

STERLING CHEMICALS INC

Form 10-Q

May 14, 2008

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**Form 10-Q**

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

**For the quarterly period ended March 31, 2008**

**OR**

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

**For the transition period from            to  
Commission File Number 000-50132**

**Sterling Chemicals, Inc.**  
*(Exact name of registrant as specified in its charter)*

**Delaware**  
*(State or other jurisdiction of  
incorporation or organization)*

**76-0502785**  
*(IRS Employer Identification No.)*

**333 Clay Street, Suite 3600  
Houston, Texas 77002-4109**  
*(Address of principal executive offices)*

**(713) 650-3700**  
*(Registrant's telephone number,  
including area code)*

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 .

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

Large accelerated filer       Accelerated filer       Non-accelerated filer       Smaller reporting company

(Do not check if a smaller reporting company)

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

As of April 30, 2008, Sterling Chemicals, Inc. had 2,828,460 shares of common stock outstanding.

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**IMPORTANT INFORMATION REGARDING THIS FORM 10-Q**

Unless otherwise indicated, references to we, us, our and ours in this Form 10-Q refer collectively to Sterling Chemicals, Inc. and our wholly-owned subsidiaries.

Readers should consider the following information as they review this Form 10-Q:

**Forward-Looking Statements**

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or the Securities Act, and Section 21E of the United States Securities Exchange Act of 1934, as amended, or the Exchange Act. Forward-looking statements give our current expectations or forecasts of future events. All statements other than statements of historical fact are, or may be deemed to be, forward-looking statements. Forward-looking statements include, without limitation, any statement that may project, indicate or imply future results, events, performance or achievements, and may contain or be identified by the words expect, intend, plan, predict, anticipate, estimate, believe, should, could, may, might, will, will be, will continue, forecast, budget and similar expressions. Statements in this report that contain forward-looking statements include, but are not limited to, information concerning our possible or assumed future results of operations and statements about the following subjects:

current and future industry conditions and their effect on our results of operations or financial position;

the extent, timing and impact of expansions of production capacity of our products, by us or by our competitors;

the potential effects of market and industry conditions and cyclicity on our competitiveness, business strategy, results of operations or financial position;

the adequacy of our liquidity;

our environmental management programs and safety initiatives;

our market sensitive financial instruments;

future uses of, and requirements for, financial resources;

future contractual obligations;

future amendments, renewals or terminations of existing contractual relationships;

business strategies;

growth opportunities;

competitive position;

expected financial position;

future cash flows or dividends;

budgets for capital and other expenditures;

plans and objectives of management;

outcomes of legal proceedings;

compliance with applicable laws;

our reliance on marketing partners;

adequacy of insurance coverage or indemnification rights;

the timing and extent of changes in commodity prices for our products or raw materials;

petrochemicals industry production capacity or operating rates;

costs associated with the shut down and decommissioning of our styrene facility;

increases in the cost of, or our ability to obtain, raw materials or energy;

regulatory initiatives and compliance with governmental laws or regulations, including environmental laws or regulations;

customer preferences;

our ability to attract or retain high quality employees;

operating hazards attendant to the petrochemicals industry;

casualty losses, including those resulting from weather related events;

changes in foreign, political, social or economic conditions;

risks of war, military operations, other armed hostilities, terrorist acts or embargoes;

changes in technology, which could require significant capital expenditures in order to maintain competitiveness or could cause existing manufacturing processes to become obsolete;

effects of litigation;

cost, availability or adequacy of insurance; and

various other matters, many of which are beyond our control.

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The risks included here are not exhaustive. Other sections of this report and our other filings with the Securities and Exchange Commission, or the SEC, including, without limitation, our Annual Report on Form 10-K for the fiscal year ended December 31, 2007, or our Annual Report, include additional factors that could adversely affect our business, results of operations or financial performance. See Risk Factors contained in Item 1A of Part I of our Annual Report. Given these risks and uncertainties, investors should not place undue reliance on forward-looking statements. Forward-looking statements included in this Form 10-Q are made only as of the date of this Form 10-Q and are not guarantees of future performance. Although we believe that the expectations reflected in these forward-looking statements are reasonable, such expectations may prove to have been incorrect. All written or oral forward-looking statements attributable to us, or persons acting on our behalf, are expressly qualified in their entirety by these cautionary statements.

**Document Summaries**

Descriptions of documents and agreements contained in this Form 10-Q are provided in summary form only, and such summaries are qualified in their entirety by reference to the actual documents and agreements filed as exhibits to our Annual Report, other periodic reports we file with the SEC or this Form 10-Q.

**Access to Filings**

Access to our annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, and amendments to those reports, filed with or furnished to the SEC pursuant to Section 13(a) of the Exchange Act, as well as reports filed electronically pursuant to Section 16(a) of the Exchange Act, may be obtained through our website (<http://www.sterlingchemicals.com>). Our website provides a hyperlink to a third-party website, where these reports may be viewed and printed at no cost as soon as reasonably practicable after we have electronically filed such material with the SEC. The contents of our website (or the third-party websites accessible through the various hyperlinks) are not, and shall not be deemed to be, incorporated into this report.

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**PART I.**  
**FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**STERLING CHEMICALS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(Unaudited)**  
**(Dollars in Thousands, Except Share Data)**

	<b>Three months ended March 31,</b>	
	<b>2007</b>	
	<b>2008</b>	<b>(As Restated)</b>
Revenues	\$ 38,199	\$ 32,715
Cost of goods sold	33,799	27,088
Gross profit	4,400	5,627
Selling, general and administrative expenses	2,418	2,298
Interest and debt related expenses	4,213	3,461
Interest income	(1,326)	(76)
Loss from continuing operations before income tax	(905)	(56)
Provision for income taxes		
Loss from continuing operations	\$ (905)	\$ (56)
Income (loss) from discontinued operations, net of tax	(6,224)	2,725
Net income (loss)	\$ (7,129)	\$ 2,669
Preferred stock dividends	4,271	3,049
Net loss attributable to common stockholders	\$ (11,400)	\$ (380)
Income (loss) per share of common stock attributable to common stockholders, basic and diluted:		
Loss from continuing operations	\$ (1.83)	\$ (1.10)
Income (loss) from discontinued operations, net of tax	(2.20)	0.96
Basic and diluted loss per share	\$ (4.03)	\$ (0.14)
Weighted average shares outstanding:		
Basic and diluted	2,828,460	2,828,460

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





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**STERLING CHEMICALS, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
**(Unaudited)**  
**(Dollars in Thousands, Except Share Data)**

	<b>March 31, 2008</b>	<b>December 31, 2007</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 170,459	\$ 100,183
Accounts receivable, net of allowance of \$49 and \$39, respectively	11,713	29,157
Inventories, net	5,211	5,044
Prepaid expenses	2,027	3,129
Deferred tax asset	5,029	5,029
Assets of discontinued operations	1,807	71,754
<b>Total current assets</b>	<b>196,246</b>	<b>214,296</b>
Property, plant and equipment, net	76,678	77,677
Other assets, net	14,301	14,471
<b>Total assets</b>	<b>\$ 287,225</b>	<b>\$ 306,444</b>
<b>LIABILITIES AND STOCKHOLDERS DEFICIENCY IN ASSETS</b>		
Current liabilities:		
Accounts payable	\$ 12,248	\$ 13,715
Accrued liabilities	26,038	30,289
Liabilities of discontinued operations	43	4,028
<b>Total current liabilities</b>	<b>38,329</b>	<b>48,032</b>
Long-term debt	150,000	150,000
Deferred tax liability	5,029	5,029
Deferred credits and other liabilities	75,217	77,604
Commitments and contingencies (Note 5)		
Redeemable preferred stock	104,137	99,866
Stockholders' equity:		
Common stock, \$.01 par value (shares authorized 20,000,000; shares issued and outstanding 2,828,460)	28	28
Additional paid-in capital	136,903	141,174
Accumulated deficit	(239,671)	(232,542)
Accumulated other comprehensive income	17,253	17,253
<b>Total stockholders' deficiency in assets</b>	<b>(85,487)</b>	<b>(74,087)</b>

Total liabilities and stockholders' deficiency in assets	\$ 287,225	\$ 306,444
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The accompanying notes are an integral part of the condensed consolidated financial statements.

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**STERLING CHEMICALS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Unaudited)**  
**(Dollars in Thousands)**

	<b>Three months ended March 31,</b>	
	<b>2007</b>	
	<b>(As</b>	
	<b>2008</b>	<b>Restated)</b>
Cash flows from operating activities:		
Net income (loss)	\$ (7,129)	\$ 2,669
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Bad debt expense	10	
Depreciation and amortization	2,635	2,729
Interest amortization	279	100
Unearned income amortization	(2,125)	
Gain on disposal of property, plant and equipment		(182)
Other		10
Change in assets/liabilities:		
Accounts receivable	72,264	17,966
Inventories	14,900	4,255
Prepaid expenses	1,102	1,118
Other assets	(164)	2,181
Accounts payable	(4,303)	(13,405)
Accrued liabilities	(4,905)	(3,581)
Other liabilities	(251)	(5,224)
 Net cash provided by operating activities	 72,313	 8,636
 Cash flows used in investing activities:		
Capital expenditures for property, plant and equipment	(2,037)	(2,248)
Increase in restricted cash		(44,146)
Net proceeds from the sale of property, plant and equipment		182
 Net cash used in investing activities	 (2,037)	 (46,212)
 Cash flows provided by financing activities:		
Repayment of Old Secured Notes		(57,994)
Proceeds from the issuance of Secured Notes		150,000
Debt issuance costs		(6,778)
 Net cash provided by financing activities		 85,228
 Net increase in cash and cash equivalents	 70,276	 47,652

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Cash and cash equivalents	beginning of year	100,183	20,690
Cash and cash equivalents	end of period	\$ 170,459	\$ 68,342

Supplemental disclosures of cash flow information:

Interest paid	\$ (128)	\$ (2,501)
Interest received	1,326	76
Cash paid for income taxes	404	299

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

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**STERLING CHEMICALS, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. Basis of Presentation**

The accompanying unaudited interim condensed consolidated financial statements were prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP, and reflect all adjustments (including normal recurring accruals) which, in our opinion, are considered necessary for the fair presentation of the results for the periods presented. The results of operations and cash flows for the periods presented are not necessarily indicative of the results to be expected for the full year. These statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report.

***Reclassifications***

Certain amounts reported in the consolidated financial statements for the prior periods have been reclassified to conform with the current consolidated financial statement presentation with no effect on net loss or stockholders equity (deficiency in assets). For the three months ended March 31, 2007, we have reclassified amounts between accrued liabilities and other liabilities on the statement of cash flows.

**2. Stock-Based Compensation**

On December 19, 2002, we adopted our 2002 Stock Plan and reserved 363,914 shares of our common stock for issuance under the plan (subject to adjustment). Under our 2002 Stock Plan, officers and key employees, as designated by our Board of Directors, may be issued stock options, stock awards, stock appreciation rights or stock units. There are currently options to purchase a total of 222,500 shares of our common stock outstanding under our 2002 Stock Plan, all at an exercise price of \$31.60, and an additional 141,414 shares of common stock available for issuance under our 2002 Stock Plan.

Stock based compensation expense was zero for the first quarter of 2008 and immaterial for the first quarter of 2007.

**3. Discontinued Operations**

On September 16, 2005, we announced that we were exiting the acrylonitrile business and related derivative operations, which included sodium cyanide and disodium iminodiacetic acid, or DSIDA. These production facilities had been shut down since February 2005 and, after our announcement, we dismantled these facilities. Our decision was based on a history of operating losses incurred by our acrylonitrile and derivatives businesses, and was made after a full review and analysis of our strategic alternatives.

On September 17, 2007, we entered into a long-term exclusive styrene supply agreement and a related railcar purchase and sale agreement with NOVA Chemicals Inc., or NOVA. Under this supply agreement, NOVA had the exclusive right to purchase 100% of our styrene production (subject to existing contractual commitments), the amount of styrene supplied in any particular period being at NOVA's option. In November 2007, this supply agreement, which was subsequently assigned by NOVA to INEOS NOVA, LLC, or INEOS NOVA, obtained clearance under the Hart-Scott-Rodino Act. This clearance caused the supply agreement and the railcar agreement to become effective and triggered a \$60 million payment to us in November 2007. In addition, in accordance with the terms of the supply agreement, INEOS NOVA assumed substantially all of our contractual obligations for future styrene deliveries. After the supply agreement became effective, INEOS NOVA nominated zero pounds of styrene under the supply agreement for the balance of 2007 and, in response, we exercised our right to terminate the supply agreement and permanently shut down our styrene facility. Under the supply agreement, we are responsible for the closure costs of our styrene facility and are also subject to a long-term commitment to not reenter the styrene business for a period of time. We operated our styrene facility through early December 2007, as we completed our production of inventory and exhausted our raw materials and purchase requirements and sold substantially all our inventory during the first quarter of 2008. During 2007 and the first quarter of 2008, we incurred closure costs to decommission our styrene facility of approximately \$1 million and \$9 million, respectively. We expect to incur up to \$5 million in additional decommissioning costs related to the closure of our styrene facility. Our styrene-related personnel continue to work on

the decommissioning and decontamination of our styrene facility and some related tanks and storage areas. We have not developed plans for a reduction in workforce at this time as we hope to transition these employees to new business ventures after their work in decommissioning our styrene facility is complete.

**Table of Contents****STERLING CHEMICALS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In accordance with Statement of Financial Accounting Standards, or SFAS, No. 144, Accounting for the Impairment and Disposal of Long Lived Assets, we have reported the operating results of these businesses as discontinued operations in our condensed consolidated financial statements. The carrying amounts of assets and liabilities related to discontinued operations as of March 31, 2008 and December 31, 2007 were as follows:

	<b>March 31, 2008</b>	<b>December 31, 2007</b>
	<b>(Dollars in Thousands)</b>	
<b>Assets of discontinued operations:</b>		
Accounts receivable, net	\$ 1,165	\$ 55,995
Inventories	642	15,709
Other assets		50
Total	\$ 1,807	\$ 71,754
<b>Liabilities of discontinued operations:</b>		
Accounts payable	\$ 21	\$ 3,363
Accrued liabilities	11	665
Deferred credits and other liabilities	11	
Total	\$ 43	\$ 4,028

Revenues and pre-tax income (loss) from discontinued operations for the three-month periods ended March 31, 2008 and 2007 are presented below (in thousands):

	<b>Three months ended March 31,</b>	
	<b>2008</b>	<b>2007</b>
Revenues	\$ 14,597	\$ 163,400
Income (loss) before income taxes	(6,224)	2,725

Current severance obligations related to the exit from our acrylonitrile operations are detailed below (in thousands):

	<b>Accrued as of December 31, 2007</b>	<b>Additional accruals</b>	<b>Cash payments</b>	<b>Accrued as of March 31, 2008</b>
Severance accrual	\$ 325	\$	\$ 325	\$

**4. Long-Term Debt**

On March 1, 2007, we commenced an offer, or our tender offer, to repurchase all \$100.6 million of our outstanding 10% Senior Secured Notes due 2007, or our Old Secured Notes, pursuant to a tender offer and a redemption. Concurrently with our tender offer, we solicited consents from the holders of our Old Secured Notes to, among other things, eliminate certain covenants contained in the indenture governing our Old Secured Notes and related security documents. On March 30, 2007, we repurchased \$58 million in aggregate principal amount of Old Secured Notes which were validly tendered prior to the expiration of our tender offer, and paid the accrued interest thereon and

\$0.1 million in consent fees. On April 27, 2007, we redeemed all of our Old Secured Notes that were not tendered pursuant to our tender offer for \$44 million, which included \$1.5 million in accrued interest.

On March 29, 2007, we sold \$150 million aggregate principal amount of unregistered 10<sup>1</sup>/<sub>4</sub>% Senior Secured Notes due 2015, or our Secured Notes, to Jefferies & Company, Inc. and CIBC World Markets Corp., as initial purchasers. Sterling Chemicals Energy, Inc., or Sterling Energy, one of our wholly-owned subsidiaries, was also a party to the Purchase Agreement as a guarantor. On May 6, 2008, Sterling Energy was merged with and into Sterling Chemicals, Inc. Upon consummation of the merger, Sterling Energy no longer had independent existence and, consequently, our Secured Notes are no longer guaranteed by Sterling Energy. On March 29, 2007, we completed a private offering of \$150 million of unregistered Secured Notes pursuant to the Purchase Agreement. In connection with that offering, we entered into an indenture, dated March 29, 2007, among us, Sterling Energy, as guarantor, and U. S. Bank National Association, as trustee and collateral agent. On August 30, 2007, we made an initial filing of an exchange offer registration statement to exchange our unregistered Secured Notes for a new issue of substantially identical debt securities registered under the Securities Act. Pursuant to a registration rights agreement among us, Sterling



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Energy and the initial purchasers, we agreed to use commercially reasonable efforts to cause the registration statement to become effective by December 24, 2007, and complete the exchange offer within 50 days of the effective date of the registration statement. However, the registration statement was not declared effective by December 24, 2007 and, as a result, the interest rate on our Secured Notes increased by 0.25% per annum on December 25, 2007 and an additional 0.25% per annum on March 24, 2008. The interest on our Secured Notes will increase by an additional 0.25% per annum on each of June 23, 2008 and August 21, 2008 if the registration statement is not declared effective by those respective dates. We expect this additional interest to aggregate between \$0.1 million and \$0.2 million depending upon when the registration statement is declared effective by the SEC, of which \$0.1 million was accrued as of March 31, 2008. Once the registration statement is declared effective, the interest rate on our Secured Notes will automatically decrease back to the face amount of 10<sup>1</sup>/<sub>4</sub>% per annum.

Our indenture contains affirmative and negative covenants and customary events of default, including payment defaults, breaches of covenants and certain events of bankruptcy, insolvency and reorganization. If an event of default occurs and is continuing, other than an event of default triggered upon certain bankruptcy events, the trustee under our indenture or the holders of at least 25% in principal amount of our outstanding Secured Notes may declare our Secured Notes to be due and payable immediately. Upon an event of default, the trustee may also take actions to foreclose on the collateral securing our outstanding Secured Notes, subject to the terms of an intercreditor agreement dated March 29, 2007, among us, Sterling Energy, the trustee and The CIT Group/Business Credit, Inc. Our indenture does not require us to maintain any financial ratios or satisfy any financial maintenance tests. We are in compliance with all of the covenants contained in our indenture.

Interest is due on our outstanding Secured Notes on April 1 and October 1 of each year. Our outstanding Secured Notes, which mature on April 1, 2015, are senior secured obligations and rank equally in right of payment with all of our existing and future senior indebtedness. Subject to specified permitted liens, our outstanding Secured Notes are secured (i) on a first priority basis by all of our and Sterling Energy's fixed assets and certain related assets, including, without limitation, all property, plant and equipment, and (ii) on a second priority basis by all of our and Sterling Energy's other assets, including, without limitation, accounts receivable, inventory, capital stock of our domestic restricted subsidiaries (including Sterling Energy), intellectual property, deposit accounts and investment property.

On December 19, 2002, we entered into a Revolving Credit Agreement, or our revolving credit facility, with The CIT Group/Business Credit, Inc., as administrative agent and a lender, and certain other lenders. Under our revolving credit facility, we and Sterling Energy are co-borrowers and are jointly and severally liable for any indebtedness thereunder. Our revolving credit facility is secured by first priority liens on all of our accounts receivable, inventory and other specified assets, as well as all of the issued and outstanding capital stock of Sterling Energy. On March 29, 2007, we amended and restated our revolving credit facility to, among other things, extend the term of our revolving credit facility until March 29, 2012, reduce the maximum commitment thereunder to \$50 million, make certain changes to the calculation of the borrowing base and lower the interest rates and fees charged thereunder. Borrowings under our revolving credit facility now bear interest, at our option, at an annual rate of either a base rate plus 0.0% to 0.50% or the LIBOR rate plus 1.50% to 2.25%, depending on our borrowing availability at the time. We are also required to pay an aggregate commitment fee of 0.375% per year (payable monthly) on any unused portion of our revolving credit facility. Available credit under our revolving credit facility is subject to a monthly borrowing base of 85% of eligible accounts receivable plus 65% of eligible inventory. As of December 31, 2007, our borrowing base exceeded the maximum commitment under our revolving credit facility, making the total credit available under our revolving credit facility \$50 million. However, the monetization of accounts receivable and inventory associated with our exit from the styrene business significantly decreased the borrowing base under our revolving credit facility. As of March 31, 2008, total credit available under our revolving credit facility was limited to \$9.5 million due to this reduced borrowing base. As of March 31, 2008, there were no loans outstanding under our revolving credit facility, and we had \$4.1 million in letters of credit outstanding, resulting in borrowing availability of \$5.4 million. Pursuant to Emerging Issues Task Force Issue No. 95-22, Balance Sheet Classification of Borrowings under Revolving Credit

Agreements That Include both a Subjective Acceleration Clause and a Lock-Box Arrangement, any balances outstanding under our revolving credit facility would be classified as a current portion of long-term debt.

Our revolving credit facility contains numerous covenants and conditions, including, but not limited to, restrictions on our ability to incur indebtedness, create liens, sell assets, make investments, make capital expenditures, engage in mergers and acquisitions and pay dividends. Our revolving credit facility also includes various circumstances and conditions that would, upon their occurrence and subject in certain cases to notice and grace periods, create an event of default thereunder. Our revolving credit facility does not require us to maintain any financial ratios or satisfy any financial maintenance tests. We are in compliance with all of the covenants contained in our revolving credit facility.

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**STERLING CHEMICALS, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**5. Commitments and Contingencies**

*Product Contracts:*

We have long-term agreements, which provide for the dedication of 100% of our production of acetic acid and plasticizers, each to one customer.

*Environmental Regulations:*

Our operations involve the handling, production, transportation, treatment and disposal of materials that are classified as hazardous or toxic and that are extensively regulated by environmental and health and safety laws, regulations and permit requirements. Environmental permits required for our operations are subject to periodic renewal and may be revoked or modified for cause or when new or revised environmental requirements are implemented. Changing and increasingly strict environmental requirements can affect the manufacture, handling, processing, distribution and use of our chemical products and, if so affected, our business and operations may be materially and adversely affected. In addition, changes in environmental requirements may cause us to incur substantial costs in upgrading or redesigning our facilities and processes, including our waste treatment, storage, disposal and other waste handling practices and equipment.

A business risk inherent in chemical operations is the potential for personal injury and property damage claims from employees, contractors and their employees and nearby landowners and occupants. While we believe our business operations and facilities generally are operated in compliance with all applicable environmental and health and safety requirements in all material respects, we cannot be sure that past practices or future operations will not result in material claims or regulatory action, require material environmental expenditures or result in exposure or injury claims by employees, contractors or their employees or the public. Some risk of environmental costs and liabilities is inherent in our operations and products, as it is with other companies engaged in similar businesses.

We have incurred, and may continue to incur, liability for investigation and cleanup of waste or contamination at our own facilities or at facilities operated by third parties where we have disposed of waste. We continually review all estimates of potential environmental liabilities, but we may not have identified or fully assessed all potential liabilities arising out of our past or present operations or the amount necessary to investigate and remediate any conditions that may be significant to us. Based on information available at this time and reviews undertaken to identify potential exposure, we believe any amount reserved for environmental matters is adequate to cover our potential exposure for clean-up costs.

Air emissions from our manufacturing facility in Texas City, Texas, or our Texas City facility, are subject to certain permit requirements and self-implementing emission limitations and standards under state and federal laws. Our Texas City facility is subject to the federal government's June 1997 National Ambient Air Quality Standards, or NAAQS, which lowered the ozone and particulate matter concentration thresholds for attainment. Our Texas City facility is located in an area that the Environmental Protection Agency, or EPA, has classified as not having achieved attainment under the NAAQS for ozone, either on a 1-hour or an 8-hour basis. Ozone is typically controlled by reduction of emissions of volatile organic compounds, or VOCs, and nitrogen oxide, or NOx. The Texas Commission for Environmental Quality, or TCEQ, has imposed strict requirements on regulated facilities, including our Texas City facility, to ensure that the air quality control region will achieve attainment under the NAAQS for ozone. Local authorities may also impose new ozone and particulate matter standards. Compliance with these stricter standards may substantially increase our future control costs for emissions of NOx, VOCs and particulate matter, the amount and full impact of which cannot be determined at this time.

In 2002, the TCEQ adopted a revised State Implementation Plan, or SIP, in order to achieve compliance with the 1-hour ozone standard under the Clean Air Act by 2007. The EPA approved this 1-hour SIP, which required an 80% reduction of NOx emissions, and extensive monitoring of emissions of highly reactive VOCs, or HRVOCs, such as ethylene, in the Houston-Galveston-Brazoria area, or the HGB area. We are in full compliance with these regulations. However, the HGB area failed to attain compliance with the 1-hour ozone standard, and Section 185 of the Clean Air Act requires implementation of a program of emissions-based fees until the standard is attained. These Section 185

fees will be assessed on all NOx and VOC emissions in 2008 and beyond in the HGB area which are in excess of 80% of the baseline year. The method for calculating baseline emissions, as well as other details of the program, has not yet been developed. At the present time, we do not expect to be assessed any fee for our emissions for 2008, primarily due to the reduction in emissions from our Texas City facility following the closure of our styrene facility.

**Table of Contents****STERLING CHEMICALS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In April 2004, the HGB area was designated a moderate non-attainment area with respect to the 8-hour ozone standard of the Clean Air Act, which would result in mandated compliance with the 8-hour ozone standard no later than June 15, 2010. However, on June 15, 2007, the Governor of the State of Texas requested that the EPA reclassify the HGB area as a severe non-attainment area, which would result in mandated compliance with the 8-hour ozone standard by June 15, 2019, and the EPA has begun the process of reclassification. On May 23, 2007, the TCEQ formally adopted revisions to the SIP designed to achieve compliance with the 8-hour ozone standard in the HGB area, as a moderate non-attainment area. This 8-hour SIP calls for relatively modest additional controls which will require very little expense on our part. However, the 8-hour SIP will need to be revised if and when the HGB area is reclassified from moderate to severe. The timing and content of any revised 8-hour SIP have not yet been determined. Based on these developments, it is difficult to predict our final cost of compliance under these regulations. However, given the permanent shutdown of our phthalic anhydride, styrene and ethylbenzene facilities, we estimate the additional cost of compliance will range from zero to \$4 million for capital expenditures and the purchase of NOx emissions allowances, depending on the terms of the final 8-hour SIP.

*Legal Proceedings:*

On July 5, 2005, Patrick B. McCarthy, an employee of Kinder-Morgan, Inc., or Kinder-Morgan, was seriously injured at Kinder-Morgan's facilities near Cincinnati, Ohio while attempting to offload a railcar containing one of our plasticizers products. On October 28, 2005, Mr. McCarthy and his family filed a suit in the Court of Common Pleas, Hamilton County, Ohio (Case No. A0509 144) against us and six other defendants. Since that time, the plaintiffs have added two additional defendants to this lawsuit. In addition, we and some of the other defendants have brought Kinder-Morgan into this lawsuit as a third-party defendant. The plaintiffs are seeking in excess of \$32 million in alleged compensatory and punitive damages. Discovery is ongoing in this case as to the underlying cause of the accident and the parties' respective liabilities, if any. At this time, it is impossible to determine what, if any, liability we will have for this incident and we will vigorously defend the suit. We believe that all, or substantially all, of any liability imposed upon us as a result of this suit and our related out-of-pocket costs and expenses will be covered by our insurance policies, subject to a \$1 million deductible which was met in January 2008, and we have set up a receivable of \$0.2 million as of March 31, 2008 for the reimbursement of amounts exceeding the deductible. We do not believe that this incident will have a material adverse affect on our business, financial position, results of operations or cash flows, although we cannot guarantee that a material adverse effect will not occur.

On August 17, 2006, we initiated an arbitration proceeding against BP Chemicals to resolve a dispute involving the interpretation of provisions of our acetic acid Production Agreement with BP Chemicals. Under the Production Agreement, BP Chemicals reimburses our manufacturing expenses and pays us a percentage of the profits derived from the sales of the acetic acid we produce. Historically, the costs of manufacturing charged to our acetic acid business, and reimbursed by BP Chemicals, included the amounts we paid Praxair for carbon monoxide, hydrogen and a blend of carbon monoxide and hydrogen commonly referred to as blend gas. Our acetic acid business has always used all of the carbon monoxide produced by Praxair, other than the small amount of carbon monoxide included in the blend gas. Until July 1, 2006, all of the blend gas produced by Praxair was used by the oxo-alcohols plant included in our plasticizers business. During the period when the oxo-alcohols plant was operating, BP Chemicals was compensated for the use of this blend gas by our oxo-alcohols plant through a credit to the amount of our manufacturing expenses reimbursed by BP Chemicals. Effective July 1, 2006, we permanently closed our oxo-alcohols plant. BP Chemicals has taken the position that it is entitled to continue to deduct a portion of the blend gas credit from the reimbursement of our manufacturing expenses, even though our oxo-alcohols plant has been closed and is no longer taking any blend gas and the Praxair facilities have been modified so that the carbon monoxide previously used in blend gas can be used in our acetic acid operations. Effective August 1, 2006, BP Chemicals began short paying our invoices for manufacturing expenses by the portion of the credit that BP Chemicals claims should continue through July 31, 2016. The disputed portion of the credit averaged approximately \$0.3 million per month during 2006 and 2007, before adjusting for the portion of the profits we receive from BP Chemicals' sale of the acetic

acid we produce. We are also seeking additional damages from BP Chemicals in the arbitration based on what we believe are breaches of duty by BP Chemicals. The parties have abated the arbitration proceedings while they attempt to reach a negotiated settlement. As part of the agreement to abate the arbitration proceedings, BP Chemicals reimbursed us \$0.8 million on February 5, 2007, which was 50% of the disputed credit through that date, and has continued and will continue to pay 50% of the disputed amount each month during the period of negotiation. As of March 31, 2008, the disputed amount is \$6.8 million and we have received payments totaling \$3.2 million. The parties have stipulated that the payments are made without prejudice, in that BP Chemicals is not admitting liability and continues to insist that we remain liable for the disputed portion of

**Table of Contents****STERLING CHEMICALS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

the blend gas credit. According to the agreement, either party may reinstate the arbitration process at any time after August 1, 2007. If the arbitration is reinstated and an award is made, the amounts paid by BP Chemicals will be credited against any sums awarded to us or refunded by us to BP Chemicals, depending on the ruling of the arbitration panel. We believe that our acetic acid Production Agreement does not contemplate the continuation of any portion of the blend gas credit under these circumstances and will vigorously pursue our position. Although we are in a dispute with BP Chemicals over the interpretation of this contractual provision, we believe that we continue to have a constructive working relationship with BP Chemicals, as has been the case since 1986. As part of the on-going settlement negotiations over the blend gas issue, we are discussing an extension of the term of the acetic acid Production Agreement.

On February 21, 2007, we received a summons naming us, several benefit plans and the plan administrators for those plans as defendants in a class action suit, Case No. H-07-0625 filed in the United States District Court, Southern District of Texas, Houston Division. The plaintiffs seek to represent a proposed class of retired employees of Sterling Fibers, Inc., one of our former subsidiaries that we sold in connection with our emergence from bankruptcy in 2002. The plaintiffs are alleging that we were not permitted to increase their premiums for retiree medical insurance based on a provision contained in the asset purchase agreement between us and Cytec Industries Inc. and certain of its affiliates governing our purchase of our former acrylic fibers business in 1997. During our bankruptcy case, we specifically rejected this asset purchase agreement and the bankruptcy court approved that rejection. The plaintiffs are claiming that we violated the terms of the benefit plans and breached fiduciary duties governed by the Employee Retirement Income Security Act and are seeking damages, declaratory relief, punitive damages and attorneys' fees. The parties have taken minimal discovery to date. The plaintiffs have moved for partial summary judgment and for class certification related to their claims for denial of benefits under our retiree medical plans. The parties have fully briefed the issues and the motions are pending before the court. However, the court has stayed all proceedings while the plaintiffs pursue administrative remedies under the terms of our retiree medical plans. On April 23, 2008, the plan administrator denied the plaintiffs' claims under the terms of our retiree medical plans. We are vigorously defending this action and are unable to state at this time if a loss is probable or remote and are unable to determine the possible range of loss related to this matter, if any.

On March 4, 2008, Gulf Hydrogen and Energy, L.L.C., or Gulf Hydrogen, filed suit against us in the 212<sup>th</sup> District Court of Galveston County, Texas (Cause No. 08CV0220) to enforce the provisions of a Memorandum of Understanding, or MOU, entered into between us and Gulf Hydrogen involving the possible sale of our outstanding equity interests to Gulf Hydrogen for approximately \$390 million. This lawsuit also names certain of our officers, a director and our primary stockholder as defendants. Gulf Hydrogen does not allege a specific amount of money damages in the lawsuit but has asked the court to enforce certain MOU provisions which expired on March 1, 2008 including restrictions on our ability to engage in negotiations related to transactions that would result in a change of control or to enter into mergers, stock sales or other transactions relating to a material part of our business or operations and other insignificant restrictions customary for transactions of a similar nature. Gulf Hydrogen alleges that the defendants breached the terms of the MOU and made certain misrepresentations in connection therewith. We are vigorously defending this lawsuit, which we believe is completely without merit. We do not believe that this incident will have a material adverse effect on our business, financial position, results of operations or cash flows, although we cannot guarantee that a material adverse effect will not occur.

We are subject to various other claims and legal actions that arise in the ordinary course of our business. We do not believe that any of these claims and actions, separately or in the aggregate, will have a material adverse effect on our business, financial position, results of operation or cash flows, although we cannot guarantee that a material adverse effect will not occur.

**6. Income Taxes**

During the first quarters of 2008 and 2007, we recorded net tax expense of zero for income taxes from continuing operations. Based on our net operating loss position and projections for the year, we expect that any tax expense or

benefit during 2008 will be fully offset by a related change in the valuation allowance, resulting in an effective tax rate of zero. For the first quarter of 2008, this resulted in \$0.1 million of tax benefit being offset by an increase of \$0.1 million to our valuation allowance. This increase in our valuation allowance brings our total valuation allowance to \$36.2 million

**7. Pension Plans and Other Postretirement Benefits**

Net periodic pension costs consisted of the following components:

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**STERLING CHEMICALS, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

	<b>Three months ended March</b>	
	<b>31,</b>	
	<b>2008</b>	<b>2007</b>
	<b>(Dollars in Thousands)</b>	
Service cost	\$	\$ 152
Interest cost	1,788	1,783
Expected return on plan assets	(2,148)	(2,025)
Amortization	2	