9)	$3,874	$3,865	$5,012	$5,423	$10,435

(a) The change in interest due to both rate and volume has been allocated to rate and volume changes in proportion to the relationship of the dollar amounts of the changes in each.

(b) Interest income and yields are presented on a fully tax-equivalent basis using a 21% federal corporate income tax rate for the 2018 periods and a 35% federal corporate income tax rate for the 2017 periods.

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Average quarterly gross loan balances increased $89.4 million, or 3%, compared to the linked quarter of 2018, which included the partial impact to average balances from the ASB acquisition on April 13, 2018. The average quarterly gross loan balances increased $399.3 million, or 17%, including acquired loans from the ASB acquisition, compared to the third quarter of 2017. For the nine months ended September 30, 2018, average gross loan balances, including acquired loans from the ASB acquisition, increased $244.2 million, or 11%, compared to the same period in the prior year. Commercial lending, including both commercial real estate and commercial and industrial loans, as well as indirect consumer lending, were among the largest contributors to the comparative growth. Compared to the second quarter of 2018, average balances in commercial real estate loans increased $40.7 million, or 3%. Compared to the third quarter of 2017, average balances in commercial real estate loans increased $195.9 million, or 15%, while average balances in consumer indirect loans increased $65.5 million, or 20%. Compared to the first nine months of 2017, average commercial real estate loan balances grew $93.2 million, or 11%, and average commercial and industrial loan balances grew $68.4 million, or 16%, while average consumer indirect loan balances grew $69.6 million, or 23%.

Net interest margin, which is calculated by dividing FTE net interest income by average interest-earning assets, serves as an important measurement of the net revenue stream generated by the volume, mix and pricing of interest-earning assets and interest-bearing liabilities. FTE net interest income is calculated by increasing interest income to convert tax-exempt income earned on obligations of states and political subdivisions to the pre-tax equivalent of taxable income using a federal corporate income tax rate of 21% for the 2018 periods and 35% for the 2017 periods.

The following table details the calculation of FTE net interest income:

	Three Months Ended			Nine Months Ended	
	September 30,	June 30,	September 30,	September 30,	
(Dollars in thousands)	2018	2018	2017	2018	2017
Net interest income, as reported	$33,324	$32,808	$ 29,220	$95,491	$84,255
Taxable equivalent adjustments	221	223	460	670	1,471
Fully tax-equivalent net interest income	$33,545	$33,031	$ 29,680	$96,161	$85,726

Loan growth, and the previous increases in interest rates, positively impacted net interest income and the net interest margin for the nine months of 2018 compared to the nine months of 2017. The ASB acquisition also impacted net interest income and net interest margin during the third and second quarter of 2018 and the nine months ended September 30, 2018. The decline in the taxable equivalent adjustments in the nine months ended September 30, 2018 was a result of the change in the federal corporate income tax rate, which was 21% for the periods reported in 2018 compared to 35% for the periods reported in 2017. The accretion income from acquisitions, net of amortization expense, was $612,000 for the third quarter of 2018, compared to $523,000 for the second quarter of 2018, and $816,000 for the third quarter of 2017, which added 7 basis points, 6 basis points, and 10 basis points, respectively, to net interest margin. On a year-to-date basis, the accretion income, net of amortization expense, from acquisitions added 7 basis points to net interest margin for the first nine months of 2018 compared to 10 basis points for the first nine months of 2017.

Additional information regarding changes in the Consolidated Balance Sheets can be found under appropriate captions of the “FINANCIAL CONDITION” section of this discussion. Additional information regarding Peoples' interest rate risk and the potential impact of interest rate changes on Peoples' results of operations and financial condition can be found later in this discussion under the caption "FINANCIAL CONDITION - Interest Rate Sensitivity and Liquidity."

Provision for Loan Losses

The following table details Peoples’ provision for loan losses:

	Three Months Ended			Nine Months Ended	
	September 30,	June 30,	September 30,	September 30,	
(Dollars in thousands)	2018	2018	2017	2018	2017
Loan losses	$1,035	$1,000	$ 900	$3,877	$2,150
Checking account overdrafts	267	188	186	596	507

Provision for loan losses	$1,302	$1,188	$ 1,086	$4,473	$2,657
As a percentage of average total loans (a)	0.19 %	0.18 %	0.19 %	0.23 %	0.16 %

(a) Presented on an annualized basis.

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The provision for loan losses recorded represents the amount needed to maintain the adequacy of the allowance for loan losses based on management's quarterly analysis of the loan portfolio and procedural methodology that estimates the amount of probable credit losses. This process considers various factors that affect losses, such as changes in Peoples' loan quality, historical loss experience and current economic conditions. Provision for loan losses continued to increase from previous quarters due to continued loan growth, while asset quality metrics were stable. The increase in the first nine months of 2018 was due primarily to one acquired commercial loan relationship, coupled with charge-offs related to indirect lending and continued loan growth.

Additional information regarding changes in the allowance for loan losses and loan credit quality can be found later in this discussion under the caption "FINANCIAL CONDITION - Allowance for Loan Losses."

Net Gain (Loss) on Asset Disposals and Other Transactions

The following table details the net gain (loss) on asset disposals and other transactions recognized by Peoples:

	Three Months Ended			Nine Months Ended	
	September 30,	June 30,	September 30,	September 30,	
(Dollars in thousands)	2018	2018	2017	2018	2017
Net gain (loss) on other assets	$ 12	$ (330)	$ (38)	$ (239)	$ 92
Net gain (loss) on other real estate owned ("OREO")	—	14	13	9	(11)
Net loss on debt extinguishment	—	(13)	—	(13)	—
Net loss on other transactions	—	(76)	—	(76)	—
Net gain (loss) on asset disposals and other transactions	$ 12	$ (405)	$ (25)	$ (319)	$ 81

During the second quarter of 2018, net loss on other assets was primarily due to the disposal of $192,000 in ASB fixed assets acquired coupled with $147,000 of market value write-downs related to closed offices that were held for sale. The net loss on other transactions for the second quarter of 2018 was due to the write down of a limited partnership investment. The net loss on other assets during the third quarter of 2017 was primarily due to the sale of a parking lot that was no longer being utilized. The year-to-date 2017 net gain on other assets was due to the sale of a previously closed branch.

Non-Interest Income

Insurance income comprised the largest portion of the third quarter 2018 total non-interest income. The following table details Peoples' insurance income:

	Three Months Ended			Nine Months Ended	
	September 30,	June 30,	September 30,	September 30,	
(Dollars in thousands)	2018	2018	2017	2018	2017
Property and casualty insurance commissions	$2,614	$ 2,597	$ 2,638	$7,856	$7,633
Life and health insurance commissions	545	596	433	1,685	1,310
Performance-based commissions	98	3	99	1,448	1,407
Credit life and A&H insurance commissions	5	4	2	14	27
Other fees and charges	126	169	173	409	484
Insurance income	$3,388	$ 3,369	$ 3,345	$11,412	$10,861

The increase in insurance income the first nine months of 2018, included the continued growth resulting from the acquisition of a third-party insurance administration company on January 31, 2017, and a property and casualty focused independent insurance agency on October 2, 2017. Revenue related to performance-based commissions is largely due to annual performance-based insurance commissions, which are primarily recognized in the first quarter of each year.

Peoples' fiduciary and brokerage revenues continued to be based primarily upon the value of assets under administration and management, with additional income generated from transaction commissions, cross-selling of products and additional retirement plan services business. Fiduciary revenue related to tax preparation income is largely recognized in the second quarter of each year.

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The following tables detail Peoples’ trust and investment income and related assets under administration and management:

	Three Months Ended			Nine Months Ended	
	September 30,	June 30,	September 30,	September 30,	
(Dollars in thousands)	2018	2018	2017	2018	2017
Fiduciary	$1,626	$1,767	$ 1,548	$5,000	$4,764
Brokerage	999	989	882	2,951	2,575
Employee benefits	485	476	408	1,459	1,158
Trust and investment income	$3,110	$3,232	$ 2,838	$9,410	$8,497

(Dollars in thousands)	September 30, 2018	June 30, 2018	March 31, 2018	December 31, 2017	September 30, 2017
Trust assets under administration and management	$ 1,489,810	$1,454,009	$1,447,636	$1,452,959	$ 1,418,360
Brokerage assets under administration and management	914,172	881,839	882,018	887,303	862,530
Total assets under administration and management	$ 2,403,982	$2,335,848	$2,329,654	$2,340,262	$ 2,280,890
Quarterly average	$ 2,378,676	$2,331,529	$2,352,798	$2,314,015	$ 2,254,997

Deposit account service charges, which are based on the recovery of costs associated with services provided, comprised a significant portion of People's non-interest income. The following table details Peoples' deposit account service charges:

	Three Months Ended			Nine Months Ended	
	September 30,	June 30,	September 30,	September 30,	
(Dollars in thousands)	2018	2018	2017	2018	2017
Overdraft and non-sufficient funds fees	$1,800	$1,584	$ 1,765	$4,823	$5,021
Account maintenance fees	691	646	543	2,012	1,624
Other fees and charges	161	158	99	325	485
Deposit account service charges	$2,652	$2,388	$ 2,407	$7,160	$7,130

The slight decline in overdrafts and non-sufficient funds fees from 2017 was partially due to changes made to the calculation of fees to be more in line with industry practices. The increase in account maintenance fees in 2018, compared to the prior year periods, was largely due to implementation of new consumer checking products that occurred during the second half of 2017. The amount of deposit account service charges, particularly fees for overdrafts and non-sufficient funds, is largely dependent on the timing and volume of customer activity. Management periodically evaluates its cost recovery fees to ensure they are reasonable based on operational costs and similar to fees charged in Peoples' markets by competitors.

The following table details the other items included within Peoples' total non-interest income:

	Three Months Ended			Nine Months Ended	
	September 30,	June 30,	September 30,	September 30,	
(Dollars in thousands)	2018	2018	2017	2018	2017
Electronic banking income	$2,890	$2,785	$ 2,544	$8,460	$7,692
Mortgage banking income	1,060	969	535	2,380	1,389
Bank owned life insurance income	495	497	482	1,460	1,471
Commercial loan swap fees	355	146	76	617	995
Other non-interest income (a)	391	421	383	2,143	1,499

(a) As of January 1, 2018, Peoples adopted ASU 2016-01, resulting in a reduction of income of $16,000 during the three months ended September 30, 2018 and a gain in income of $208,000 for the nine months ended September 30, 2018.

Peoples' electronic banking ("e-banking") services include ATM and debit cards, direct deposit services, internet and mobile banking, and remote deposit capture and serve as alternative delivery channels to traditional sales offices for providing services to clients. Revenue is derived largely from ATM and debit cards, as other services are mainly provided at no charge to the customers. The amount of e-banking income is largely dependent on the timing and volume of customer activity.

Mortgage banking income is comprised mostly of net gains from the origination and sale of long-term, fixed-rate real estate loans in the secondary market, servicing income for sold loans as well as servicing released premiums for sold loans. As a result, the amount of income recognized by Peoples is largely dependent on customer demand and long-term interest rates for residential real estate loans offered in the secondary market. In the second and third quarters of 2018, and the nine months ended September 30, 2018, the increase in mortgage banking income was largely attributable to gains on sale of real estate loans originated by the mortgage origination operation acquired as part of the ASB acquisition.

In the third quarter of 2018, Peoples sold approximately $20.6 million in loans to the secondary market compared to $19.1 million in the linked quarter and $20.2 million in the third quarter of 2017. The volume of sales has a direct impact on the amount of mortgage banking income. During the third quarter of 2018, Peoples sold approximately $19.2 million in loans with servicing released premiums, compared to $13.6 million in loans with servicing released premiums for the second quarter of 2018.

Commercial loan swap fee income is largely dependent on the timing and volume of customer activity. Demand has decreased in the current year due largely to the current interest rate environment.

For the first nine months of 2018, other non-interest income was $2.1 million, compared to $1.5 million for the first nine months of 2017. The increase of $644,000, or 43%, was primarily due to $208,000 recorded in connection with the implementation of a new accounting standard, which changed how the fair value of equity investment securities was to be recognized beginning January 1, 2018, coupled with an increase of $179,000 in the gain on sale of SBA loans and other operating income which included recoveries of previously charged off acquired loans.

Non-Interest Expense

Salaries and employee benefit costs remain Peoples' largest non-interest expense, accounting for over one-half of total non-interest expense. The following table details Peoples' salaries and employee benefit costs:

	Three Months Ended			Nine Months Ended	
	September 30,	June 30,	September 30,	September 30,	
(Dollars in thousands)	2018	2018	2017	2018	2017
Base salaries and wages	$11,889	$12,656	$ 10,043	$34,917	$29,860
Sales-based and incentive compensation	3,125	3,003	2,653	8,364	7,630
Employee benefits	1,897	1,499	1,535	4,953	4,971
Payroll taxes and other employment costs	1,036	1,036	945	3,255	3,056
Stock-based compensation	564	410	359	2,046	1,370
Deferred personnel costs	(602)	(579)	(394)	(1,612)	(1,201)
Salaries and employee benefit costs	$17,909	$18,025	$ 15,141	$51,923	$45,686
Full-time equivalent employees:					
Actual at end of period	849	862	778	849	778
Average during the period	860	844	778	832	778

The decrease in base salaries and wages for the third quarter of 2018 compared to the linked quarter was primarily due to acquisition-related expenses of $466,000 in the third quarter of 2018, compared to $1.9 million in the second quarter of 2018. The increase in base salaries and wages for the first nine months of 2018, compared to the first nine months of 2017 was partially due to acquisition-related expenses of $2.4 million recorded in 2018, compared to none in 2017.

The increase in sales-based and incentive compensation for both the third quarter of 2018 and first nine months of 2018, compared to the 2017 periods, was increased sales volume and overall corporate performance for 2018.

The increase in employee benefits for the third quarter of 2018 compared to the linked quarter was primarily due to higher medical insurance costs and a pension settlement charge of $176,000 recognized in the third quarter of 2018, compared to no pension settlement charges in the linked quarter.

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The increase in stock-based compensation for the first nine months of 2018, compared to the first nine months of 2017 was due primarily to the grant in the first quarter of a one-time award of unrestricted common shares to all full-time and part-time employees who did not already participate in the equity plan, which resulted in an expense of $388,000, coupled with restricted stock granted to new key position hires in 2018.

Peoples' net occupancy and equipment expense was comprised of the following:

	Three Months Ended			Nine Months Ended	
	September 30,	June 30,	September 30,	September 30,	
(Dollars in thousands)	2018	2018	2017	2018	2017
Depreciation	$1,237	$1,248	$ 1,206	$3,704	$3,649
Repairs and maintenance costs	697	659	577	2,203	1,930
Net rent expense	264	235	264	709	689
Property taxes, utilities and other costs	652	661	572	1,903	1,712
Net occupancy and equipment expense	$2,850	$2,803	$ 2,619	$8,519	$7,980

The increase in net occupancy and equipment for the first nine months of 2018 was due to the increased maintenance costs, property taxes, utilities and other costs coupled with to the addition of seven full-service bank branches and two loan production offices in the ASB acquisition and ongoing increased operating costs associated with the expanded footprint.

The following table details the other items included in total non-interest expense:

	Three Months Ended			Nine Months Ended	
	September 30,	June 30,	September 30,	September 30,	
(Dollars in thousands)	2018	2018	2017	2018	2017
Electronic banking expense	$1,552	$1,448	$ 1,403	$4,409	$4,293
Data processing and software expense	1,408	1,359	1,092	4,089	3,330
Professional fees	1,395	3,022	1,393	6,135	4,532
Amortization of other intangible assets	862	861	869	2,477	2,603
Franchise tax expense	616	614	583	1,874	1,750
Marketing expense	456	656	488	1,437	1,122
FDIC insurance expense	391	416	449	1,173	1,339
Foreclosed real estate and other loan expenses	373	338	214	923	589
Communication expense	305	300	334	949	1,134
Other non-interest expense	2,713	6,129	1,973	11,113	6,211

Professional fees decreased $1.6 million, or 53%, from the second quarter of 2018, due to $652,000 of ASB acquisition-related expenses recognized in the second quarter of 2018, coupled with a decrease in consulting and legal fees. The increase of $1.6 million, or 35%, in professional fees for the first nine months ended September 2018, compared to the nine months ended September 30, 2017, was due to acquisition-related expenses coupled with increased consulting and legal fees.

Data processing and software expense increased $49,000, or 4%, from the linked quarter and $316,000, or 29%, from the third quarter of 2017 and $759,000, or 23%, for the first nine months of 2018, compared to the same period in 2017. The increase was driven by the implementation of enhanced functionalities for Peoples' core banking system, including making certain mobile banking tools available to customers.

Marketing expense decreased $200,000, or 30%, for the third quarter of 2018, from the linked quarter and increased $315,000, or 28%, for the first nine months of 2018, compared to the first nine months of 2017. For the second quarter and the first nine months of 2018, marketing expense increased in connection with the timing of the ASB acquisition and additional marketing campaigns in the new market areas.

Other non-interest expense decreased $3.5 million, or 56%, for the third quarter of 2018, compared to the linked quarter, which had included $3.4 million of acquisition-related expenses, primarily related to fees associated with early termination of contracts and de-conversion fees. For the first nine months of 2018, other non-interest expense increased $4.9 million, or 79%, which included $3.6 million of acquisition-related expenses, compared to no acquisition-related expenses in the first nine months of 2017.

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Income Tax Expense

Income tax expense was $2.8 million for the third quarter of 2018, compared to $1.0 million for the linked quarter and $5.1 million for the third quarter of 2017. The increase in income tax expense compared to the linked quarter was due to higher pre-tax income, as a result of reduced acquisition-related expenses, coupled with the release of a valuation allowance during the second quarter of 2018 of $0.8 million. The decline in income tax expense compared to the third quarter of 2017 was directly related to the reduction in the federal corporate income tax rate from the Tax Cuts and Jobs Act enacted in December 2017.

For the first nine months of 2018, income tax expense totaled $6.2 million compared to $13.4 million in 2017 and the effective tax rate for the first nine months of 2018 was 16.1%, compared to 31.2% for the first nine months of 2017. The reduction in income tax expense compared to 2017 was largely a result of the Tax Cuts and Jobs Act, which lowered the federal corporate income tax rate from 35% to 21%, coupled with the release of the valuation allowance of $0.8 million during the second quarter of 2018.

Additional information regarding income taxes can be found in Note 12 of the Notes to the Consolidated Financial Statements included in Peoples' 2017 Form 10-K.

Pre-Provision Net Revenue

Pre-provision net revenue ("PPNR") has become a key financial measure used by state and federal bank regulatory agencies when assessing the capital adequacy of financial institutions. PPNR is defined as net interest income plus total non-interest income minus total non-interest expense while excluding the provision for loan losses and all gains and losses included in earnings. As a result, PPNR represents the earnings capacity that can be either retained in order to build capital or used to absorb unexpected losses and preserve existing capital.

The following table provides a reconciliation of this non-GAAP financial measure to the amounts reported in Peoples' Unaudited Consolidated Financial Statements for the periods presented:

	Three Months Ended			Nine Months Ended	
	September 30,	June 30,	September 30,	September 30,	
(Dollars in thousands)	2018	2018	2017	2018	2017
Pre-provision net revenue:					
Income before income taxes	$15,546	$8,904	$16,022	$38,574	$42,863
Add: provision for loan losses	1,302	1,188	1,086	4,473	2,657
Add: loss on debt extinguishment	—	13	—	13	—
Add: net loss on OREO	—	—	—	—	24
Add: net loss on investment securities	—	147	—	146	—
Add: net loss on other assets	—	330	—	239	—
Add: net loss on other transactions		76	38	76	41
Less: net gain on OREO	—	14	13	9	13
Less: net gain on investment securities	—	—	1,861	—	2,219
Less: net gain on other assets	12	—	—	—	133
Pre-provision net revenue	$16,836	$10,644	$15,272	$43,512	$43,220
Total average assets	$3,998,254	$3,897,957	$3,541,220	$3,832,554	$3,492,772
Pre-provision net revenue to total average assets (a)	1.67 %	1.10 %	1.71 %	1.52 %	1.65 %

(a) Presented on an annualized basis.

The pre-provision net revenue increased in the third quarter of 2018 compared to the linked quarter due to higher income before income taxes. The linked quarter included $6.1 million of acquisition-related expenses compared to $675,000 in the third quarter of 2018. The decrease in pre-provision net revenue to total average assets for the first nine months of 2018, compared to the first nine months of 2017, was due primarily to average assets increasing partially due to the ASB acquisition which included $6.9 million of acquisition-related expenses.

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Core Non-Interest Expense

Core non-interest expense is a financial measure used to evaluate Peoples' recurring expense stream. This measure is non-GAAP since it excludes the impact of acquisition-related expenses and pension settlement charges.

The following table provides a reconciliation of this non-GAAP financial measure to the comparable GAAP amounts reported in Peoples' Unaudited Consolidated Financial Statements for the periods presented:

	Three Months Ended			Nine Months Ended	
	September 30,	June 30,	September 30,	September 30,	
(Dollars in thousands)	2018	2018	2017	2018	2017
Core non-interest expense:					
Total non-interest expense	$30,829	$35,971	$ 26,558	$95,021	$80,569
Less: acquisition-related expenses	675	6,056	—	6,880	—
Less: pension settlement charges	176	—	—	176	—
Core non-interest expense	$29,978	$29,915	$ 26,558	$87,965	$80,569

Efficiency Ratio

The efficiency ratio is a key financial measure used to monitor performance. The efficiency ratio is calculated as total non-interest expense (less amortization of other intangible assets) as a percentage of FTE net interest income plus total non-interest income (excluding all gains and all losses). This measure is non-GAAP since it excludes amortization of other intangible assets and all gains and/or losses included in earnings, and uses FTE net interest income.

The following table provides a reconciliation of this non-GAAP financial measure to the amounts reported in Peoples' Consolidated Financial Statements for the periods presented:

	Three Months Ended			Nine Months Ended	
	September 30,	June 30,	September 30,	September 30,	
(Dollars in thousands)	2018	2018	2017	2018	2017
Efficiency ratio:					
Total non-interest expense	$30,829	$35,971	$ 26,558	$95,021	$80,569
Less: Amortization of other intangible assets	862	861	869	2,477	2,603
Adjusted total non-interest expense	$29,967	$35,110	$ 25,689	$92,544	$77,966
Total non-interest income	14,353	13,255	14,446	42,577	41,834
Less: net (loss) gain on investment securities	—	(147)	1,861	(146)	2,219
Less: net gain (loss) on asset disposals and other transactions	12	(405)	(25)	(319)	81
Adjusted total non-interest income	$14,341	$13,807	$ 12,610	$43,042	$39,534
Net interest income	$33,324	$32,808	$ 29,220	$95,491	$84,255
Add: Fully tax-equivalent adjustment (a)	221	223	460	670	1,471
Net interest income on a fully tax-equivalent basis	$33,545	$33,031	$ 29,680	$96,161	$85,726
Adjusted revenue	$47,886	$46,838	$ 42,290	$139,203	$125,260
Efficiency ratio	62.58 %	74.96 %	60.74 %	66.48 %	62.24 %
Core non-interest expense	$29,978	$29,915	$ 26,558	$87,965	$80,569
Less: Amortization of other intangible assets	862	861	869	2,477	2,603
Adjusted core non-interest expense	$29,116	$29,054	$ 25,689	$85,488	$77,966
Adjusted revenue	47,886	46,838	42,290	139,203	125,260
Efficiency ratio adjusted for non-core items	60.80 %	62.03 %	60.74 %	61.41 %	62.24 %

(a) Used a 21% federal corporate income tax rate for 2018 periods and a 35% federal corporate income tax rate for the 2017 periods.

Peoples' efficiency ratio for the third quarter of 2018 was 62.6%, compared to 75.0% for the second quarter of 2018 and 60.7% for the third quarter of 2017. The efficiency ratio, when adjusted for non-core expenses, was 60.8% for the third quarter of 2018, compared to 62.0% for the second quarter of 2018 and 60.7% for the third quarter of 2017. The decline in the

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efficiency ratio compared to the linked quarter was primarily due to the acquisition-related expenses recognized during the second quarter of 2018, while the increase compared to the third quarter of 2017 was mostly due to higher total non-interest expense. For the first nine months of 2018, the efficiency ratio was 66.5%, compared to 62.2% for the same period in 2017. The efficiency ratio for the first nine months of 2018, when adjusted for non-core expenses, was 61.4% and was 62.2% for the first nine months of 2017. Management is targeting an efficiency ratio of 60% to 62% for the fourth quarter of 2018, after excluding acquisition-related expenses and other non-core expenses.

Return on Average Tangible Stockholders' Equity

The return on average tangible stockholders' equity ratio is a key financial measure used to monitor performance. The return on tangible stockholders' equity is calculated as net income (less after-tax impact of amortization of other intangible assets) divided by tangible stockholders' equity. The return on tangible stockholders' equity is calculated as net income (less the after-tax impact of amortization of other intangible assets) divided by tangible stockholders' equity. This measure is non-GAAP since it excludes amortization of other intangible assets from earnings and the impact of goodwill and other intangible assets acquired through acquisitions on total stockholders' equity.

	Three Months Ended			Nine Months Ended	
	September 30,	June 30,	September 30,	September 30,	
(Dollars in thousands)	2018	2018	2017	2018	2017
Annualized net income excluding amortization of other intangible assets:					
Net income	$12,725	$7,892	$ 10,895	$32,358	$29,470
Add: amortization of other intangible assets	862	861	869	2,477	2,603
Less: tax effect of amortization of other intangible assets (a)	181	181	304	520	911
Net income excluding amortization of other intangible assets	$13,406	$8,572	$ 11,460	$34,315	$31,162
Days in the quarter	92	91	92	273	273
Days in the year	365	365	365	365	365
Annualized net income	$50,485	$31,655	$ 43,225	$43,263	$39,401
Annualized net income excluding amortization of other intangible assets	$53,187	$34,382	$ 45,466	$45,879	$41,663
Average tangible stockholders' equity:					
Total average stockholders' equity	$501,785	$489,876	$ 456,198	$482,138	$447,592
Less: average goodwill and other intangible assets	163,615	161,600	144,267	156,540	144,950
Average tangible stockholders' equity	$338,170	$328,276	$ 311,931	$325,598	$302,642
Return on average stockholders' equity ratio:					
Annualized net income	$50,485	$31,655	$ 43,225	$43,263	$39,401
Average stockholders' equity	$501,785	$489,876	$ 456,198	$482,138	$447,592
Return on average stockholders' equity	10.06 %	6.46 %	9.48 %	8.97 %	8.80 %
Return on average tangible stockholders' equity ratio:					
Annualized net income excluding amortization of other intangible assets	$53,187	$34,382	$ 45,466	$45,879	$41,663
Average tangible stockholders' equity	$338,170	$328,276	$ 311,931	$325,598	$302,642
Return on average tangible stockholders' equity	15.73 %	10.47 %	14.58 %	14.09 %	13.77 %

(a) Used a 21% federal corporate income tax rate for 2018 periods and 35% for the 2017 periods.

The return on average stockholders' equity and average tangible stockholders' equity ratios increased in the third quarter of 2018 compared to both the linked quarter and the third quarter of 2017, reflecting increases in net income, which were partially offset by dividends declared and paid during each quarter.

The return on average stockholders' equity and average tangible stockholders' equity ratios were impacted in the second quarter of 2018 by the ASB acquisition which created increases in capital and decreased net income due to the acquisition-

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related costs, which include gains and losses. However, the ASB acquisition-related costs were primarily recorded in the second quarter of 2018 and should not continue to decrease the return on average stockholders' equity.

FINANCIAL CONDITION

Cash and Cash Equivalents

At September 30, 2018, Peoples' interest-bearing deposits in other banks increased $20.5 million from December 31, 2017. The total cash and cash equivalent balance included $25.0 million of excess cash reserves being maintained at the FRB of Cleveland at September 30, 2018, compared to $9.3 million at December 31, 2017. The amount of excess cash reserves maintained is dependent upon Peoples' daily liquidity position, which is driven primarily by changes in deposit and loan balances.

Through the first nine months of 2018, Peoples' total cash and cash equivalents increased $23.0 million as Peoples' net cash used in investing activities of $121.7 million was less than the sum of net cash provided by financing and operating activities of $94.4 million and $50.3 million, respectively. Peoples' investing activities reflected a net increase of $113.4 million in loans and purchases of $120.5 million in available-for-sale investment securities, which were partially offset by $111.3 million in net proceeds from sales, principal payments, calls and prepayments on available-for-sale and held-to-maturity investment securities. Financing activities included a net increase of $111.7 million in deposits offset partially by $15.3 million of cash dividends paid.

Through the first nine months of 2017, Peoples' total cash and cash equivalents increased $3.9 million as Peoples' net cash provided by financing and operating activities of $128.1 million exceeded cash used in investing activities of $124.2 million. Peoples' investing activities reflected purchases of $142.1 million in available-for-sale and held-to-maturity investment securities and a net increase of $99.8 million in loans, which were partially offset by $120.7 million in net proceeds from sales, principal payments, calls and prepayments on available-for-sale and held-to-maturity investment securities. Financing activities included a net increase of $154.9 million in deposits which was offset partially by a net decrease of $61.3 million in borrowings and $10.9 million of cash dividends paid.

Further information regarding the management of Peoples' liquidity position can be found later in this discussion under “Interest Rate Sensitivity and Liquidity.”

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Investment Securities

The following table provides information regarding Peoples' investment portfolio:

(Dollars in thousands)	September 30, 2018	June 30, 2018	March 31, 2018	December 31, 2017	September 30, 2017
Available-for-sale securities, at fair value:					
Obligations of:					
U.S. Treasury and government agencies	$ —	$43	$—	$ —	$ —
States and political subdivisions	93,790	96,913	97,205	101,569	104,560
Residential mortgage-backed securities	688,656	688,002	681,746	673,664	672,106
Commercial mortgage-backed securities	6,713	6,799	6,864	6,976	7,128
Bank-issued trust preferred securities	4,166	4,167	5,095	5,129	5,154
Equity investment securities (a)	—	—	—	7,849	8,073
Total fair value	$ 793,325	$795,924	$790,910	$ 795,187	$ 797,021
Total amortized cost	$ 819,431	$816,217	$808,689	$ 797,732	$ 792,810
Net unrealized (loss) gain	$ (26,106)	$(20,293)	$(17,779)	$ (2,545)	$ 4,211
Held-to-maturity securities, at amortized cost:					
Obligations of:					
States and political subdivisions	$ 4,451	$4,530	$3,807	$ 3,810	$ 3,812
Residential mortgage-backed securities	29,765	30,668	31,590	32,487	33,648
Commercial mortgage-backed securities	3,574	3,636	4,254	4,631	4,703
Total amortized cost	$ 37,790	$38,834	$39,651	$ 40,928	$ 42,163
Other investment securities (a)	$ 43,044	$42,007	$46,756	$ 38,371	$ 38,371
Total investment portfolio:					
Amortized cost	$ 900,265	$897,058	$895,096	$ 877,031	$ 873,344
Carrying value	$ 874,159	$876,765	$877,317	$ 874,486	$ 877,555

(a) As of January 1, 2018, Peoples adopted ASU 2016-01, resulting in the reclassification of equity investment securities from available-for-sale investment securities to other investment securities. At December 31, 2017, $7.8 million of equity investment securities were included in available-for-sale investment securities, and at September 30, 2018, $278,000 of equity investment securities were included in other investment securities compared to $294,000 and $7.5 million at June 30, 2018 and March 31, 2018, respectively.

During the second quarter of 2018, Peoples acquired, in the ASB acquisition, investment securities totaling approximately $18.8 million and subsequently sold approximately $14.6 million of acquired available-for-sale investment securities.

Peoples' investment in residential and commercial mortgage-backed securities largely consists of securities either guaranteed by the U.S. government or issued by U.S. government sponsored agencies, such as Fannie Mae and Freddie Mac. The remaining portions of Peoples' mortgage-backed securities consist of securities issued by other entities, including other financial institutions, which are not guaranteed by the U.S. government.

The amount of these "non-agency" securities included in the residential mortgage-backed securities totals above was as follows:

(Dollars in thousands)	September 30, 2018	June 30, 2018	March 31, 2018	December 31, 2017	September 30, 2017
Total fair value	$ 919	$1,162	$ 1,478	$ 1,924	$ 2,067
Total amortized cost	985	1,225	1,607	2,109	2,253
Net unrealized loss	$ (66)	$(63)	$ (129)	$ (185)	$ (186)

Management continues to reinvest the principal runoff from the non-agency securities in U.S. agency investments, which accounted for the decline in the past year. At September 30, 2018, Peoples' non-agency portfolio consisted entirely of first lien residential mortgages, with nearly all of the underlying loans in these securities originated prior to

2004 and possessing fixed interest rates. Management continues to monitor the non-agency portfolio closely for leading indicators of increasing stress and will continue to be proactive in taking actions to mitigate such risk when necessary.

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Additional information regarding Peoples' investment portfolio can be found in Note 3 of the Notes to the Unaudited Consolidated Financial Statements.

Loans

The following table provides information regarding outstanding loan balances:

(Dollars in thousands)	September 30, 2018	June 30, 2018	March 31, 2018	December 31, 2017	September 30, 2017
Gross originated loans:					
Commercial real estate, construction	$103,562	$107,255	$99,757	$107,118	$111,187
Commercial real estate, other	630,720	650,512	627,932	595,447	573,256
Commercial real estate	734,282	757,767	727,689	702,565	684,443
Commercial and industrial	510,591	471,270	455,243	438,051	407,468
Residential real estate	299,768	299,934	302,890	304,523	304,094
Home equity lines of credit	92,892	89,957	87,722	88,902	88,421
Consumer, indirect	396,701	373,384	347,607	340,390	335,436
Consumer, direct	72,601	71,545	67,386	67,010	68,286
Consumer	469,302	444,929	414,993	407,400	403,722
Deposit account overdrafts	649	860	543	849	507
Total originated loans	$2,107,484	$2,064,717	$1,989,080	$1,942,290	$1,888,655
Gross acquired loans (a):					
Commercial real estate, construction	$13,050	$14,780	$8,054	$8,319	$8,565
Commercial real estate, other	191,993	207,195	156,115	165,120	174,157
Commercial real estate	205,043	221,975	164,169	173,439	182,722
Commercial and industrial	41,188	40,938	33,815	34,493	36,462
Residential real estate	308,178	309,629	194,063	184,864	194,950
Home equity lines of credit	42,961	45,933	20,008	20,575	22,366
Consumer, indirect	161	198	253	329	408
Consumer, direct	2,712	3,101	940	1,147	1,472
Consumer	2,873	3,299	1,193	1,476	1,880
Total acquired loans	$600,243	$621,774	$413,248	$414,847	$438,380
Total loans	$2,707,727	$2,686,491	$2,402,328	$2,357,137	$2,327,035
Percent of loans to total loans:					
Commercial real estate, construction	4.3%	4.5%	4.5%	4.9%	5.1%
Commercial real estate, other	30.4%	31.9%	32.6%	32.3%	32.2%
Commercial real estate	34.7%	36.4%	37.1%	37.2%	37.3%
Commercial and industrial	20.3%	19.1%	20.4%	20.0%	19.1%
Residential real estate	22.5%	22.7%	20.7%	20.8%	21.4%
Home equity lines of credit	5.0%	5.1%	4.5%	4.6%	4.8%
Consumer, indirect	14.7%	13.9%	14.5%	14.5%	14.4%
Consumer, direct	2.8%	2.8%	2.8%	2.9%	3.0%
Consumer	17.5%	16.7%	17.3%	17.4%	17.4%
Deposit account overdrafts (b)	NM	NM	NM	NM	NM
Total percentage	100.0%	100.0%	100.0%	100.0%	100.0%
Residential real estate loans being serviced for others	$458,999	$451,391	$412,154	$412,965	$409,199

(a) Includes all loans acquired, and related loan discount or premium, recorded in 2012 and thereafter. Loans that were acquired and subsequently re-underwritten, are reported as originated upon execution of such credit actions (for example, renewals and increases in lines of credit).

(b) Not meaningful.

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As of September 30, 2018, balances in loan accounts acquired from ASB totaled $216.6 million, including $119.8 million in residential real estate loans, $52.0 million in commercial real estate loans, $25.4 million in home equity lines of credit, $10.0 million in commercial and industrial loans, $7.5 million in construction loans, and $1.9 million in consumer loans.

Period-end total loan balances at September 30, 2018 increased $21.2 million, or 3% annualized, compared to June 30, 2018, due to organic growth of $33.4 million, or 5% annualized, that was muted by $30.4 million of payoffs and paydowns related to several large commercial real estate loan relationships. Commercial and industrial loan balances experienced significant organic growth compared to June 30, 2018, and increased $41.5 million, or 8%. Consumer indirect lending continued to provide additional organic growth, with balances increasing $25.6 million, or 28% annualized, compared to June 30, 2018. Compared to December 31, 2017, total loan balances increased $350.6 million, or 20% annualized, and were up $380.7 million, or 16%, from September 30, 2017. The increases in the first nine months of 2018, were mostly due to acquired loans from ASB, coupled with organic growth in commercial and industrial loans of $69.3 million and consumer indirect loans of $56.1 million.

Loan Concentration

Peoples categorizes its commercial loans according to standard industry classifications and monitors for concentrations in a single industry or multiple industries that could be impacted by changes in economic conditions in a similar manner. Peoples' commercial lending activities continue to be spread over a diverse range of businesses from all sectors of the economy, with no single industry comprising over 10% of Peoples' total loan portfolio.

Loans secured by commercial real estate, including commercial construction loans, continued to comprise the largest portion of Peoples' loan portfolio. The following table provides information regarding the largest concentrations of commercial real estate loans within the loan portfolio at September 30, 2018:

(Dollars in thousands)	Outstanding Balance	Loan Commitments	Total Exposure	% of Total
Commercial real estate, construction:				
Apartment complexes	$ 33,795	$ 36,989	$ 70,784	35.3 %
Office buildings	10,582	14,351	24,933	12.4 %
Assisted living facilities and nursing homes	6,501	17,690	24,191	12.1 %
Mixed used facility	14,153	8,783	22,936	11.4 %
Educational services	8,777	—	8,777	4.4 %
Light industrial	8,507	108	8,615	4.3 %
Child care	3,750	2,345	6,095	3.0 %
Residential Property	2,032	1,962	3,994	2.0 %
Other (a)	28,515	1,482	29,997	15.1 %
Total commercial real estate, construction	$ 116,612	$ 83,710	$ 200,322	100.0 %

(a) All other outstanding balances are less than 2% of the total loan portfolio.

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(Dollars in thousands)	Outstanding Balance	Loan Commitments	Total Exposure	% of Total
Commercial real estate, other:				
Mixed-use facilities:				
Owner occupied	35,350	726	36,076	4.2 %
Non-owner occupied	72,255	2,334	74,589	8.7 %
Total mixed-use facilities	107,605	3,060	110,665	12.9 %
Office buildings and complexes:				
Owner occupied	$ 44,389	$ 2,789	$ 47,178	5.5 %
Non-owner occupied	48,831	796	49,627	5.8 %
Total office buildings and complexes	93,220	3,585	96,805	11.3 %
Apartment complexes	92,372	662	93,034	10.9 %
Light industrial facilities:				
Owner occupied	48,346	3,779	52,125	6.1 %
Non-owner occupied	17,896	1,088	18,984	2.2 %
Total light industrial facilities	66,242	4,867	71,109	8.3 %
Retail facilities:				
Owner occupied	27,979	1,439	29,418	3.4 %
Non-owner occupied	32,361	98	32,459	3.8 %
Total retail facilities	60,340	1,537	61,877	7.2 %
Lodging and lodging related	33,089	347	33,436	3.9 %
Warehouse facilities	30,747	669	31,416	3.7 %
Assisted living facilities and nursing homes	29,890	256	30,146	3.5 %
Other	309,208	20,765	327,973	38.3 %
Total commercial real estate, other	$ 822,713	$ 35,748	$ 856,461	100.0 %

Peoples' commercial lending activities continue to focus on lending opportunities inside its primary and secondary market areas within Ohio, West Virginia and Kentucky. In all other states, the aggregate outstanding balances of commercial loans in each state were not material at either September 30, 2018 or December 31, 2017.

Allowance for Loan Losses

The amount of the allowance for loan losses at the end of each period represents management's estimate of expected losses from existing loans based upon its quarterly analysis of the loan portfolio. While this process involves allocations being made to specific loans and pools of loans, the entire allowance is available for all losses incurred within the loan portfolio.

The following details management's allocation of the allowance for loan losses:

(Dollars in thousands)	September 30, 2018	June 30, 2018	March 31, 2018	December 31, 2017	September 30, 2017
Commercial real estate	$ 7,966	$ 8,271	$ 8,062	$ 7,797	$ 7,534
Commercial and industrial	6,138	5,365	5,269	5,813	6,415
Total commercial	14,104	13,636	13,331	13,610	13,949
Residential real estate	999	1,005	1,086	904	924
Home equity lines of credit	708	618	690	693	679
Consumer, indirect	3,423	3,339	3,034	2,944	2,814
Consumer, direct	395	465	473	464	441
Consumer	3,818	3,804	3,507	3,408	3,255
Deposit account overdrafts	95	95	76	70	70
Originated allowance for loan losses	19,724	19,158	18,690	18,685	18,877
Acquired allowance for loan losses	155	108	108	108	115
Allowance for loan losses	$ 19,879	$ 19,266	$ 18,798	$ 18,793	$ 18,992
	0.73 %	0.72 %	0.78 %	0.80 %	0.82 %

As a percent of total loans, net of deferred fees and costs

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At September 30, 2018, the allowance for loan losses was $19.9 million, compared to $18.9 million at September 30, 2017 and $18.8 million at December 31, 2017. The ratio of the allowance for loan losses as a percent of total loans, net of deferred fees and costs, was 0.73% at September 30, 2018, compared to 0.82% at September 30, 2017 and 0.80% at December 31, 2017. The ratio includes all acquired loans, from both ASB and previous acquisitions, of $600.2 million and allowance for acquired loan losses of $155,000. The declines in the ratio were attributable to stable asset quality metrics, and to the ASB acquisition, as the loans acquired from ASB were recorded at a preliminary fair value, in accordance with generally accepted accounting principles, and no allowance for loan loss related to these loans has been recorded based on an analysis of the loans as of September 30, 2018. The allowance for loan loss continued to increase slightly as consumer indirect lending balances increased $25.6 million, or 28% annualized, compared to June 30, 2018.

The significant allocations of allowance for loan losses to commercial loans reflect the higher credit risk associated with this type of lending and the size of this loan category in relationship to the entire loan portfolio. The allowance allocated to the residential real estate and consumer loan categories is based upon Peoples' allowance methodology for homogeneous pools of loans. The fluctuations in these allocations have been directionally consistent with the changes in loan quality, loss experience and loan balances in these categories.

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The following table summarizes Peoples' net charge-offs and recoveries:

(Dollars in thousands)	Three Months Ended September 30, 2018	June 30, 2018	March 31, 2018	December 31, 2017	September 30, 2017
Gross charge-offs:					
Commercial real estate, other	$—	$7	$842	$ 383	$ —
Commercial and industrial	—	7	31	10	48
Residential real estate	66	82	145	186	245
Home equity lines of credit	10	20	37	31	80
Consumer, indirect	488	550	929	617	494
Consumer, direct	78	109	110	104	106
Consumer	566	659	1,039	721	600
Deposit account overdrafts	311	215	205	271	246
Total gross charge-offs	$953	$990	$2,299	$ 1,602	$ 1,219
Recoveries:					
Commercial real estate, other	$15	$28	$15	$ 11	$ 19
Commercial and industrial	10	—	—	—	1
Residential real estate	32	41	26	24	19
Home equity lines of credit	3	2	7	4	3
Consumer, indirect	131	138	134	166	175
Consumer, direct	31	15	69	27	46
Consumer	162	153	203	193	221
Deposit account overdrafts	44	46	70	56	47
Total recoveries	$266	$270	$321	$ 288	$ 310
Net charge-offs (recoveries):					
Commercial real estate, other	$(15)	$(21)	$827	$ 372	$ (19)
Commercial and industrial	(10)	7	31	10	47
Residential real estate	34	41	119	162	226
Home equity lines of credit	7	18	30	27	77
Consumer, indirect	357	412	795	451	319
Consumer, direct	47	94	41	77	60
Consumer	404	506	836	528	379
Deposit account overdrafts	267	169	135	215	199
Total net charge-offs	$687	$720	$1,978	$ 1,314	$ 909
Ratio of net charge-offs to average total loans (annualized):					
Commercial real estate	— %	— %	0.14 %	0.06 %	— %
Commercial and industrial	— %	— %	0.01 %	— %	0.01 %
Residential real estate	— %	0.01 %	0.02 %	0.03 %	0.04 %
Home equity lines of credit	— %	— %	0.01 %	— %	0.02 %
Consumer, indirect	0.05 %	0.06 %	0.13 %	0.08 %	0.05 %
Consumer, other	0.01 %	0.01 %	0.01 %	0.01 %	0.01 %
Consumer	0.06 %	0.07 %	0.14 %	0.09 %	0.06 %
Deposit account overdrafts	0.04 %	0.03 %	0.02 %	0.04 %	0.03 %
Total	0.10 %	0.11 %	0.34 %	0.22 %	0.16 %

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The increase in net charge-offs during the first quarter of 2018 had been primarily related to one acquired commercial loan relationship and increased consumer indirect charge-offs related to the increased portfolio. During the second and third quarters of 2018, the net charge-offs decreased as Peoples' asset quality remained stable.
The following table details Peoples’ nonperforming assets:

(Dollars in thousands)	September 30, 2018	June 30, 2018	March 31, 2018	December 31, 2017	September 30, 2017
Loans 90+ days past due and accruing:					
Commercial real estate, construction	$ 401	$—	$—	$ —	$ —
Commercial real estate, other	60	615	71	215	1,272
Commercial real estate	461	615	71	215	1,272
Commercial and industrial	—	—	—	45	832
Residential real estate	1,338	1,308	930	1,278	1,415
Home equity lines of credit	84	6	29	72	15
Consumer, indirect	2	—	—	—	—
Consumer, direct	—	46	—	16	8
Consumer	2	46	—	16	8
Total loans 90+ days past due and accruing	$ 1,885	$1,975	$1,030	$ 1,626	$ 3,542
Nonaccrual loans:					
Commercial real estate, construction	$ 725	$725	$732	$ 754	$ 776
Commercial real estate, other	6,751	6,422	6,268	6,348	7,321
Commercial real estate	7,476	7,147	7,000	7,102	8,097
Commercial and industrial	939	1,265	1,252	506	584
Residential real estate	3,725	3,770	3,967	4,267	4,055
Home equity lines of credit	796	681	656	772	589
Consumer, indirect	286	221	180	158	79
Consumer, direct	14	12	11	32	31
Consumer	300	233	191	190	110
Total nonaccrual loans	$ 13,236	$13,096	$13,066	$ 12,837	$ 13,435
Nonaccrual troubled debt restructurings (TDRs):					
Commercial real estate, other	$ 186	$236	$674	$ 721	$ 336
Commercial and industrial	430	436	487	492	694
Residential real estate	2,087	2,132	1,761	1,447	1,592
Home equity lines of credit	160	71	81	90	85
Consumer, indirect	119	93	126	98	75
Consumer, direct	17	5	7	7	2
Consumer	136	98	133	105	77
Total nonaccrual TDRs	$ 2,999	$2,973	$3,136	$ 2,855	$ 2,784
Total nonperforming loans (NPLs)	$ 18,120	$18,044	$17,232	$ 17,318	$ 19,761
Other real estate owned (OREO):					
Commercial	$ —	$—	$—	$ —	$ 167
Residential	106	63	99	208	109
Total OREO	$ 106	$63	$99	$ 208	$ 276
Total nonperforming assets (NPAs)	$ 18,226	$18,107	$17,331	$ 17,526	$ 20,037
Criticized loans (a)	$ 118,703	$120,809	$116,243	$ 90,418	$ 96,671
Classified loans (b)	49,058	55,596	44,661	46,380	41,233

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(Dollars in thousands)	September 30, 2018		June 30, 2018		March 31, 2018		December 31, 2017		September 30, 2017	
Asset Quality Ratios:										
NPLs as a percent of total loans (c)(d)	0.67	%	0.67	%	0.72	%	0.73	%	0.85	%
NPAs as a percent of total assets (c)(d)	0.46	%	0.46	%	0.48	%	0.49	%	0.56	%
NPAs as a percent of total loans and OREO (c)(d)	0.67	%	0.67	%	0.72	%	0.74	%	0.86	%
Allowance for loan losses as a percent of NPLs (c)	109.71	%	106.77	%	109.08	%	108.52	%	96.11	%
Criticized loans as a percent of total loans (c)	4.38	%	4.50	%	4.84	%	3.84	%	4.15	%
Classified loans as a percent of total loans (c)	1.81	%	2.07	%	1.86	%	1.97	%	1.77	%

(a) Includes loans categorized as special mention, substandard or doubtful.

(b) Includes loans categorized as substandard or doubtful.

(c) Data presented as of the end of the period indicated.

(d) Nonperforming loans include loans 90+ days past due and accruing, troubled debt restructured loans and nonaccrual loans. Nonperforming assets include nonperforming loans and OREO.

Nonperforming loans were relatively unchanged compared to June 30, 2018, and declined $1.6 million, or 8%, compared to September 30, 2017. Classified loans, which are those categorized as substandard or doubtful, declined $6.5 million, or 12%, compared to June 30, 2018, and were up $7.8 million, or 19%, from September 30, 2017. Compared to June 30, 2018, the improvement in classified loans was mostly due to a single commercial relationship that was upgraded from substandard to special mention during the quarter. Criticized loans, which are those categorized as special mention, substandard or doubtful, decreased $2.1 million, or 2%, compared to June 30, 2018, and increased $22.0 million, or 23%, compared to September 30, 2017.

Deposits

The following table details Peoples’ deposit balances:

(Dollars in thousands)	September 30, 2018	June 30, 2018	March 31, 2018	December 31, 2017	September 30, 2017
Non-interest-bearing deposits (a)	$ 617,447	$585,861	$570,804	$ 556,010	$ 724,846
Interest-bearing deposits:					
Interest-bearing demand accounts (a)	547,172	570,359	584,563	593,415	384,261
Savings accounts	473,240	480,615	461,440	446,714	440,633
Money market deposit accounts	391,377	389,893	364,232	371,376	388,876
Governmental deposit accounts	344,320	305,255	341,920	264,524	289,895
Retail certificates of deposit (CDs)	402,309	406,214	335,843	338,673	343,122
Brokered CDs	265,258	211,062	154,379	159,618	93,049
Total interest-bearing deposits	2,423,676	2,363,398	2,242,377	2,174,320	1,939,836
Total deposits	$ 3,041,123	$2,949,259	$2,813,181	$ 2,730,330	$ 2,664,682

(a) The sum of amounts presented is considered total demand deposits.

At September 30, 2018, period-end deposits increased $91.9 million, or 3%, compared to June 30, 2018; $310.8 million, or 11%, compared to December 31, 2017; and $376.4 million, or 14%, compared to September 30, 2017. The growth from December 2017 and September 2017 was largely due to $198.6 million of balances in deposit accounts acquired from ASB on April 13, 2018. Contributing to the linked quarter growth were increases of $39.1 million in governmental deposits and $31.6 million in non-interest-bearing deposits, coupled with higher one-way buy Certificate of Deposit Account Registry Services ("CDARs") deposits, which are included in brokered CD balances. The increase in period-end deposit balances compared to September 30, 2017 was largely due to the acquired deposit balances from ASB remaining at September 30, 2018, coupled with higher one-way buy CDARs deposit balances. Total demand deposit accounts comprised 38% of total deposits at September 30, 2018, compared to 39% at June 30, 2018 and 42% at September 30, 2017. Peoples continues its deposit strategy of growing low-cost core deposits, such as checking and savings accounts and retail CDs when possible, and relying on higher-cost, non-core deposits, such as brokered CDs when deposits are not available in Peoples' footprint.

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Borrowed Funds
The following table details Peoples’ short-term and long-term borrowings:

(Dollars in thousands)	September 30, 2018	June 30, 2018	March 31, 2018	December 31, 2017	September 30, 2017
Short-term borrowings:					
FHLB advances	$ 232,000	$284,566	$104,579	$ 92,592	$ 116,597
Retail repurchase agreements	64,840	76,177	98,896	116,899	77,120
Unamortized debt issuance cost	(10)	(16)	—	—	—
Total short-term borrowings	296,830	360,727	203,475	209,491	193,717
Long-term borrowings:					
FHLB advances	103,860	105,890	116,352	136,939	148,862
National market repurchase agreements	—	—	—	—	40,000
Unamortized debt issuance costs	—	—	(22)	(27)	(33)
Junior subordinated debt securities	7,239	7,195	7,151	7,107	7,061
Total long-term borrowings	111,099	113,085	123,481	144,019	195,890
Total borrowed funds	$ 407,929	$473,812	$326,956	$ 353,510	$ 389,607

Peoples' short-term FHLB advances generally consist of overnight borrowings maintained in connection with the management of Peoples' daily liquidity position. As of September 30, 2018, this included 90-day advances used to fund $100.0 million in an aggregate notional value of interest rate swaps with maturity dates ranging from 2021 to 2028. These advances are expected to be extended every 90 days through the maturity dates of the swaps. Peoples' short-term FHLB advances at September 30, 2018 decreased $63.9 million, and increased $87.3 million, compared to June 30, 2018 and December 31, 2017, respectively. The increase in short-term borrowings compared to December 31, 2017 was primarily related to the funding of the interest rate swaps and long-term FHLB advances being reclassified to short-term borrowings due to the advances maturing within one year, coupled with loan growth out-pacing deposit growth. The increase at June 30, 2018 from March 31, 2018 also includes $21.0 million in short-term FHLB advances acquired from ASB, of which all $21.0 million matured in July of 2018. Peoples continually evaluates the overall balance sheet position given the interest rate environment.
Peoples acquired three interest rate swaps with the ASB acquisition in the second quarter of 2018, which had a notional value of $7.0 million, and all of which matured in July 2018. As of September 30, 2018, Peoples had ten effective interest rate swaps, for an aggregate notional value of $100.0 million, and two additional swaps, with an aggregate notional value of $10.0 million, became effective in October of 2018. These interest rate swaps are associated with Peoples' cash outflows for various FHLB advances. The $43.0 million increase in notional value during the third quarter of 2018 was due to Peoples entering into an additional five interest rate swaps, partially offset by the three acquired interest rate swaps maturing in July 2018. These dates roughly coincide with the maturity of existing FHLB advances.
Additional information regarding Peoples' interest rate swaps can be found in Note 9 of the Notes to the Unconsolidated Financial Statements.

Capital/Stockholders’ Equity
At September 30, 2018, capital levels for both Peoples and Peoples Bank remained substantially higher than the minimum amounts needed to be considered "well capitalized" institutions under applicable banking regulations. These higher capital levels reflect Peoples' desire to maintain a strong capital position. In order to avoid limitations on dividends, equity repurchases and compensation, Peoples must exceed the three minimum required ratios by at least the capital conservation buffer. The capital conservation buffer is being phased in from 0.625% beginning January 1, 2016 to 2.50% by January 1, 2019, and applies to the common equity tier 1 ("CET1") ratio, the tier 1 capital ratio and the total risk-based capital ratio. At September 30, 2018, Peoples' had a capital conservation buffer of 6.30%, compared to 2.50% for the fully phased-in capital conservation buffer required by January 1, 2019. As such, Peoples exceeded the minimum ratios including the capital conservation buffer at September 30, 2018.

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The following table details Peoples' risk-based capital levels and corresponding ratios:

(Dollars in thousands)	September 30, 2018		June 30, 2018		March 31, 2018		December 31, 2017		September 30, 2017	
Capital Amounts:										
Common Equity Tier 1	368,195		$359,645		$335,393		$327,172		$326,966	
Tier 1	375,433		366,840		342,544		334,279		334,027	
Total (Tier 1 and Tier 2)	395,313		386,105		361,343		355,977		355,951	
Net risk-weighted assets	$2,765,328		$2,765,769		$2,524,970		$2,473,329		$2,456,797	
Capital Ratios:										
Common Equity Tier 1	13.31	%	13.00	%	13.28	%	13.23	%	13.31	%
Tier 1	13.58	%	13.26	%	13.57	%	13.52	%	13.60	%
Total (Tier 1 and Tier 2)	14.30	%	13.96	%	14.31	%	14.39	%	14.49	%
Leverage ratio	9.71	%	9.75	%	9.86	%	9.75	%	9.81	%

The capital ratios increased at September 30, 2018 compared to June 30, 2018 due to increased equity as earnings exceeded the dividends declared, while net risk-weighted assets decreased slightly in relation to some large payoffs that were higher volatility commercial real estate loans. Peoples' capital ratios at June 30, 2018 decreased compared to the linked quarter and December 31, 2017 largely due to the percentage of risk-weighted assets acquired from the ASB acquisition that were greater than capital added, net of goodwill, from the ASB acquisition. Leverage ratio decreased slightly due to the increase in average assets in the third quarter of 2018 compared to the second quarter as ASB was acquired on April 13, 2018.

In addition to traditional capital measurements, management uses tangible capital measures to evaluate the adequacy of Peoples' stockholders' equity. Such ratios represent non-GAAP financial measures since their calculation removes the impact of goodwill and other intangible assets acquired through acquisitions on amounts reported in the Consolidated Balance Sheets. Management believes this information is useful to investors since it facilitates the comparison of Peoples' operating performance, financial condition and trends to peers, especially those without a similar level of intangible assets to that of Peoples. Further, intangible assets generally are difficult to convert into cash, especially during a financial crisis, and could decrease substantially in value should there be deterioration in the overall franchise value. As a result, tangible equity represents a conservative measure of the capacity for Peoples to incur losses but remain solvent.

The following table reconciles the calculation of these non-GAAP financial measures to amounts reported in Peoples' Unaudited Consolidated Financial Statements:

(Dollars in thousands)	September 30, 2018	June 30, 2018	March 31, 2018	December 31, 2017	September 30, 2017
Tangible equity:					
Total stockholders' equity	$504,290	$499,339	$456,815	$458,592	$457,386
Less: goodwill and other intangible assets	163,401	163,953	143,820	144,576	143,859
Tangible equity	$340,889	$335,386	$312,995	$314,016	$313,527
Tangible assets:					
Total assets	$4,003,089	$3,972,091	$3,634,929	$3,581,686	$3,552,412
Less: goodwill and other intangible assets	163,401	163,953	143,820	144,576	143,859
Tangible assets	$3,839,688	$3,808,138	$3,491,109	$3,437,110	$3,408,553
Tangible book value per common share:					
Tangible equity	$340,889	$335,386	$312,995	$314,016	$313,527
Common shares outstanding	19,550,014	19,528,952	18,365,035	18,287,449	18,281,194
Tangible book value per common share	$17.44	$17.17	$17.04	$17.17	$17.15
Tangible equity to tangible assets ratio:					
Tangible equity	$340,889	$335,386	$312,995	$314,016	$313,527
Tangible assets	$3,839,688	$3,808,138	$3,491,109	$3,437,110	$3,408,553

Tangible equity to tangible assets	8.88 %	8.81 %	8.97 %	9.14 %	9.20 %

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The decrease in the tangible equity to tangible assets ratio at September 30, 2018 and June 30, 2018, compared to previous periods was due largely to higher tangible assets attributable to loan growth and the ASB acquisition, offset partially by the issuance of equity in the form of common shares in connection with the ASB acquisition.

Interest Rate Sensitivity and Liquidity

While Peoples is exposed to various business risks, the risks relating to interest rate sensitivity and liquidity are major risks that can materially impact future results of operations and financial condition due to their complexity and dynamic nature. The objective of Peoples' asset/liability management ("ALM") function is to measure and manage these risks in order to optimize net interest income within the constraints of prudent capital adequacy, liquidity and safety. This objective requires Peoples to focus on interest rate risk exposure and adequate liquidity through its management of the mix of assets and liabilities, their related cash flows, and the rates earned and paid on those assets and liabilities. Ultimately, the ALM function is intended to guide management in the acquisition and disposition of earning assets, and selection of appropriate funding sources.

Interest Rate Risk

Interest rate risk ("IRR") is one of the most significant risks arising in the normal course of business of financial services companies like Peoples. IRR is the potential for economic loss due to future interest rate changes that can impact the earnings stream as well as market values of financial assets and liabilities. Peoples' exposure to IRR is due primarily to differences in the maturity or repricing of interest-earning assets and interest-bearing liabilities. In addition, other factors, such as prepayments of loans and investment securities, or early withdrawal of deposits, can expose Peoples to IRR and increase interest costs or reduce revenue streams.

Peoples has assigned overall management of IRR to its Asset-Liability Committee (the "ALCO"), which has established an IRR management policy that sets minimum requirements and guidelines for monitoring and managing the level of IRR. The methods used by ALCO to assess IRR remain largely unchanged from those disclosed in Peoples' 2017 Form 10-K. However during the third quarter of 2018, Peoples began using new software for modeling the balance sheet which offers increased capabilities and functionality better suited for Peoples given the growth in the company.

The following table shows the estimated changes in net interest income and the economic value of equity based upon a standard, parallel shock analysis (dollars in thousands):

Increase (Decrease) in Interest Rate	Estimated Increase (Decrease) in Net Interest Income				Estimated (Decrease) Increase in Economic Value of Equity			
(in Basis Points)	September 30, 2018		December 31, 2017		September 30, 2018		December 31, 2017	
300	$7,393	5.6 %	$4,114	3.5 %	$(39,550)	(3.9)%	$(83,466)	(11.9)%
200	5,376	4.1 %	3,368	2.9 %	(22,337)	(2.2)%	(56,377)	(8.0)%
100	3,175	2.4 %	2,252	1.9 %	(6,077)	(0.6)%	(27,710)	(4.0)%
(100)	(8,318)	(6.3)%	(8,352)	(7.1)%	(31,657)	(3.1)%	10,317	1.5 %

Estimated changes in net interest income and economic value of equity are partially driven by assumptions regarding the rate at which non-maturity deposits will reprice given a move in short-term interest rates. Peoples takes a historically conservative approach when determining what repricing rates (deposit betas) are used in modeling interest rate risk. These assumptions are monitored closely by Peoples and are updated at least annually. The actual deposit betas experienced recently by Peoples in the repricing of non-maturity deposits are lower than those used in Peoples' current interest rate risk modeling. Peoples has benefited from this trend in the current interest rate and competitor environment as it has provided for growth in Peoples' net interest income. However, in recent months, Peoples has experienced more pressure on margin expansion and rate competition in it's markets.

At September 30, 2018, Peoples' consolidated balance sheet was positioned to benefit from rising interest rates in terms of potential impact on net interest income. The table above illustrates this point as changes to net interest income increase in the rising rate scenarios. The increase in asset sensitivity from December 31, 2017 was largely attributable to the 90-day advances Peoples entered into to fund the interest rate swaps, effectively reducing the interest rate sensitivity of the liabilities on the balance sheet. However, there was a slight reduction of asset sensitivity as a result of the ASB acquisition. While parallel interest rate shock scenarios are useful in assessing the level of IRR inherent in the balance sheet, interest rates typically move in a non-parallel manner with differences in the timing, direction, and magnitude of changes in short-term and long-term interest rates. Thus, any benefit that might occur as a result of the Federal Reserve increasing short-term interest rates in the future could be offset by an inverse movement in long-term interest rates.

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The table also illustrates a significant reduction in long-term interest rate risk as is evidenced by the drop in the negative impact of rising interest rates on economic value of equity. The reduction is largely attributable to the increased functionality of the new interest rate risk model employed by Peoples during the third quarter, primarily the ability to apply enhanced pre-payment estimates on loans.

Peoples has entered into interest rate swaps as part of its interest rate risk management strategy. These interest rate swaps are designated as cash flow hedges and involve the receipt of variable rate amounts from a counterparty in exchange for Peoples making fixed payments. As of September 30, 2018, Peoples had entered into twelve interest rate swap contracts, ten of which were effective with an aggregate notional value of $100.0 million. The remaining two became effective in October 2018 with an aggregate notional value of $10.0 million. Additional information regarding Peoples' interest rate swaps can be found in Note 14 of the Notes to the Consolidated Financial Statements included in Peoples' 2017 Form 10-K and Note 9 of the Notes to the Unconsolidated Financial Statements included in this Form 10-Q.

Liquidity

In addition to IRR management, another major objective of the ALCO is to maintain a sufficient level of liquidity at Peoples Bank. The methods used by the ALCO to monitor and evaluate the adequacy of Peoples Bank's liquidity position remain unchanged from those disclosed in Peoples' 2017 Form 10-K.

At September 30, 2018, Peoples Bank had liquid assets of $169.1 million, which represented 3.8% of total assets and unfunded loan commitments. This amount exceeded the minimal level by $80.7 million, or 2.0% of total loans and unfunded commitments, currently required under Peoples' liquidity policy. Peoples also had an additional $74.7 million of unpledged investment securities not included in the measurement of liquid assets.

Management believes the current balance of cash and cash equivalents, and anticipated cash flows from the investment portfolio, along with the availability of other funding sources, will allow Peoples to meet anticipated cash obligations, as well as special needs and off-balance sheet commitments.

Off-Balance Sheet Activities and Contractual Obligations

In the normal course of business, Peoples is a party to financial instruments with off-balance sheet risk necessary to meet the financing needs of Peoples' customers. These financial instruments include commitments to extend credit and standby letters of credit. The instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the Consolidated Balance Sheets. The contract amounts of these instruments express the extent of involvement Peoples has in these financial instruments.

Loan Commitments and Standby Letters of Credit

Loan commitments are made to accommodate the financial needs of Peoples' customers. Standby letters of credit are instruments issued by Peoples Bank guaranteeing the beneficiary payment by Peoples Bank in the event of default by Peoples Bank's customer in the performance of an obligation or service. Historically, most loan commitments and standby letters of credit expire unused. Peoples Bank's exposure to credit loss in the event of nonperformance by the counter-party to the financial instrument for loan commitments and standby letters of credit is represented by the contractual amount of those instruments. Peoples Bank uses the same underwriting standards in making commitments and conditional obligations as it does for on-balance sheet instruments. The amount of collateral obtained is based on management's credit evaluation of the customer. Collateral held varies, but may include accounts receivable, inventory, property, plant, and equipment, and income-producing commercial properties.

Peoples Bank routinely engages in activities that involve, to varying degrees, elements of risk that are not reflected in whole or in part in the consolidated financial statements. These activities are part of Peoples Bank's normal course of business and include traditional off-balance sheet credit-related financial instruments, interest rate contracts and commitments to make additional capital contributions in low-income housing tax credit investments. Traditional off-balance sheet credit-related financial instruments continue to represent the most significant off-balance sheet exposure.

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The following table details the total contractual amount of loan commitments and standby letters of credit:

(Dollars in thousands)	September 30, 2018	June 30, 2018	March 31, 2018	December 31, 2017	September 30, 2017
Home equity lines of credit	$ 101,651	$ 103,975	$ 86,787	$ 83,949	$ 84,101
Unadvanced construction loans	71,836	87,477	106,410	112,475	103,732
Other loan commitments	324,059	319,519	267,482	260,552	280,974
Loan commitments	$ 497,546	$ 510,971	$ 460,679	$ 456,976	$ 468,807
Standby letters of credit	$ 9,979	$ 20,354	$ 20,481	$ 20,873	$ 21,788

Management does not anticipate that Peoples Bank's current off-balance sheet activities will have a material impact on its future results of operations and financial condition based on historical experience and recent trends.

ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The information called for by this Item 3 is provided under the caption "Interest Rate Sensitivity and Liquidity" under "ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS" in this Form 10-Q, and is incorporated herein by reference.

ITEM 4 CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Peoples' management, with the participation of Peoples' President and Chief Executive Officer and Peoples' Executive Vice President, Chief Financial Officer and Treasurer, has evaluated the effectiveness of Peoples' disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of September 30, 2018. Based upon that evaluation, Peoples' President and Chief Executive Officer and Peoples' Executive Vice President, Chief Financial Officer and Treasurer have concluded that:

(a) information required to be disclosed by Peoples in this Quarterly Report on Form 10-Q and other reports Peoples files or submits under the Exchange Act would be accumulated and communicated to Peoples' management, including its President and Chief Executive Officer and its Executive Vice President, Chief Financial Officer and Treasurer, as appropriate to allow timely decisions regarding required disclosure;

(b) information required to be disclosed by Peoples in this Quarterly Report on Form 10-Q and other reports Peoples files or submits under the Exchange Act would be recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms; and

(c) Peoples' disclosure controls and procedures were effective as of the end of the fiscal quarter covered by this Quarterly Report on Form 10-Q.

Changes in Internal Control Over Financial Reporting

There were no changes in Peoples' internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that occurred during Peoples' fiscal quarter ended September 30, 2018, that have materially affected, or are reasonably likely to materially affect, Peoples' internal control over financial reporting.

PART II

ITEM 1 LEGAL PROCEEDINGS

In the ordinary course of their respective businesses or operations, Peoples or one of its subsidiaries may be named as a plaintiff, a defendant, or a party to a legal proceeding or any of their respective properties may be subject to various pending and threatened legal proceedings and various actual and potential claims. In view of the inherent difficulty of predicting the outcome of such matters, Peoples cannot state what the eventual outcome of any such matters will be. However, based on management's current knowledge and after consultation with legal counsel, management believes these proceedings will not have a material adverse effect on the consolidated financial position, results of operations or liquidity of Peoples.

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ITEM 1A RISK FACTORS

Peoples has entered into interest rate swaps as part of its interest rate risk management strategy. These interest rate swaps are designated as cash flow hedges and involve the receipt of variable rate amounts from a counterparty in exchange for Peoples making fixed payments. As of September 30, 2018, Peoples had entered into twelve interest rate swap contracts, ten of which were effective with an aggregate notional value of $100.0 million. The remaining two became effective in October 2018 with an aggregate notional value of $10.0 million. Additional information regarding Peoples' interest rate swaps can be found in Note 14 of the Notes to the Consolidated Financial Statements included in Peoples' 2017 Form 10-K and Note 9 of the Notes to the Unconsolidated Financial Statements in this Form 10-Q. Although Peoples expects that each of the hedging relationships will be highly effective as described above, it has not assumed that there will be no ineffectiveness in the hedging relationships. As of September 30, 2018, the termination value of derivative financial instruments was in a net asset position, which included accrued interest but excluded any adjustment for nonperformance risk, related to the twelve interest rate swaps, was $3.9 million. As of September 30, 2018, Peoples has posted collateral of $6.6 million against its obligations under these agreements. If Peoples had breached any of these provisions at September 30, 2018, it could have been required to settle its obligations under the agreements at the termination value.

There have been no other material changes from those risk factors previously disclosed in “ITEM 1A. RISK FACTORS” of Part I of Peoples’ 2017 Form 10-K. Those risk factors are not the only risks Peoples faces. Additional risks and uncertainties not currently known to management or that management currently deems to be immaterial also may materially adversely affect Peoples’ business, financial condition and/or operating results.

ITEM 2 UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

The following table details repurchases by Peoples and purchases by “affiliated purchasers” as defined in Rule 10b-18(a)(3) under the Securities Exchange Act of 1934, as amended, of Peoples’ common shares during the three months ended September 30, 2018:

Period	(a) Total Number of Common Shares Purchased	(b) Average Price Paid per Common Share	(c) Total Number of Common Shares Purchased as Part of Publicly Announced Plans or Programs (1)	(d) Maximum Number (or Approximate Dollar Value) of Common Shares that May Yet Be Purchased Under the Plans or Programs (1)
July 1-31, 2018 (2)(3)	2,189	$ 37.35	—	$ 15,049,184
August 1-31, 2018	—	—	—	15,049,184
September 1-30, 2018 (3)	320	36.51	—	15,049,184
Total	2,509	$ 37.25	—	$ 15,049,184

(1) On November 3, 2015, Peoples announced that on that same date, Peoples' Board of Directors authorized a share repurchase program authorizing Peoples to purchase up to $20.0 million of its outstanding common shares. No common shares were purchased under this share repurchase program during the three months ended September 30, 2018.

(2) Information reported includes 1,519 common shares withheld during July to pay income taxes associated with restricted common shares which vested.

(3) Information reported includes 670 common shares and 320 common shares purchased in open market transactions during July and September, respectively, by Peoples Bank under the Rabbi Trust Agreement. The Rabbi Trust Agreement establishes a rabbi trust that holds assets to provide funds for the payment of the benefits under the Peoples Bancorp Inc. Third Amended and Restated Deferred Compensation Plan for Directors of Peoples Bancorp

Inc. and Subsidiaries.

ITEM 3 DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4 MINE SAFETY DISCLOSURES

Not applicable.

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ITEM 5 OTHER INFORMATION

None

ITEM 6 EXHIBITS

Exhibit Number	Description	Exhibit Location
2	Agreement and Plan of Merger, dated as of October 23, 2017, between Peoples Bancorp Inc. and ASB Financial Corp.+	Included as Annex A to the proxy statement / prospectus which forms a part of the Registration Statement on Form S-4 of Peoples Bancorp Inc. ("Peoples") (Registration No. 333-222054)
3.1(a)	Amended Articles of Incorporation of Peoples Bancorp Inc. (as filed with the Ohio Secretary of State on May 3, 1993)	Incorporated herein by reference to Exhibit 3(a) to Peoples' Registration Statement on Form 8-B filed July 20, 1993 (File No. 0-16772)
3.1(b)	Certificate of Amendment to the Amended Articles of Incorporation of Peoples Bancorp Inc. (as filed with the Ohio Secretary of State on April 22, 1994)	Incorporated herein by reference to Exhibit 3.1(b) to Peoples' Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2017 (File No. 0-16772) ("Peoples' September 30, 2017 Form 10-Q")
3.1(c)	Certificate of Amendment to the Amended Articles of Incorporation of Peoples Bancorp Inc. (as filed with the Ohio Secretary of State on April 9, 1996)	Incorporated herein by reference to Exhibit 3.1(c) to Peoples' September 30, 2017 Form 10-Q
3.1(d)	Certificate of Amendment to the Amended Articles of Incorporation of Peoples Bancorp Inc. (as filed with the Ohio Secretary of State on April 23, 2003)	Incorporated herein by reference to Exhibit 3(a) to Peoples' Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2003 (File No. 0-16772) ("Peoples' March 31, 2003 Form 10-Q")
3.1(e)	Certificate of Amendment by Shareholders to the Amended Articles of Incorporation of Peoples Bancorp Inc. (as filed with the Ohio Secretary of State on January 22, 2009)	Incorporated herein by reference to Exhibit 3.1 to Peoples' Current Report on Form 8-K dated and filed on January 23, 2009 (File No. 0-16772)
3.1(f)	Certificate of Amendment by Directors to Articles filed with the Secretary of State of the State of Ohio on January 28, 2009, evidencing adoption of amendments by the Board of Directors of Peoples Bancorp Inc. to Article FOURTH of Amended Articles of Incorporation to establish express terms of Fixed Rate Cumulative Perpetual Preferred Shares, Series A, each without par value, of Peoples Bancorp Inc.	Incorporated herein by reference to Exhibit 3.1 to Peoples' Current Report on Form 8-K dated and filed on February 2, 2009 (File No. 0-16772)

3.1(g)	Amended Articles of Incorporation of Peoples Bancorp Inc. (This document represents the Amended Articles of Incorporation of Peoples Bancorp Inc. in compiled form incorporating all amendments. The compiled document has not been filed with the Ohio Secretary of State.)	Incorporated herein by reference to Exhibit 3.1(g) to Peoples' Annual Report on Form 10-K for the fiscal year ended December 31, 2008 (File No. 0-16772)
3.2(a)	Code of Regulations of Peoples Bancorp Inc.	Incorporated herein by reference to Exhibit 3(b) to Peoples' Registration Statement on Form 8-B filed on July 20, 1993 (File No. 0-16772)
3.2(b)	Certified Resolutions Regarding Adoption of Amendments to Sections 1.03, 1.04, 1.05, 1.06, 1.08, 1.10, 2.03(C), 2.07, 2.08, 2.10 and 6.02 of the Code of Regulations of Peoples Bancorp Inc. by shareholders on April 10, 2003	Incorporated herein by reference to Exhibit 3(c) to Peoples' March 31, 2003 Form 10-Q
3.2(c)	Certificate regarding adoption of amendments to Sections 3.01, 3.03, 3.04, 3.05, 3.06, 3.07, 3.08 and 3.11 of the Code of Regulations of Peoples Bancorp Inc. by shareholders on April 8, 2004	Incorporated herein by reference to Exhibit 3(a) to Peoples' Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2004 (File No. 0-16772)

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

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Exhibit Number	Description	Exhibit Location
3.2(d)	Certificate regarding adoption of amendments to Sections 2.06, 2.07, 3.01 and 3.04 of Peoples Bancorp Inc.'s Code of Regulations by the shareholders on April 13, 2006	Incorporated herein by reference to Exhibit 3.1 to Peoples' Current Report on Form 8-K dated and filed on April 14, 2006 (File No. 0-16772)
3.2(e)	Certificate regarding adoption of an amendment to Section 2.01 of Peoples Bancorp Inc.'s Code of Regulations by the shareholders on April 22, 2010	Incorporated herein by reference to Exhibit 3.2(e) to Peoples' Quarterly Report on Form 10-Q/A (Amendment No. 1) for the quarterly period ended June 30, 2010 (File No. 0-16772)
3.2(f)	Certificate regarding Adoption of Amendment to Division (D) of Section 2.02 of Code of Regulations of Peoples Bancorp Inc. by the Shareholders at the Annual Meeting of Shareholders on April 26, 2018	Incorporated herein by reference to Exhibit 3.1 to Peoples' Current Report on Form 8-K dated and filed on June 28, 2018 (File No. 0-16772)
3.2(g)	Code of Regulations of Peoples Bancorp Inc. (This document represents the Code of Regulations of Peoples Bancorp Inc. in compiled form incorporating all amendments.)	Incorporated herein by reference to Exhibit 3.2 to Peoples' Current Report on Form 8-K dated and filed on June 28, 2018 (File No. 0-16772)
10.1	Peoples Bancorp Inc. Third Amended and Restated 2006 Equity Plan Time-Based Restricted Stock Award Agreement (for Executives) used and to be used to evidence awards of time-based restricted stock granted to executives of Peoples Bancorp Inc. on and after July 31, 2018	Filed herewith
10.2	Peoples Bancorp Inc. Third Amended and Restated 2006 Equity Plan Performance-Based Restricted Stock Award Agreement (for Executives) used and to be used to evidence awards of time-based restricted stock granted to executives of Peoples Bancorp Inc. on and after July 31, 2018	Filed herewith
31.1	Rule 13a-14(a)/15d-14(a) Certifications [President and Chief Executive Officer]	Filed herewith
31.2	Rule 13a-14(a)/15d-14(a) Certifications [Executive Vice President, Chief Financial Officer and Treasurer]	Filed herewith
32	Section 1350 Certifications	Furnished herewith
101.INS	XBRL Instance Document	Submitted electronically herewith #
101.SCH	XBRL Taxonomy Extension Schema Document	Submitted electronically herewith #
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document	Submitted electronically herewith #

101.LAB	XBRL Taxonomy Extension Label Linkbase Document	Submitted electronically herewith #
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document	Submitted electronically herewith #
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document	Submitted electronically herewith #

Attached as Exhibit 101 to the Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2018 of Peoples Bancorp Inc. are the following documents formatted in XBRL (eXtensible Business Reporting Language): (i) Consolidated Balance Sheets (unaudited) at September 30, 2018 and December 31, 2017; (ii) Consolidated Statements of Income (unaudited) for the three and nine months ended September 30, 2018 and 2017; (iii) Consolidated Statements of Comprehensive Income (unaudited) for the three and nine months ended September 30, 2018 and 2017; (iv) Consolidated Statement of Stockholders' Equity (unaudited) for the nine months ended September 30, 2018; (v) Condensed Consolidated Statements of Cash Flows (unaudited) for the nine months ended September 30, 2018 and 2017; and (vi) Notes to the Unaudited Consolidated Financial Statements.

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SIGNATURES

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

			PEOPLES BANCORP INC.
Date:	November 7, 2018	By: /s/	CHARLES W. SULERZYSKI Charles W. Sulerzyski President and Chief Executive Officer
Date:	November 7, 2018	By: /s/	JOHN C. ROGERS John C. Rogers Executive Vice President, Chief Financial Officer and Treasurer