FOREST OIL CORP
Form 10-Q
May 10, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2006

Or

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

For the transition period from to

Commission File Number 1-13515

FOREST OIL CORPORATION

(Exact name of registrant as specified in its charter)

New York	**25-0484900**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

707 17th Street, Suite 3600 Denver, Colorado 80202
(Address of principal executive offices) (Zip Code)

Registrant s telephone number, including area code: **(303) 812-1400**

Former name, former address and former fiscal year, if changed since last report.

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. x Yes o No

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

Large accelerated filer x   Accelerated filer o   Non-accelerated filer o

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

As of April 30, 2006 there were 62,799,154 shares of the registrant s common stock, par value $.10 per share, outstanding.

FOREST OIL CORPORATION
INDEX TO FORM 10-Q
March 31, 2006

PART I FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

FOREST OIL CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)
(In Thousands, Except Share Data)

	March 31, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 6,310	7,231
Accounts receivable	159,459	178,124
Derivative instruments	7,286	941
Deferred tax assets	21,533	77,346
Other current assets	39,803	52,283
Total current assets	234,391	315,925
Property and equipment, at cost:		
Oil and gas properties, full cost method of accounting:		
Proved, net of accumulated depletion of $2,078,900 and $3,059,031	2,205,335	2,898,774
Unproved	255,909	275,684
Net oil and gas properties	2,461,244	3,174,458
Other property and equipment, net of accumulated depreciation and amortization of $28,803 and $32,527	26,873	25,560
Net property and equipment	2,488,117	3,200,018
Derivative instruments	1,410	
Goodwill	86,984	87,072
Other assets	30,987	42,531
	$ 2,841,889	3,645,546
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 217,716	312,076
Accrued interest	18,016	4,260
Derivative instruments	58,858	151,678
Asset retirement obligations	1,497	33,329
Other current liabilities	19,883	21,573
Total current liabilities	315,970	522,916
Long-term debt	1,056,363	884,807
Asset retirement obligations	59,502	178,225
Other liabilities	44,596	45,691
Deferred income taxes	146,444	329,385
Total liabilities	1,622,875	1,961,024
Shareholders equity:		
Preferred stock, none issued		
Common stock, 64,645,608 and 64,548,229 shares issued and outstanding	6,465	6,455
Capital surplus	1,225,109	1,529,102
(Accumulated deficit) retained earnings	(27,035)	217,293
Accumulated other comprehensive income (loss)	64,556	(18,220)
Treasury stock, at cost, 1,860,143 and 1,861,143 shares held	(50,081)	(50,108)
Total shareholders equity	1,219,014	1,684,522
	$ 2,841,889	3,654,546

See accompanying Notes to Condensed Consolidated Financial Statements.

FOREST OIL CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended March 31, 2006	2005
	(In Thousands, Except Per Share Amounts)	
Revenue:		
Oil and gas sales:		
Natural gas	$ 127,053	154,526
Oil, condensate, and natural gas liquids	92,043	104,344
Total oil and gas sales	219,096	258,870
Marketing, processing, and other	2,350	1,421
Total revenue	221,446	260,291
Operating expenses:		
Lease operating expenses	45,331	47,860
Production and property taxes	10,728	9,897
Transportation costs	4,729	5,172
General and administrative (including stock-based compensation of $7,854 and $128 in 2006 and 2005, respectively)	17,136	10,756
Depreciation and depletion	77,668	96,276
Accretion of asset retirement obligations	3,352	4,277
Impairments		2,924
Spin-off and merger costs	5,416	
Total operating expenses	164,360	177,162
Earnings from operations	57,086	83,129
Other income and expense:		
Interest expense	15,151	14,499
Unrealized losses on derivative instruments, net	24,114	6,580
Realized losses on derivative instruments, net	3,915	532
Other expense, net	860	1,401
Total other income and expense	44,040	23,012
Earnings before income taxes and discontinued operations	13,046	60,117
Income tax expense:		
Current	1,002	1,557
Deferred	10,795	19,689
Total income tax expense	11,797	21,246
Earnings from continuing operations	1,249	38,871
Income from discontinued operations, net of tax	2,422	
Net earnings	$ 3,671	38,871
Basic earnings per common share:		
Earnings from continuing operations	$ .02	.65
Income from discontinued operations, net of tax	.04	
Net earnings per common share	$ .06	.65
Diluted earnings per common share:		
Earnings from continuing operations	$ .02	.63
Income from discontinued operations, net of tax	.04	
Net earnings per common share	$ .06	.63

See accompanying Notes to Condensed Consolidated Financial Statements.

FOREST OIL CORPORATION
CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY
(Unaudited)

	Common Stock		Capital Surplus	Retained Earnings (Accumulated Deficit)	Accumulated Other Comprehensive (Loss) Income	Treasury Stock	Total Shareholders Equity
	(In Thousands)						
Balances at January 1, 2006	64,548	$ 6,455	1,529,102	217,293	(18,220)	(50,108)	1,684,522
Exercise of stock options	80	8	2,050	(8)		27	2,077
Tax benefit of stock options exercised			12				12
Employee stock purchase plan	6	1	173				174
Restricted stock issued, net of forfeitures	12	1	(1)				
Amortization of stock-based compensation			11,440				11,440
Pro rata distribution of FERI common stock to shareholders (Note 2)			(317,667)	(247,991)	7,549		(558,109)
Comprehensive earnings:							
Net earnings				3,671			3,671
Unrealized gain on effective derivative instruments, net of tax					77,074		77,074
Decrease in unfunded pension liability, net of tax					83		83
Foreign currency translation					(1,930)		(1,930)
Total comprehensive earnings							78,898
Balances at March 31, 2006	64,646	$ 6,465	1,225,109	(27,035)	64,556	(50,081)	1,219,014

See accompanying Notes to Condensed Consolidated Financial Statements.

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FOREST OIL CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Three Months Ended March 31, 2006 (In Thousands)	2005
Operating activities:		
Net earnings	$ 3,671	38,871
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and depletion	77,668	96,276
Accretion of asset retirement obligations	3,352	4,277
Stock-based compensation	7,315	128
Impairment of oil and gas properties		2,924
Unrealized losses on derivative instruments, net	24,114	6,580
Amortization of deferred derivative losses	15,204	
Deferred income tax expense	12,022	19,689
Other, net	886	(1,262)
Changes in operating assets and liabilities, net of effects of acquisitions and divestitures:		
Accounts receivable	(13,988)	(6,243)
Other current assets	(20,716)	(1,599)
Accounts payable	(6,499)	(35,543)
Accrued interest and other current liabilities	11,506	11,985
Net cash provided by operating activities	114,535	136,083
Investing activities:		
Capital expenditures for property and equipment:		
Exploration, development, and acquisition costs	(465,175)	(96,603)
Other fixed assets	(2,643)	(693)
Proceeds from sales of assets	1,018	6,867
Other, net	106	(6,217)
Net cash used by investing activities	(466,694)	(96,646)
Financing activities:		
Proceeds from bank borrowings	876,818	363,953
Repayments of bank borrowings	(527,415)	(477,000)
Proceeds from the exercise of options and warrants and employee stock purchases	2,250	24,383
Other, net	(24)	1,079
Net cash provided (used) by financing activities	351,629	(87,585)
Effect of exchange rate changes on cash	(391)	(1,295)
Net decrease in cash and cash equivalents	(921)	(49,443)
Cash and cash equivalents at beginning of period	7,231	55,251
Cash and cash equivalents at end of period	$ 6,310	5,808
Cash paid during the period for:		
Interest	$ 3,080	1,583
Income taxes	1,969	2,473

See accompanying Notes to Condensed Consolidated Financial Statements.

FOREST OIL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

(1) BASIS OF PRESENTATION

The Condensed Consolidated Financial Statements included herein are unaudited and include the accounts of Forest Oil Corporation and its consolidated subsidiaries (collectively, Forest or the Company). In the opinion of management, all adjustments, consisting of normal recurring accruals, have been made which are necessary for a fair presentation of the financial position of Forest at March 31, 2006, the results of its operations for the three months ended March 31, 2006 and 2005, and its cash flows for the three months ended March 31, 2006 and 2005. Quarterly results are not necessarily indicative of expected annual results because of the impact of fluctuations in prices received for liquids (oil, condensate, and natural gas liquids) and natural gas and other factors.

In the course of preparing the Condensed Consolidated Financial Statements, 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 oil and gas reserves used in calculating depletion, the amount of future net revenues used in computing the ceiling test limitations, and the amount of future capital costs and abandonment obligations used in such calculations. Assumptions, judgments, and estimates are also required in determining impairments of undeveloped properties, valuing deferred tax assets, and estimating fair values of derivative instruments.

Certain amounts in the prior year financial statements have been reclassified to conform to the 2006 financial statement presentation.

For a more complete understanding of Forest s operations, financial position, and accounting policies, reference is made to the consolidated financial statements of Forest, and related notes thereto, filed with Forest s annual report on Form 10-K for the year ended December 31, 2005, previously filed with the Securities and Exchange Commission.

(2) ACQUISITIONS AND DIVESTITURES

Acquisitions

On March 31, 2006, Forest completed the acquisition of oil and gas properties located primarily in the Cotton Valley trend in East Texas. Forest paid approximately $255 million, as adjusted to reflect an economic effective date of February 1, 2006, for properties with an estimated 110 Bcfe of estimated proved reserves at the time the acquisition was announced and production that averaged 13 MMcfe per day in January 2006. Forest acquired approximately 26,000 net acres in the fields, of which approximately 14,000 net acres are undeveloped. Forest funded this acquisition utilizing its bank credit facilities.

Divestitures

Spin-off and Merger of Offshore Gulf of Mexico Operations

On March 2, 2006, Forest completed the spin-off of its offshore Gulf of Mexico operations by means of a special dividend, which consisted of a pro rata spin-off (the Spin-off) of all outstanding shares of Forest Energy Resources, Inc. (FERI), a total of 50,637,010 shares of common stock, to holders of

(2) ACQUISITIONS AND DIVESTITURES (Continued)

record of Forest common stock as of the close of business on February 21, 2006. Immediately following the Spin-off, FERI was merged with a subsidiary of Mariner in a stock for stock transaction (the Merger). Mariner s common stock commenced trading on the New York Stock Exchange on March 3, 2006.

The Spin-off was a tax-free transaction for federal income tax purposes. Prior to the Merger, as part of the Spin-off, FERI paid Forest approximately $176.1 million. The $176.1 million was drawn on a newly created bank credit facility established by FERI immediately prior to the Spin-off. This credit facility and associated liability was included in the Spin-off. Subsequent to March 31, 2006, Forest received an additional $21.7 million from FERI for total proceeds of $197.8 million. The cash amount is subject to further potential adjustment to reflect an economic effective date of July 1, 2005.

The table below sets forth the effect of the Spin-off on the Company s balance sheet at the time of the Spin-off:

	Change in Balance Sheet Accounts (In Thousands)
Assets (Increase/(Decrease))	
Cash	$ (10)
Accounts receivable Due from FERI	21,525
Accounts receivable third parties	(54,078)
Other current assets	(44,837)
Proved oil and gas properties, net of accumulated depletion	(1,065,992)
Unproved oil and gas properties	(38,523)
Other assets	(7,919)
Liabilities and Shareholders Equity ((Increase)/Decrease)	
Current liabilities	96,142
Derivative instruments	17,087
FERI credit facility	176,102
Asset retirement obligations	150,182
Deferred income taxes	192,212
Accumulated other comprehensive income	(7,549)
Net decrease to capital surplus and retained earnings	$ (565,658)

The following table presents the revenues and direct operating expenses of the offshore Gulf of Mexico operations reported in the Condensed Consolidated Statements of Operations. The 2006 period includes only two months of the offshore Gulf of Mexico operations, through February 28, 2006, whereas the 2005 period includes all three months of activity.

	Period Ended March 31, 2006 (In Thousands)	2005
Oil and gas revenues	$ 46,289	120,843
Oil and gas production expense:		
Lease operating expenses	18,296	16,622
Transportation costs	344	842
Production and property taxes	151	593
Oil and gas revenues in excess of direct operating expenses	$ 27,498	102,786

(2) ACQUISITIONS AND DIVESTITURES (Continued)

Sale of ProMark Discontinued Operations

On March 1, 2004, the Company sold the assets and business operations of Producers Marketing, Ltd. (ProMark) to Cinergy Canada, Inc. (Cinergy) for $11.2 million CDN. As a result of the sale, ProMark s results of operations were reported as discontinued operations in the historical financial statements. Under the terms of the purchase and sale agreement, Forest may receive additional contingent consideration over a period of five years through February 2009. During the quarter ended March 31, 2006, Forest recognized an additional $3.6 million contingent payment ($2.4 million net of tax), which has been reflected as income from discontinued operations in the Condensed Consolidated Statements of Operations.

(3) EARNINGS PER SHARE AND COMPREHENSIVE EARNINGS (LOSS)

Earnings per Share

Basic earnings per share is computed by dividing net earnings attributable to common stock by the weighted average number of common shares outstanding during each period, excluding treasury shares.

Diluted earnings per share is computed by adjusting the average number of common shares outstanding for the dilutive effect, if any, of stock options, unvested restricted stock grants, unvested phantom stock units, and warrants. The following sets forth the calculation of basic and diluted earnings per share:

	Three Months Ended March 31,	
	2006	2005
	(In Thousands, Except Per Share Amounts)	
Earnings from continuing operations	$ 1,249	38,871
Income from discontinued operations, net of tax	2,422	
Net earnings	$ 3,671	38,871
Weighted average common shares outstanding during the period	62,115	60,209
Add dilutive effects of stock options, unvested restricted stock grants, and unvested phantom stock units	1,055	947
Add dilutive effects of warrants		932
Weighted average common shares outstanding, including the effects of dilutive securities	63,170	62,088
Basic earnings per share:		
From continuing operations	$ .02	.65
From discontinued operations	.04	
Basic earnings per share	$ .06	.65
Diluted earnings per share:		
From continuing operations	$ .02	.63
From discontinued operations	.04	
Diluted earnings per share	$ .06	.63

Comprehensive Earnings (Loss):

Comprehensive earnings (loss) is a term used to refer to net earnings (loss) plus other comprehensive income (loss). Other comprehensive income (loss) is comprised of revenues, expenses, gains, and losses that under generally accepted accounting principles are reported as separate components of shareholders

(3) EARNINGS PER SHARE AND COMPREHENSIVE EARNINGS (LOSS) (Continued)

equity instead of net earnings (loss). Items included in Forest s other comprehensive income (loss) for the three months ended March 31, 2006 and 2005 are foreign currency gains related to the translation of the assets and liabilities of Forest s Canadian operations, changes in the unfunded pension liability, and changes in hedging losses related to the change in fair value of derivative instruments eligible for cash flow hedge accounting.

The components of comprehensive earnings (loss) are as follows:

	Three Months Ended March 31, 2006	2005
	(In Thousands)	
Net earnings	$ 3,671	38,871
Other comprehensive income (loss):		
Foreign currency translation losses	(1,930)	(2,879)
Unfunded pension liability, net of tax	83	(149)
Unrealized gain (loss) on derivative instruments, net of tax	77,074	(75,509)
Total comprehensive earnings (loss)	$ 78,898	(39,666)

(4) STOCK-BASED COMPENSATION

Prior to January 1, 2006, the Company accounted for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. Under APB Opinion No. 25, no compensation expense was recognized for stock options issued to employees if the grant price equaled or was above the market price on the date of the option grant. Effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 123 (Revised), Share-Based Payment (SFAS 123(R)) using the modified prospective method. Under this method, compensation cost is recorded for all unvested stock options, restricted stock, and phantom stock units beginning in the period of adoption and prior period financial statements are not restated. Under the fair value recognition provisions of SFAS 123(R), stock-based compensation is measured at the grant date based on the value of the awards and the value is recognized on a straight-line basis over the requisite service period (usually the vesting period).

In accordance with the provisions of SFAS 123(R), total stock-based compensation cost in the amount of $12.9 million was recorded in the three months ended March 31, 2006. Of this amount, $7.9 million was recorded as compensation expense and $5.0 million was capitalized to oil and gas properties in accordance with the full cost method of accounting. As discussed in more detail below, approximately $9.7 million of the $12.9 million of total stock-based compensation for the quarter ended March 31, 2006 was attributable to a partial settlement of the Company s restricted stock awards and phantom stock unit awards in connection with the Spin-off. SFAS 123(R) requires the Company to estimate forfeitures in calculating the cost related to stock-based compensation as opposed to recognizing these forfeitures and the corresponding reduction in expense as they occur. The cumulative adjustment to include estimated forfeitures in the calculation was less than $.1 million. This amount was recorded as a reduction in general and administrative expense and capitalized oil and gas properties in 2006 and was not presented separately in the Condensed Consolidated Statement of Operations. The impact of adopting SFAS 123(R) as of January 1, 2006 resulted in a decrease to net income of approximately $.5 million, or $.01 per basic and diluted share.

(4) STOCK-BASED COMPENSATION (Continued)

Equity Incentive Plans

In 2001, the Company adopted the Forest Oil Corporation 2001 Stock Incentive Plan (the 2001 Plan) under which non-qualified stock options, incentive stock options, restricted stock, phantom stock units, and other awards may be granted to employees, consultants, and non-employee directors. In 2003, the Company amended the 2001 Plan to increase the number of shares reserved for issuance. The aggregate number of shares of Common Stock that the Company may issue under the 2001 Plan may not exceed 5,012,074 million shares, which amount reflects an adjustment to the amount of shares available for grant to reflect the Spin-off. Options are granted at a price equal to the fair market value of one share of Common Stock on the date of grant. Options granted to employees under the 2001 Plan generally vest in increments of 25% on each of the first four anniversary dates of the date of grant and have a term of ten years. Options granted to non-employee directors vest immediately and have a term of ten years. In connection with the Spin-off, the shares available for grant and outstanding stock options under the 2001 Plan were adjusted to reflect the economic effect of the Spin-off by reducing the exercise price and increasing the number of underlying shares. As of March 31, 2006, the Company had 620,339 shares available for issuance under the 2001 Plan.

The Company also had a Stock Incentive Plan (the 1996 Plan) that expired on March 5, 2002 under which non-qualified stock options and restricted stock were granted to employees and director stock awards were granted to non-employee directors. Options granted under the 1996 Plan generally vested in increments of 20% commencing on the date of grant and on each of the first four anniversaries of the date of the grant and generally had a term of ten years.

The Company has historically issued new shares of common stock or treasury stock to settle its equity based awards.

Stock Options

The following table summarizes stock option activity in the Company s stock-based compensation plans for the quarter ended March 31, 2006. The number of shares and the exercise price of the outstanding stock options were adjusted so that the fair value of each award was the same immediately before and after the Spin-off, in accordance with the anti-dilution provisions in the 2001 Plan and 1996 Plan.

	Number of Options	Weighted Average Exercise Price Per Share	Aggregate Intrinsic Value (In Thousands)(1)	Number of Shares Exercisable
Outstanding at January 1, 2006	2,578,235	$ 27.78	$ 45,889	1,348,599
Granted				
Exercised	(58,337)	28.71	1,255	
Cancelled	(98,587)	30.91		
Outstanding at March 2, 2006	2,421,311	27.63	55,723	
Adjustment to give effect to Spin-off	1,176,804			
Granted				
Exercised	(21,742)	18.35	370	
Cancelled	(2,878)	25.44		
Outstanding at March 31, 2006	3,573,495	18.59	65,620	2,177,224

(1) The intrinsic value of a stock option is the amount by which the current market value of the underlying stock exceeds the exercise price of the option.

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(4) STOCK-BASED COMPENSATION (Continued)

Stock options are granted at the fair market value of one share of Common Stock on the date of grant. Options granted to non-employee directors vest immediately and options granted to officers and other employees vest ratably over four years and have a term of ten years. No stock options were granted during the first quarter ended March 31, 2006.

The fair value of stock options granted in the first quarter of 2005 was estimated using the Black-Scholes option pricing model. The following assumptions were used to compute the weighted average fair market value of stock options granted in the first quarter of 2005:

	Three Months Ended March 31, 2005
Expected life of options	5 years
Risk free interest rates	3.64% - 4.20 %
Estimated volatility	35%
Dividend yield	0.0%
Weighted average fair market value of options granted during the year	$13.05

The expected life of the options is based, in part, on historical exercise patterns of the holders of options with similar terms with consideration given to how historical patterns may differ from future exercise patterns based on current or expected market conditions and employee turnover. The risk free interest rate was based on the U.S. Treasury yield curve in effect at the time of grant. The expected volatility was based on the historical volatility of the Company s stock for the past five years.

As of March 31, 2006, there was $10 million of total unrecognized compensation cost related to stock options which is expected to be amortized over a weighted-average period of 1.7 years.

The following table summarizes information about options outstanding at March 31, 2006:

	Stock Options Outstanding				Stock Options Exercisable		
Range of Exercise Prices	Number of Options	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Aggregate Intrinsic Value (In Thousands)	Number Exercisable	Weighted Average Exercise Price	Aggregate Intrinsic Value (In Thousands)
$8.41 - 16.75	750,543	6.55	$14.93	$16,527	533,531	$14.78	$11,828
16.82 - 16.85	812,905	7.32	16.84	16,346	506,446	16.84	10,186
16.88 - 20.02	768,604	5.09	18.91	13,864	712,886	19.00	12,798
20.19 - 20.47	34,550	8.14	20.31	575	10,589	20.37	176
20.60 - 35.23	1,206,893	8.41	21.78	18,308	413,772	21.63	6,341
$8.41 - 35.23	3,573,495	7.06	18.59	$65,620	2,177,224	17.97	$41,329

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(4) STOCK-BASED COMPENSATION (Continued)

Restricted Stock and Phantom Stock Units

The following summarizes restricted stock and phantom stock unit activity during the first quarter of 2006. The grant date fair value of the restricted common stock and phantom stock units was determined by reference to the average of the high and low stock price as published by the NYSE on the date of grant.

	Restricted Stock		Phantom Stock Units	
	Number of Shares	**Weighted Average Grant Date Fair Value**(1)	**Number of Shares**	**Weighted Average Grant Date Fair Value**(1)
Unvested at January 1, 2006	634,000	$43.72	72,350	$46.07
Granted	16,200	48.54	1,500	46.72
Vested	(100)	46.07		
Forfeited	(4,300)	46.07		
Unvested at March 31, 2006	645,800	$43.83	73,850	$46.08

(1) These per-share fair values represent the actual grant date fair value and have not been adjusted to give effect to the Spin-off.

The restricted stock and phantom stock units generally vest on the third anniversary of the date of the award, but may vest earlier upon a qualifying disability, death, retirement, or a change in control of the Company in accordance with the terms of the underlying agreement. The phantom stock units may be settled in cash, shares of Common Stock, or a combination of both, at the Company s discretion.

Concurrent with the special dividend on March 2, 2006, employees who held unvested restricted stock awards received .8093 unrestricted shares of FERI for each share of restricted stock. Accordingly, compensation cost of approximately $8.4 million was recognized during the first quarter of 2006 for the partial settlement of the outstanding restricted stock awards. In addition, cash bonuses totaling $1.2 million were paid to Canadian employees who held phantom stock units on that date, representing the per-share value of the FERI shares received by each holder of restricted stock.

The Company recorded amortization of deferred stock-based compensation for restricted stock and phantom stock unit awards of $2.0 million and $.2 million during the three months ended March 31, 2006 and 2005, respectively. As of March 31, 2006 there was $14.9 million of total unrecognized compensation cost related to restricted stock and phantom stock unit awards which is expected to be recognized over a weighted-average period of approximately 2.6 years. As of March 31, 2006, approximately $.2 million of compensation was accrued related to the phantom stock units.

Employee Stock Purchase Plan

The Company has a 1999 Employee Stock Purchase Plan (the ESPP), under which it is authorized to issue up to 300,000 shares of Common Stock. Employees who are regularly scheduled to work more than 20 hours per week and more than five months in any calendar year may participate in the ESPP. Under the terms of the ESPP, employees may elect each quarter to have up to 15% of their annual base earnings withheld to purchase shares of Common Stock, up to a limit of $25,000 of Common Stock per calendar year. The ESPP currently provides for four offering periods during the year which coincide with the calendar quarters. The purchase price of the Common Stock purchased under the ESPP is equal to 85% of the lower of the beginning-of-quarter or end-of-quarter market price. ESPP participants are restricted from selling the shares of Common Stock purchased under the ESPP for a period of six months after purchase. As of March 31, 2006, the Company had 182,864 shares available for issuance under the ESPP.

(4) STOCK-BASED COMPENSATION (Continued)

The fair value of each stock purchase right granted under the ESPP during the quarters ended March 31, 2006 and 2005 was estimated using the Black-Scholes option pricing model. The following assumptions were used to compute the weighted average fair market value of purchase rights granted during the periods presented:

	Three Months Ended March 31,	
	2006	2005
Expected option life	3 months	3 months
Risk free interest rates	4.16%	2.32%
Estimated volatility	36%	23%
Dividend yield	0.0%	0.0%
Weighted average fair market value of purchase rights granted	$9.50	$8.65

The risk free rate was based on the U.S. Treasury yield curve in effect at the time of grant and the average expected life was the term of the quarterly look-back option. The expected volatility was based on the historical volatility of the Company s Common Stock for the quarter. For purposes of the ESPP offering that closed on March 31, 2006, the beginning stock price was adjusted to reflect the economic effect of the Spin-off. Compensation cost of $.1 million was recorded under the provisions of SFAS 123(R) related to purchase rights granted under the ESPP plan for the quarter ended March 31, 2006. Pro forma compensation cost associated with the purchase rights granted under the ESPP for the quarter ended March 31, 2005 was $.1 million.

Pro Forma Effects

Had Forest recognized compensation expense for all stock-based awards based upon the estimated fair value on the grant date under the fair value methodology prescribed by SFAS 123, as amended by SFAS 148 and SFAS 123(R), its pro forma net earnings and earnings per common share for the three months ended March 31, 2005 would have been as follows:

	Three Months Ended March 31, 2005 (In Thousands)
Net earnings, as reported	$ 38,871
Add: Stock-based employee compensation included in reported net income, net of tax	75
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of tax	(736)
Pro forma net earnings	$ 38,210
Basic earnings per common share:	
As reported	$ .65
Pro forma	$ .63
Diluted earnings per common share:	
As reported	$ .63
Pro forma	$ .62

(5) LONG-TERM DEBT

Components of long-term debt are as follows:

	March 31, 2006				December 31, 2005			
	Principal	Unamortized Premium (Discount)	Other(1)	Total	Principal	Unamortized Premium (Discount)	Other(1)	Total
	(In Thousands)							
U.S. Credit Facility	$ 259,000			259,000	97,000			97,000
Canadian Credit Facility	67,813			67,813	56,806			56,806
8% Senior Notes Due 2008	265,000	(219)	5,085	269,866	265,000	(244)	5,652	270,408
8% Senior Notes Due 2011	285,000	7,427	4,785	297,212	285,000	7,750	4,992	297,742
7 3⁄4% Senior Notes Due 2014	150,000	(1,930)	14,402	162,472	150,000	(1,990)	14,841	162,851
	$ 1,026,813	5,278	24,272	1,056,363	853,806	5,516	25,485	884,807

(1) Represents the unamortized portion of gains realized upon termination of interest rate swaps that were accounted for as fair value hedges. The gains are being amortized as a reduction of interest expense over the terms of the notes.

(6) PROPERTY AND EQUIPMENT

Forest uses the full cost method of accounting for oil and gas properties. Separate cost centers are maintained for each country in which Forest has operations. During the periods presented, Forest s primary oil and gas operations were conducted in the United States and Canada. All costs incurred in the acquisition, exploration, and development of properties (including costs of surrendered and abandoned leaseholds, delay lease rentals, dry holes, and overhead related to exploration and development activities) and the fair value of estimated future costs of site restoration, dismantlement, and abandonment activities are capitalized.

Investments in unproved properties, including related capitalized interest costs, are not depleted pending determination of the existence of proved reserves. Unproved properties are assessed periodically to ascertain whether impairment has occurred. Unproved properties whose costs are individually significant are assessed individually by considering the primary lease terms of the properties, the holding period of the properties, and geographic and geologic data obtained relating to the properties. Where it is not practicable to assess individually the amount of impairment of properties for which costs are not individually significant, such properties are grouped for purposes of assessing impairment. The amount of impairment assessed is added to the costs to be amortized, or is reported as a period expense, as appropriate.

Pursuant to full cost accounting rules, capitalized costs less related accumulated depletion and deferred income taxes for each cost center may not exceed the sum of (1) the present value of future net revenue from estimated production of proved oil and gas reserves using current prices, including the effects of derivative instruments but excluding the future cash outflows associated with settling asset retirement obligations that have been accrued on the balance sheet, and a discount factor of 10%; plus (2) the cost of properties not being amortized, if any; plus (3) the lower of cost or estimated fair value of unproved properties included in the costs being amortized, if any; less (4) income tax effects related to differences in the book and tax basis of oil and gas properties. There were no such provisions for impairment of oil and gas properties in the periods presented. Gain or loss is not recognized on the sale of oil and gas properties unless the sale significantly alters the relationship between capitalized costs and estimated proved oil and gas reserves attributable to a cost center.

(6) PROPERTY AND EQUIPMENT (Continued)

Depletion of proved oil and gas properties is computed on the units-of-production method, whereby capitalized costs, as adjusted for future development costs and asset retirement obligations, are amortized over the total estimated proved reserves. Furniture and fixtures, computer hardware and software, and other equipment are depreciated on the straight-line or declining balance method, based upon estimated useful lives of the assets ranging from three to 12 years.

(7) ASSET RETIREMENT OBLIGATIONS

Forest records estimated future asset retirement obligations pursuant to the provisions of Statement of Financial Accounting Standards No. 143, *Accounting for Asset Retirement Obligations* (SFAS No. 143). SFAS No. 143 requires entities to record the fair value of a liability for an asset retirement obligation in the period in which it is incurred with a corresponding increase in the carrying amount of the related long-lived asset. Subsequent to initial measurement, the asset retirement liability is required to be accreted each period to its present value. Capitalized costs are depleted as a component of the full cost pool using the units-of-production method. Forest s asset retirement obligations consist of costs related to the plugging of wells, the removal of facilities and equipment, and site restoration on oil and gas properties.

The following table summarizes the activity for Forest s asset retirement obligations for the three months ended March 31, 2006 and 2005:

	Three Months Ended March 31, 2006	**2005**
	(In Thousands)	
Asset retirement obligations at beginning of period	$ 211,554	210,176
Accretion expense	3,352	4,277
Liabilities incurred	202	2,146
Liabilities assumed	1,009	
Liabilities included in the Spin-off	(150,182)	
Liabilities settled	(4,379)	(1,462)
Revisions of estimated liabilities	(484)	4,240
Impact of foreign currency exchange rate	(73)	(81)
Asset retirement obligations at end of period	60,999	219,296
Less: current asset retirement obligations	(1,497)	(29,229)
Long-term asset retirement obligations	$ 59,502	190,067

(8) EMPLOYEE BENEFITS

The following table sets forth the components of the net periodic cost of Forest s defined benefit pension plans and postretirement benefits in the United States for the three months ended March 31, 2006 and 2005:

	Pension Benefits Three Months Ended March 31,		Postretirement Benefits Three Months Ended March 31,	
	2006	2005	2006	2005
	(In Thousands)			
Service cost	$		169	167
Interest cost	548	581	118	113
Curtailment gain(1)			(1,851)	
Expected return on plan assets	(608)	(586)		
Recognized actuarial loss	227	188		
Total net periodic expense	$ 167	183	(1,564)	280

(1) Forest recognized a $1.9 million curtailment gain in connection with the Spin-off on March 2, 2006. This gain was recorded as a reduction in general and administrative expense for the three months ended March 31, 2006.

(9) FINANCIAL INSTRUMENTS

Forest periodically enters into derivative instruments such as swap, basis swap, and collar agreements in order provide a measure of stability to Forest s cash flows in an environment of volatile oil and gas prices and to manage the exposure to commodity price risk. Forest s commodity derivative instruments generally serve as effective economic hedges of commodity price exposure; however, various circumstances can cause commodity hedges to not qualify for cash flow hedge accounting either at the inception of the hedge or during the term of the hedge. When the criteria for cash flow hedge accounting are not met, realized gains and losses (i.e., cash settlements) are recorded in other income and expense in the Condensed Consolidated Statements of Operations. Similarly, changes in the fair value of the derivative instruments are recorded as unrealized gains or losses in the Condensed Consolidated Statements of Operations. In contrast, cash settlements for derivative instruments that qualify for hedge accounting are recorded as additions to or reductions of oil and gas revenues while changes in fair value of cash flow hedges are recognized, to the extent the hedge is effective, in other comprehensive income until the hedged item is recognized in earnings.

Discontinuance of Hedge Accounting

As a result of production deferrals experienced in the Gulf of Mexico related to hurricanes Katrina and Rita, Forest was required to discontinue cash flow hedge accounting on many of the Company s natural gas and oil hedges during the third and fourth quarters of 2005. Additionally, as a result of the Spin-off on March 2, 2006, additional commodity swaps and collars formerly designated as cash flow hedges of offshore Gulf of Mexico production also no longer qualified for hedge accounting.

Because a significant portion of the Company s derivatives no longer qualified for hedge accounting and to increase clarity in its financial statements, the Company elected to discontinue hedge accounting prospectively for all of its remaining commodity derivatives beginning in March 2006. This change in reporting will have no impact on the Company s reported cash flows, although future results of operations will be affected by mark-to-market gains and losses which fluctuate with volatile oil and gas prices. The Company will recognize all prospective mark-to-market gains and losses in earnings, rather than deferring such amounts in accumulated other comprehensive income included in shareholders equity.

(9) FINANCIAL INSTRUMENTS (Continued)

The net mark-to-market loss on the Company s remaining swaps and collars that qualified for cash flow hedge accounting at the date the decision was made to discontinue hedge accounting are deferred in accumulated other comprehensive income and will be amortized into oil and gas revenues as the original forecasted hedged oil and gas production occurs in 2006. Amortization of the net deferred losses will be recorded in 2006 as follows:

	(In Thousands)
Second Quarter 2006	$ 1,677
Third Quarter 2006	2,250
Fourth Quarter 2006	3,207
	$ 7,134

The table below summarizes the realized and unrealized losses Forest incurred related to its derivative instruments for the periods indicated.

	Three Months Ended March 31,	
	2006	2005
	(In Thousands)	
Realized losses on derivatives designated as cash flow hedges(1)	$ 36,680	20,809
Realized losses on derivatives not designated as cash flow hedges(2)	3,915	532
Ineffectiveness recognized on derivatives designated as cash flow hedges(2)	(5,573)	1,389
Unrealized losses on derivatives not designated as cash flow hedges(2)	29,687	5,191
Total realized and unrealized losses recorded	$ 64,709	27,921

(1) Included in oil and gas sales in the Condensed Consolidated Statements of Operations.

(2) Included in other income and expense in the Condensed Consolidated Statements of Operations.

The tables below set forth Forest s outstanding commodity swaps and collars as of March 31, 2006:

	Swaps			
	Natural Gas (NYMEX HH)		Oil (NYMEX WTI)	
	Bbtu Per Day	Weighted Average Hedged Price per MMBtu	Barrels Per Day	Weighted Average Hedged Price per Bbl
Second Quarter 2006	10.0	$ 5.51	4,000	$ 31.58
Third Quarter 2006	10.0	5.51	4,000	31.58
Fourth Quarter 2006	10.0	5.51	4,000	31.58

	Costless Collars			
	Natural Gas (NYMEX HH)		Oil (NYMEX WTI)	
	Bbtu Per Day	Weighted Average Hedged Floor and Ceiling Price per MMBtu	Barrels Per Day	Weighted Average Hedged Floor and Ceiling Price per Bbl
Second Quarter 2006	50.0	$ 7.43/11.88	5,500	$ 46.73/65.87
Third Quarter 2006	50.0	7.43/11.88	5,500	46.73/65.87
Fourth Quarter 2006	50.0	7.43/11.88	5,500	46.73/65.87
Fiscal 2007	10.0	9.60/10.25		

(9) FINANCIAL INSTRUMENTS (Continued)

At March 31, 2006, the fair value of Forest s commodity derivative contracts was a current liability of $58.9 million and a derivative asset of $8.7 million (of which $7.3 million was classified as current). Forest is exposed to risks associated with swap and collar agreements arising from movements in the prices of oil and natural gas and from the unlikely event of non-performance by the counterparties to the swap and collar agreements.

In April 2006, the Company entered into additional costless collar agreements. The table below sets forth the weighted average terms of these costless collar agreements.

	Costless Collars			
	Natural Gas (NYMEX HH)		Oil (NYMEX WTI)	
	Bbtu Per Day	Weighted Average Hedged Floor and Ceiling Price per MMBtu	Barrels Per Day	Weighted Average Hedged Floor and Ceiling Price per Bbl
Fiscal 2007	5.0	$ 9.60/12.05	1,000	$ 65.00/85.00

(10) BUSINESS AND GEOGRAPHICAL SEGMENTS

Segment information has been prepared in accordance with Statement of Financial Accounting Standards No. 131, *Disclosures About Segments of an Enterprise and Related Information*. At March 31, 2006, Forest had five reportable segments consisting of oil and gas operations in five business units (Southern (formerly Gulf Coast), Western, Alaska, Canada, and International). Forest s remaining marketing and processing activities are not significant and therefore are not reported as a separate segment, but are included as a reconciling item in the information below. The segments were determined based upon the type of operations in each business unit and the geographical location of each. The segment data presented below was prepared on the same basis as the Condensed Consolidated Financial Statements. Effective in the first quarter of 2006, general and administrative expenses are no longer allocated to the Company s business units to correspond with the Company s decision to monitor and evaluate general and administrative expenses at the corporate level. Additionally, the Company modified the method utilized in allocating depletion expense between its business units effective in the first quarter of 2006 such that the depletion rate per Mcfe is consistent among those business units within the U.S. cost center. Segment information previously reported has been modified to conform with the current presentation.

Three Months Ended March 31, 2006

	Oil and Gas Operations						
	Southern	Western	Alaska	Total U.S.	Canada	International	Total Company
	(In Thousands)						
Revenue	$ 70,845	80,224	23,521	174,590	44,506		219,096
Expenses:							
Lease operating expenses	22,491	9,763	6,765	39,019	6,312		45,331
Production and property taxes	2,209	7,207	600	10,016	712		10,728
Transportation costs	660	593	1,603	2,856	1,873		4,729
Depletion	26,077	25,192	6,648	57,917	18,939		76,856
Accretion of asset retirement obligations	2,454	222	416	3,092	249	11	3,352
Earnings (loss) from operations	$ 16,954	37,247	7,489	61,690	16,421	(11)	78,100
Capital expenditures	$ 331,543	82,988	9,302	423,833	49,687	874	474,394
Goodwill	$ 15,003	56,374		71,377	15,607		86,984

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(10) BUSINESS AND GEOGRAPHICAL SEGMENTS (Continued)

A reconciliation of segment earnings (loss) from operations to consolidated earnings before income taxes and discontinued operations is as follows:

	(In Thousands)
Earnings from operations for reportable segments	$ 78,100
Marketing, processing, and other	2,350
General and administrative expense (including stock-based compensation)	(17,136)
Administrative asset depreciation	(812)
Spin-off and merger costs	(5,416)
Interest expense	(15,151)
Unrealized losses on derivative instruments, net	(24,114)
Realized losses on derivative instruments, net	(3,915)
Other expense, net	(860)
Earnings before income taxes and discontinued operations	$ 13,046

Three Months Ended March 31, 2005