TETON ENERGY CORP
Form 10-Q
August 14, 2007

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U.S. SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended June 30, 2007

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

For the transition period from __________ to __________

Commission file number: 001-31679

TETON ENERGY CORPORATION

(Exact name of registrant as specified in its charter)

DELAWARE	**84-1482290**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)
410 17th Street Suite 1850 Denver, Colorado	**80202**
(Address of principal executive offices)	(Zip Code)

(303) 565-4600

(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 periods that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

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

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

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

As of August 13, 2007, 17,148,372 shares of the issuer s common stock were outstanding.

TETON ENERGY CORPORATION AND SUBSIDIARIES

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SIGNATURES

Form of Senior Subordinated Convertible Note
Form of Common Stock Purchast Warrant
Form of Common Stock Purchase Warrant
Purchase and Sale Agreement
Purchase and Sale Agreement
Placement Agent Agreement
Placement Agency Agreement
Certification of CEO Pursuant to Section 302
Certification of CFO Pursuant to Section 302
Certification of CEO Pursuant to Section 906
Certification of CFO Pursuant to Section 906

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Part 1. FINANCIAL INFORMATION
Item 1. Consolidated Financial Statements
TETON ENERGY CORPORATION AND SUBSIDIARIES
Consolidated Balance Sheets

	June 30, 2007 (Unaudited)	December 31, 2006
Assets		
Current assets:		
Cash and cash equivalents	$ 4,039,616	$ 4,324,784
Trade accounts receivable	920,161	860,070
Advances to operator		401,491
Tubular inventory	148,628	148,628
Fair value of derivatives	205,220	402,867
Prepaid expenses and other assets	183,941	142,163
Debt issuance costs net of amortization of $31,380	1,701,430	
Total current assets	7,198,996	6,280,003
Non-current assets:		
Oil and gas properties (using successful efforts method of accounting)		
Proved	19,874,816	11,635,699
Producing facilities	3,107,667	690,244
Unproved	14,693,970	13,959,480
Wells in progress	12,786,573	8,492,150
Facilities in progress	2,650,518	1,363,644
Land	306,000	300,000
Fixed assets	251,273	242,691
Total property and equipment	53,670,817	36,683,908
Less accumulated depreciation and depletion	(3,040,443)	(1,911,889)
Net property and equipment	50,630,374	34,772,019
Debt issuance costs net	209,335	191,685
Total non-current assets	50,839,709	34,963,704
Total assets	$ 58,038,705	$ 41,243,707
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 6,305,095	$ 1,506,873
Accrued liabilities	2,019,821	4,195,674
Accrued payroll	86,663	890,877
Accrued franchise taxes payable	41,198	30,518
Accrued purchase consideration		775,054

8% senior subordinated convertible notes, net of discount of $8,836,999	163,001	
Derivative contract liabilities	11,527,200	
Total current liabilities	20,142,978	7,398,996
Long term liabilities		
Long term debt senior secured bank debt	6,000,000	
Asset retirement obligations	239,476	78,115
Total long term liabilities	6,239,476	78,115
Total liabilities	26,382,454	7,477,111
Commitments		
Stockholders equity		
Common stock, $0.001 par value, 250,000,000 shares authorized, 16,184,312 and 15,180,649 shares issued and outstanding at June 30, 2007 and December 31, 2006, respectively	16,184	15,180
Additional paid in capital	65,979,000	60,836,839
Stock based compensation	4,931,175	3,138,772
Accumulated deficit	(39,270,108)	(30,224,195)
Total stockholders equity	31,656,251	33,766,596
Total liabilities and stockholders equity	$ 58,038,705	$ 41,243,707

See notes to unaudited consolidated financial statements.

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TETON ENERGY CORPORATION AND SUBSIDIARIES
Consolidated Statements of Operations and Comprehensive Loss
(Unaudited)

	For the Three Months Ended June 30, 2007	For the Three Months Ended June 30, 2006	For the Six Months Ended June 30, 2007	For the Six Months Ended June 30, 2006
Oil and gas sales	$ 832,943	$ 650,234	$ 1,901,284	$ 940,483
Cost of sales and expenses:				
Lease operating expense	64,388	114,410	107,281	148,198
Production taxes	89,306	11,832	153,306	19,850
General and administrative	2,180,291	1,705,942	4,059,639	3,048,745
Depreciation, depletion and amortization	581,288	330,173	1,128,554	425,939
Accretion expense from asset retirement obligations	12,769		20,376	
Exploration expense	308,668	74,745	614,802	215,262
Total cost of sales and expenses	3,236,710	2,237,102	6,083,958	3,857,994
Loss from operations	(2,403,767)	(1,586,868)	(4,182,674)	(2,917,511)
Other income (expense):				
Realized gain on natural gas derivative contract	201,000		255,900	
Unrealized loss on natural gas derivative contracts	(104,761)		(197,647)	
Loss on derivative liabilities	(4,629,390)		(4,629,390)	
Interest income	25,137	60,523	54,118	128,540
Interest expense	(333,186)		(346,220)	
Total other income (expense)	(4,841,200)	60,523	(4,863,239)	128,540
Net loss applicable to common shares	$ (7,244,967)	$ (1,526,345)	$ (9,045,913)	$ (2,788,971)
Basic and diluted weighted average common shares outstanding	16,125,492	12,017,214	15,846,748	11,821,760
Basic and diluted loss per common share	$ (0.45)	$ (0.13)	$ (0.57)	$ (0.24)

See notes to unaudited consolidated financial statements.

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TETON ENERGY CORPORATION AND SUBSIDIARIES
Consolidated Statements of Cash Flows
(Unaudited)

	For the Six Months Ended June 30, 2007	2006
Cash flows from operating activities		
Net loss	$ (9,045,913)	$ (2,788,971)
Adjustments to reconcile net loss to net cash used in operating activities		
Depreciation and depletion	1,128,554	425,939
Debt issuance cost amortization	57,448	
Accretion expense from asset retirement obligations	20,376	
Accrued stock based compensation net of stock returned	1,792,403	1,038,513
Non-cash loss on derivative liabilities	4,629,390	
Unrealized loss-natural gas derivative contracts	197,647	
Accretion of debt discount on 8% senior subordinated convertible notes	163,001	
Changes in assets and liabilities		
Discontinued operations		(255,000)
Trade accounts receivable	50,809	(284,511)
Advances to operator		(3,321)
Prepaid expenses and other current assets	(41,778)	(57,949)
Accounts payable and accrued liabilities	223,499	497,324
Accrued payroll and franchise taxes payable	(793,534)	26,328
	7,427,815	1,387,323
Net cash used in operating activities	(1,618,098)	(1,401,648)
Cash flows from investing activities		
Proceeds from sale of oil and gas properties		2,700,000
Purchase of fixed assets	(8,582)	(103,050)
Development of oil and gas properties	(14,933,234)	(7,037,981)
Net cash used in investing activities	(14,941,816)	(4,441,031)
Cash flows from financing activities		
Proceeds from exercise of warrants and issuance of stock	2,018,755	4,108,756
Proceeds from 8% senior subordinated convertible notes	9,000,000	
Borrowings from senior bank credit facility	6,000,000	
Debt issuance costs from bank debt and 8% senior subordinated convertible notes	(744,009)	(190,328)
Net cash provided by financing activities	16,274,746	3,918,428
Net decrease in cash and cash equivalents	(285,168)	(1,924,251)
Cash and cash equivalents beginning of year	4,324,784	7,064,295

Cash and cash equivalents end of period	$	4,039,616	$	5,140,044
Supplemental disclosure of non-cash activity:				
Accrued stock based compensation	$	1,792,403	$	1,196,013
Reduction in accounting service fees	$		$	(157,500)
Deposit applied to oil and gas properties Note 1	$		$	300,000
Capital expenditures included in accounts payable and accrued liabilities	$	7,366,906	$	1,879,748
Asset retirement obligation additions associated with oil and gas properties	$	140,985	$	
Placement agent warrants recorded as debt issuing costs	$	1,022,220	$	
Sale of Frenchman Creek undeveloped leasehold interest	$	110,900	$	
Reclassification of derivative liabilities to stockholder s equity	$	3,124,410	$	

See notes to unaudited consolidated financial statements.

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TETON ENERGY CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements
(Unaudited)

Note 1 Organization and Summary of Significant Accounting Policies

Organization

Teton Energy Corporation (Teton or the Company) was formed in November 1996 and is incorporated in the State of Delaware. Teton is an independent energy company engaged primarily in the development, production, and marketing of natural gas and oil in North America. The Company s strategy is to increase shareholder value by profitably growing reserves and production, primarily through acquiring under-valued properties with reasonable risk-reward potential and by participating in or actively conducting drilling operations. The Company seeks high-quality exploration and development projects with potential for providing long-term drilling inventories that generate high returns. The Company s current operations are focused in four basins in the Rocky Mountain region of the United States.

Interim Reporting

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information. Pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC), they do not necessarily include all the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, the accompanying unaudited consolidated financial statements include all adjustments (consisting of normal and recurring accruals) considered necessary to present fairly the Company s financial position as of June 30, 2007, the results of operations for the three and six months ended June 30, 2007 and 2006, and cash flows for the six months ended June 30, 2007 and 2006. For a more complete understanding of the Company s operations, financial position and accounting policies, these consolidated unaudited financial statements and the notes thereto should be read in conjunction with the Company s Annual Report on Form 10-K for the year ended December 31, 2006, previously filed with the SEC on March 19, 2007.

In the course of preparing the consolidated financial statements, the Company s management makes various assumptions, judgments, and estimates to determine the reported amount of assets, liabilities, revenue and expenses, and in the disclosures of commitments and contingencies. Changes in these assumptions, judgments, and estimates will occur as a result of the passage of time and the occurrence of future events and, accordingly, actual results could differ from amounts initially established.

The more significant areas requiring the use of assumptions, judgments, and estimates relate to volumes of natural gas and oil reserves used in calculating depletion, the amount of expected future cash flows used in determining possible impairments of oil and gas proved and unproved properties, the amount of accrued capital expenditures used in such calculations, future abandonment obligations, non-cash, stock-based compensation expense related to the Company s Long Term Incentive Plan, and the fair value of derivative liabilities.

Principles of Consolidation

The consolidated financial statements include the accounts of all of the Company s wholly owned subsidiaries. All inter-company profits, transactions, and balances have been eliminated.

Inventory Tubular

Tubular inventory consists primarily of tubular pipe and casing used in the Company s operations and is stated at the lower of average cost or market value.

Sale of Oil and Gas Properties

Effective December 31, 2005, the Company entered into an Acreage Earning Agreement (the Earning Agreement) with Noble Energy, Inc. (Noble), which closed on January 27, 2006. Under the terms of the Earning Agreement, Noble was entitled to earn a 75% working interest in Teton s Denver-Julesburg (DJ) Basin acreage, which included acreage within a defined Area of Mutual Interest (DJ-AMI) after payment of the $3,000,000 and after drilling 20 wells by March 1, 2007 at no cost to Teton. Noble paid the Company $3,000,000 under the Earning Agreement and the Company recorded the entire $3,000,000 (including $300,000, which was reflected as a deposit at December 31, 2005) as a reduction of the investment in its DJ Basin property. Teton is entitled to receive 25% of any net revenues derived from the drilling and completion of those first 20 wells. After completion of the first 20 wells, the Earning Agreement provides that

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TETON ENERGY CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements Continued
(Unaudited)

Teton and Noble will split all costs associated with future drilling and related facilities according to each party s working interest percentage.

On December 21, 2006, the Company received notification from Noble that the first 20 wells had been drilled and completed for the DJ Basin Niobrara pilot project. Therefore, pursuant to the Earning Agreement, Noble earned 75% of all acreage within the DJ-AMI. Teton s interests in the oil and gas rights and leases are recorded directly to Teton DJ Basin LLC, a wholly owned subsidiary.

On May 1, 2007 the Company sold 50% of it s working interest in its Frenchman Creek undeveloped leasehold interest in the DJ Basin to an undisclosed third party, for approximately $110,900. The Company recorded this transaction as a reduction of its investment in the undeveloped leasehold interest.

Purchase of Oil and Gas Properties

On May 5, 2006, the Company closed a definitive agreement with American Oil and Gas, Inc. (American) acquiring a 25% working interest in approximately 87,192 gross acres, or 16,024 net acres in the Williston Basin located in North Dakota for a total purchase price of approximately $6.17 million.

Per the terms of the agreement, the Company paid American approximately $2.47 million in cash at closing and an additional $3.7 million in respect of American s 50% share for drilling and completion of the two planned wells through June 1, 2007. Any portion of the $3.7 million not expended for drilling and completion by June 1, 2007, was required to be paid to American on that date. In addition to the obligation to fund American s share, the Company is also obligated to pay costs in respect of its 25% share of drilling and completion costs of such wells. As of June 30, 2007, the Company satisfied its entire obligation to American.

In May 2007, the Company acquired approximately 12,000 gross and net acres in the Big Horn Basin in the state of Wyoming with a 100 percent working interest for approximately $900,000. At this time, the Company has no partners in this acreage and intends to serve as the project operator.

Debt Issuance Costs

Debt issuance costs are amortized to interest expense over the life of the related credit facility using the effective interest method. The costs incurred in respect to the BNP Paribas Senior Credit Facility in place as of June 30, 2007 had a term of 48 months maturing June 15, 2010 and is included in long-term assets on the Company s consolidated balance sheet. On August 9, 2007, JPMorgan Chase Bank, N.A. (JPMorgan Chase) purchased and assumed the BNP Paribas position in the Credit Facility and the Company and JPMorgan Chase entered into an amended and restated Credit Facility. See Note 9 Subsequent Events and Note 4 Long Term Debt for more information.

In addition, debt issuance costs in respect to the Company s 8% Senior Subordinated Convertible Notes are included in current assets on its consolidated balance sheets. See Note 9 Subsequent Events, JPMorgan Chase Amended and Restated Credit Facility, and Note 3 8% Senior Subordinated Convertible Notes.

Revenue Recognition

Oil and natural gas revenue is recognized monthly based on production and delivery. The Company follows the sales method of accounting for natural gas and crude oil revenue, and recognizes sales revenue on all natural gas or crude oil sold to purchasers at a fixed or determinable price, when delivery has occurred and title has transferred, and if collectibility of the revenue is probable. Processing costs for natural gas that are paid in-kind are deducted from revenue.

The volume of natural gas sold may differ from the volume to which the Company is entitled based on the Company s working interest. When this occurs, a gas imbalance is deemed to exist. An imbalance is recognized as a liability only when the estimated remaining reserves will not be sufficient to enable the under-produced owner(s) to recoup its entitled share through future production. Natural gas imbalances can arise on properties for which two or more owners have the right to take production in-kind. In a typical gas balancing arrangement, each owner is entitled to an agreed-upon percentage of a property s total production; however, at any given time, the amount of natural gas sold by each owner may differ from its allowable percentage. Two principal accounting practices have evolved to account for natural gas imbalances. These methods differ as to whether revenue is recognized based on the actual sale of natural gas (sales method) or an owner s entitled share of the current period s production (entitlement method). The Company has elected to use the sales method. If the Company used the entitlement method, the Company s future reported revenue may be materially different than those reported under the sales method.

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TETON ENERGY CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements Continued
(Unaudited)

At June 30, 2007, there were no gas imbalances in respect to the Company s oil and gas operations.

Successful Efforts Method of Accounting

The Company accounts for its crude oil exploration and natural gas development activities utilizing the successful efforts method of accounting. Under this method, costs of productive exploratory wells, development dry holes, productive wells and undeveloped leases are capitalized. Oil and gas lease acquisition costs are also capitalized. Exploration costs, including personnel costs, certain geological and geophysical expenses and delay rentals for oil and gas leases, are charged to expense as incurred. Exploratory drilling costs are initially capitalized, but charged to expense if and when the well is determined not to have found reserves in commercial quantities. The sale of a partial interest in a proved or an unproved property is accounted for as a cost recovery and no gain or loss is recognized as long as this treatment does not significantly affect the unit-of-production amortization rate. A gain or loss is recognized for all other sales of producing properties or unproved properties.

The application of the successful efforts method of accounting requires managerial judgment to determine the proper classification of wells designated as developmental or exploratory, which will ultimately determine the proper accounting treatment of the costs incurred. The results from a drilling operation can take considerable time to analyze and the determination that commercial reserves have been discovered requires both judgment and industry experience. Wells may be completed that are assumed to be productive and actually deliver oil and gas in quantities insufficient to be economic, which may result in the abandonment of the wells at a later date. Wells are drilled that have targeted geologic structures that are both developmental and exploratory in nature. In this case an allocation of costs to the exploratory and development segments is required. Delineation seismic costs incurred to select development locations within an oil and gas field is typically considered a development cost and capitalized, but often these seismic programs extend beyond the reserve area considered proved and management must estimate the portion of the seismic costs to expense. The evaluation of oil and gas leasehold acquisition costs requires managerial judgment to estimate the fair value of these costs with reference to drilling activity in a given area. Drilling activities in an area by other companies may also effectively condemn leasehold positions.

The successful efforts method of accounting can have a significant impact on our operational results reported when we are entering a new exploratory area in an effort to find an oil and gas field that will be the focus of future development drilling activity.

The initial exploratory wells may be unsuccessful and will be expensed. Seismic costs can be substantial, which will result in additional exploration expense when incurred. In addition, in the event that wells do not produce economic quantities of oil and or gas an impairment event may occur and part or all of the costs capitalized at that point in time would be expensed.

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TETON ENERGY CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements Continued
(Unaudited)

Derivative Financial Instruments

Derivative financial instruments, as defined in Financial Accounting Standard No. 133, Accounting for Derivative Financial Instruments and Hedging Activities (SFAS 133), consist of financial instruments or other contracts that contain a notional amount and one or more underlying variables (e.g., interest rate, security price or other variable), require no initial net investment and permit net settlement. Derivative financial instruments may be free-standing or embedded in other financial instruments. Further, derivative financial instruments are initially, and subsequently, measured at fair value and recorded as liabilities or assets.

The Company generally uses derivative financial instruments to hedge exposures to cash-flow risks. All derivatives are recognized on the balance sheet and measured at fair value. The Company reviews estimated fair values of the derivative contracts as reported by the counterparty s to the contract, and also independently assesses the fair value of derivative contracts and records the changes in the fair value at each reporting period. For derivative contracts that do not qualify as cash flow hedges, changes in the derivative contracts fair value are recorded as unrealized gains and losses based on the change in the contracts fair value and charged to the consolidated statements of income. The Company does not have any derivative contracts that qualify as cash flow hedges. The Company recognizes realized gains and losses in its consolidated statements of income. For the three month and six month periods ended June 30, 2007, the Company recorded unrealized losses on derivative contracts of $104,761 and $197,647, respectively. For the same periods, the Company recorded realized gains on derivative contracts of $201,000 and $255,900, respectively.

The Company has also entered into various types of financing arrangements to fund its business capital requirements, including convertible debt and other financial instruments indexed to the Company s common stock. These contracts require careful evaluation to determine whether derivative features embedded in host contracts require bifurcation and fair value measurement or, in the case of freestanding derivatives (principally warrants) whether certain conditions for equity classification have been achieved. In instances where derivative financial instruments require liability classification, the Company is required to initially and subsequently measure such instruments at fair value. Accordingly, the Company adjusts the fair value of these derivative components at each reporting period through a charge to earnings until such time as the instruments are permitted classification in stockholders equity.

The Company estimates fair values of derivative financial instruments using various techniques (and combinations thereof) that are considered to be consistent with the objective measuring fair values. In selecting the appropriate technique, management considers, among other factors, the nature of the instrument, the market risks that it embodies and the expected means of settlement. For less complex derivative instruments, such as free-standing warrants, the Company generally uses the Black-Scholes-Merton option valuation technique because it embodies all of the requisite assumptions (including trading volatility, estimated terms and risk free rates) necessary to estimate the fair value of these instruments. For complex derivative instruments, such as embedded conversion options, the Company generally uses the Flexible Monte Carlo valuation technique because it embodies all of the requisite assumptions (including credit risk, interest-rate risk and exercise/conversion behaviors) that are necessary to estimate the fair value of these more complex instruments. For forward contracts that contingently require net-cash settlement as the principal means of settlement, the Company projects and discounts future cash flows applying probability-weightage to multiple possible outcomes. Estimating fair values of derivative financial instruments requires the development of significant and subjective estimates that may, and are likely to, change over the duration of the instrument with related changes in internal and external market factors. In addition, option-based techniques are highly volatile and sensitive to changes in the trading market price of our common stock, which has a high-historical volatility. Since derivative financial instruments are initially and subsequently carried at fair values, our income (loss) will reflect the volatility in these estimate and assumption changes.

As of June 30, 2007, derivative financial instruments classified as a component of current liabilities consist of the fair value of financing warrants to purchase 3,600,000 shares of the Company s common stock that do not achieve all of the requisite conditions for equity classification. These freestanding derivative financial instruments arose in connection with the 8.0% Senior Subordinated Convertible Notes financing that is more fully discussed in Note 3.

During the three and six months ended June 30, 2007, the Company incurred expense from the valuation adjustments to derivative liabilities as follows:

Changes in fair value

Derivative Financial Instruments:	
Financing warrants	$ 1,461,024
Compound embedded derivative	306,621
Other warrants	561,111
	2,328,756
Day-one loss from derivative allocation	2,300,634
Loss or derivative liabilities	$ 4,629,390

Our derivative liabilities as of June 30, 2007, and our derivative expense arising from fair value adjustments during the three and six months ended June 30, 2007 are significant to our consolidated financial statements. The magnitude of the derivative expense reflects the following:

(a) During the short period (May 18, 2007 to June 30, 2007) that our derivative liabilities were classified as liabilities, the trading price of our common stock, which significantly affects the fair value of our derivative financial instruments, experienced a material price increase from $4.66 to $5.20.

TETON ENERGY CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements Continued
(Unaudited)

(b) During May 2007, we entered into a $9,000,000 convertible debt and warrant financing arrangement, more fully discussed in Note 3. In connection with our accounting for this financing arrangement we encountered the unusual circumstance of a day-one derivative loss related to the recognition of derivative instruments arising from the arrangement. That means that the fair value of the bifurcated compound derivative and warrants exceeded the net proceeds that we received from the arrangement and we were required to record a loss to record the derivative financial instruments at fair value. The loss that we recorded amounted to $2,300,634. We did not enter into any other financing arrangements during the periods reported that reflected day-one losses.

Significant valuation assumptions:

The following table sets forth the significant assumptions, or ranges of assumptions, underlying the valuation of derivative financial instruments:

Freestanding Warrants:

	Inception Date **(a)**	Reclassification Date **(a)**	Quarter End
Trading market value	$4.66 $4.67	$5.11	$ 5.20
Strike prices	$1.75 $5.00	$1.75 $4.35	$ 5.00
Estimated term (years)	0.88 6.78	0.77 6.66	4.88
Estimated volatility	43.46%	39.01%	
	85.04%	80.07%	69.18%
Risk-free rates	4.62% 4.82%	4.95% 5.02%	4.92%

(a) See Note 3 for pertinent information regarding the origination of freestanding warrants that were classified or reclassified as derivative liabilities. The inception and reclassification date assumptions include those applied to freestanding warrants that were reclassified from stockholders equity. See Note 5 Stockholders Equity.

Compound Derivative:

	Inception Date **(b)(c)**	Reclassification Date **(b)(c)**	Quarter End
Trading market value	$4.66	$5.11	
Conversion price	$5.00	$5.00	
Equivalent term (years)	1.00	.885	
Equivalent volatility	43.67%	43.29%	
	45.50%	50.63%	
Equivalent risk-adjusted interest rate	8.42% 9.00%	8.42% 9.00%	
Equivalent credit-risk adjusted yield	13.67%	13.67%	
	22.67%	22.67%	

(b) See Note 3 for pertinent information regarding the origination of compound-embedded derivative financial instruments. On June 28, 2007, the compound-embedded derivative financial instruments were reclassified to stockholders equity in accordance with EITF 06-07 Issuer s Accounting for a Previously Bifurcated Conversion Option in a Convertible Debt Instrument When the Conversion Option No Longer Meets the Bifurcation Criteria in FAS No. 133.

(c) Equivalent assumption amounts and percentages reflect the net results of multiple simulations that the Monte Carlo Simulation methodology applies to multiple data points in the ranges of the underlying assumptions.

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TETON ENERGY CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements Continued
(Unaudited)

Reclassification

Certain amounts in the 2006 financial statements have been reclassified to conform to the 2007 presentation.

Income Taxes

In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes , an interpretation of Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes (FIN 48). The interpretation creates a single model to address accounting for uncertainty in tax positions. Specifically, the pronouncement prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition of certain tax positions.

The Company adopted the provisions of FIN 48 effective January 1, 2007. The adoption of this accounting principle did not have an effect on our financial statements as of June 30, 2007.

Recently Issued Accounting Pronouncements

In September 2006, the FASB issued Statement No. 157, Fair Value Measurements (SFAS 157). The adoption of SFAS 157 is not expected to have a material impact on our consolidated financial position or results of operations. However, additional disclosures may be required about the information used to develop certain fair value measurements. SFAS 157 establishes a single authoritative definition of fair value, sets out a framework for measuring fair value and requires additional disclosures about fair value measurements. This standard requires companies to disclose the fair value of their financial instruments according to a fair value hierarchy. SFAS 157 does not require any new fair value measurements, but will remove inconsistencies in fair value measurements between various accounting pronouncements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company is currently evaluating this pronouncement for any impact that it might have on its financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, which permits an entity to measure certain financial assets and financial liabilities at fair value. The objective of SFAS No. 159 is to improve financial reporting by allowing entities to mitigate volatility in reported earnings caused by the measurement of related assets and liabilities using different attributes, without having to apply complex hedge accounting provisions. Under SFAS No. 159, entities that elect the fair value option (by instrument) will report unrealized gains and losses in earnings at each subsequent reporting date. The fair value option election is irrevocable, unless a new election date occurs. SFAS No. 159 establishes presentation and disclosure requirements to help financial statement users understand the effect of the entity s election on its earnings, but does not eliminate disclosure requirements of other accounting standards. Assets and liabilities that are measured at fair value must be displayed on the face of the balance sheet. This statement is effective beginning January 1, 2008, and the Company is currently evaluating this pronouncement for any impact that it might have on its financial statements.

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TETON ENERGY CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements Continued
(Unaudited)

Note 2 Earnings per Share

Basic earnings per common share (EPS) are computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that would occur if securities or other contracts to issue common stock were exercised or converted into common stock. All potential dilutive securities have an anti-dilutive effect on earnings (loss) per share and accordingly, basic and dilutive weighted average shares are the same. As of June 30, 2007, a total of 8,499,218 shares of dilutable securities have been excluded from the calculation of EPS as the effect of including these securities would be anti-dilutive.

Note 3 8% Senior Subordinated Convertible Notes

On May 16, 2007, the Company closed on a financing consisting of $9.0 million face value of 8% senior subordinated convertible notes (the Notes) due May 16, 2008 and warrants to purchase 3,600,000 shares of the Company s common stock at a $5.00 strike price for a period of five years. In addition, the warrant agreement allows for the exercise of the warrants on a cashless basis. Net proceeds from the sale of the Notes and warrants amounted to $8.3 million after fees and expenses. In addition, the Company issued to the Placement Agent warrants to purchase 360,000 shares of the Company s common stock at a $5.00 strike price for five years. The fair value of the Placement Agent warrant was $1,022,220 using the Black-Scholes-Merton valuation technique and has been initially recorded as debt issuance costs. The Notes bear interest at 8% per annum which is payable on a quarterly basis on July 1, October 1, January 1 and April 1, beginning July 1, 2007, either in cash or common stock at the Company s option. The Notes were initially convertible into common stock at a conversion price of $5.00 per share subject to adjustment at maturity to a then market-indexed rate. The conversion feature also provided full-ratchet anti-dilution protection in the event of sales of shares or other share-indexed instruments below the conversion price. The Notes are unsecured but provide for penalties in the event of default.

The Company evaluated the terms and conditions embedded in the Notes for indications of features that were not clearly and closely related to debt-associated risk and concluded that the conversion feature, share-indexed interest feature, anti-dilution protections and certain default features required compounding and bifurcation as a derivative liability in accordance with FAS 133. In addition, the financing and Placement Agent warrants did not meet all the conditions for equity classification on the inception date of the transaction and required liability classification. Since derivative financial instruments are initially and subsequently measured at fair value, the Company allocated financing proceeds to those instruments plus other financing components, as follows.

Derivative Financial Instruments:	
Financing warrants	$ 11,194,020
Compound embedded derivative	1,128,834
Day-one loss from derivative allocation	(2,300,634)
Direct finance costs	(1,732,611)