

CALLON PETROLEUM CO

Form 10-Q

May 07, 2010

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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, 2010**

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 001-14039
CALLON PETROLEUM COMPANY
(Exact name of registrant as specified in its charter)**

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

64-0844345
*(I.R.S. Employer
Identification No.)*

**200 North Canal Street
Natchez, Mississippi**
(Address of principal executive offices)

39120
(Zip Code)

601-442-1601

(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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

Indicate by check mark whether the registrant is a larger accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of "accelerated filer", "large 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 May 5, 2010 there were outstanding 28,762,343 shares of the Registrant's common stock, par value \$0.01 per share.

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Callon Petroleum Company
Consolidated Balance Sheets
(in thousands, except share data)

	March 31, 2010	December 31, 2009
	(Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 42,229	\$ 3,635
Accounts receivable	15,087	20,798
Accounts receivable MMS royalty recoupment (See Note 3)	7,927	51,534
Fair market value of derivatives	637	145
Other current assets	987	1,572
Total current assets	66,867	77,684
Oil and gas properties, full-cost accounting method:		
Evaluated properties	1,234,825	1,593,884
Less accumulated depreciation, depletion and amortization	(1,130,942)	(1,488,718)
Net oil and gas properties	103,883	105,166
Unevaluated properties excluded from amortization	27,714	25,442
Total oil and gas properties	131,597	130,608
Other property and equipment, net	2,528	2,508
Restricted investments	4,327	4,065
Investment in Medusa Spar LLC	11,180	11,537
Other assets, net	1,819	1,589
Total assets	\$ 218,318	\$ 227,991
LIABILITIES AND STOCKHOLDERS EQUITY (DEFICIT)		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 8,575	\$ 12,887
Asset retirement obligations	3,613	4,002
9.75% Senior Notes, net of \$174 and \$232 discount, respectively	15,878	15,820
Fair market value of derivatives	302	
	28,368	32,709
Callon Entrada non-recourse credit facility (See Note 2)		84,847
Total current liabilities	28,368	117,556

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13% Senior Notes (See Note 6)		
Principal outstanding	137,961	137,961
Deferred credit, net of accumulated amortization of \$1,183 and \$294, respectively	30,324	31,213
Total 13% Senior Notes	168,285	169,174
Senior secured revolving credit facility		
Asset retirement obligations	10,425	10,648
Other long-term liabilities	1,908	1,467
Total liabilities	208,986	308,845
Stockholders' equity (deficit):		
Preferred Stock, \$.01 par value, 2,500,000 shares authorized;		
Common Stock, \$.01 par value, 60,000,000 shares authorized;		
28,776,331 and 28,742,926 shares outstanding at March 31, 2010 and		
December 31, 2009, respectively		
Capital in excess of par value	244,818	243,898
Other comprehensive loss	(7,288)	(7,478)
Retained (deficit) earnings	(228,486)	(317,561)
Total stockholders' equity (deficit)	9,332	(80,854)
Total liabilities and stockholders' equity (deficit)	\$ 218,318	\$ 227,991

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

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Callon Petroleum Company
Consolidated Statements of Operations (Unaudited)
(in thousands, except per share data)

	Three Months Ended March	
	2010	2009
Operating revenues:		
Oil sales	\$ 16,663	\$ 15,952
Gas sales	6,722	8,863
Total operating revenues	23,385	24,815
Operating expenses:		
Lease operating expenses	4,648	4,039
Depreciation, depletion and amortization	6,813	9,413
General and administrative	4,304	1,819
Accretion expense	580	1,038
Total operating expenses	16,345	16,309
Income from operations	7,040	8,506
Other (income) expenses:		
Interest expense	3,594	4,782
Callon Entrada non-recourse credit facility interest expense (See Note 2)		1,556
Other income	(361)	(95)
Total other (income) expenses	3,233	6,243
Income before income taxes	3,807	2,263
Income tax benefit		(24)
Income before equity in earnings of Medusa Spar LLC	3,807	2,287
Equity in earnings of Medusa Spar LLC	116	117
Net income available to common shares	\$ 3,923	\$ 2,404
Net income per common share:		
Basic	\$ 0.14	\$ 0.11
Diluted	\$ 0.13	\$ 0.11

Shares used in computing net income per common share:

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Basic	28,738	21,607
Diluted	29,229	21,607

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

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Callon Petroleum Company
Consolidated Statements of Cash Flows (Unaudited)
(in thousands)

	Three Months Ended March	
	31,	
	2010	2009
Cash flows from operating activities:		
Net income	\$ 3,923	\$ 2,404
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation, depletion and amortization	6,989	9,629
Accretion expense	580	1,038
Amortization of non-cash debt related items	137	731
Amortization of deferred credit	(889)	
Equity in earnings of Medusa Spar LLC	(116)	(117)
Deferred income tax expense		(24)
Non-cash charge related to compensation plans	643	569
Changes in current assets and liabilities:		
Accounts receivable	47,081	5,761
Other current assets	585	912
Current liabilities	(2,850)	(19,614)
Change in gas balancing receivable	(44)	319
Change in gas balancing payable	87	30
Change in other long-term liabilities	(115)	618
Change in other assets, net	(343)	(10)
Cash provided by operating activities	55,668	2,246
Cash flows from investing activities:		
Capital expenditures	(6,974)	(19,295)
MMS bond for plugging and abandonment	(262)	
Distribution from Medusa Spar LLC	473	574
Cash used in investing activities	(6,763)	(18,721)
Cash flows from financing activities:		
Payments on senior secured credit facility	(10,000)	
Cash used in financing activities	(10,000)	
Net change in cash and cash equivalents	38,905	(16,475)
Cash and cash equivalents:		
Balance, beginning of period	3,635	17,126
Less: Cash held by subsidiary deconsolidated at January 1, 2010	(311)	
Balance, end of period	\$ 42,229	\$ 651

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

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**Callon Petroleum Company
Notes to the Consolidated Financial Statements**

(all amounts in thousands, except per-share, per-note and per-hedge data)

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Note 1 Description of Business and Basis of Presentation

Description of Business

Callon Petroleum Company was incorporated under the laws of the state of Delaware in 1994 and succeeded to the business of a publicly traded limited partnership, a joint venture with a consortium of European investors and an independent energy company partially owned by a member of current management. As used herein, the Company, Callon, we, us, and our refer to Callon Petroleum Company and its predecessors and subsidiaries unless the context requires otherwise.

Callon is engaged in the acquisition, development, exploration and operation of oil and gas properties. The Company's properties and operations are geographically concentrated onshore in Louisiana and Texas and the offshore waters of the Gulf of Mexico.

Basis of Presentation

These interim financial statements of the Company have been prepared in accordance with (1) accounting principles generally accepted in the United States, (2) the Security and Exchange Commission's instructions to Quarterly Report on Form 10-Q and (3) Rule 10-01 of Regulation S-X, and should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

In the opinion of management, the accompanying unaudited consolidated financial statements reflect all adjustments (including normal recurring adjustments) necessary to present fairly the Company's financial position, the results of its operations and its cash flows for the periods indicated. Operating results for the periods presented are not necessarily indicative of the results that may be expected for the year ended December 31, 2010.

All amounts contained in the notes to the consolidated financial statements are presented in thousands, with the exception of years, per-share, per-note and per-hedge amounts. Certain reclassifications have been made to conform prior year financial information to the current period presentation.

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Callon Petroleum Company
Notes to the Consolidated Financial Statements

(all amounts in thousands, except per-share, per-note and per-hedge data)

Note 2 Deconsolidation of Callon Entrada

In April 2008, Callon completed the sale of a 50% working interest in the Entrada Field to CIECO Energy (US) Limited (CIECO) effective January 1, 2008. At closing, CIECO paid Callon \$155,000, and reimbursed the Company \$12,600 for 50% of Entrada capital expenditures incurred prior to the closing date. In addition, as part of the purchase and sale agreement, CIECO agreed to loan Callon Entrada, a wholly owned subsidiary of the Company, up to \$150,000 plus interest expense incurred up to \$12,000, for its share of the development costs for the Entrada project. Based on the terms of the credit agreement with CIECO Energy (Entrada) LLC (CIECO Entrada), the debt was to be repaid solely from assets, primarily production, from the Entrada field. All assets of Callon Entrada, and its stock, are pledged to CIECO Entrada under the Callon Entrada credit agreement, and neither Callon nor its subsidiaries (other than Callon Entrada) guaranteed the Callon Entrada credit facility.

Prior to January 1, 2010, the Company was required to consolidate the financial statements and results of operations of Callon Entrada, and as such, Callon Entrada's non-recourse credit facility was reflected in a separate line item in Callon's 2009 consolidated financial statements.

In June 2009, the FASB issued an accounting standard which became effective for the first annual reporting period that begins after November 15, 2009 (with early adoption prohibited), and which amended US GAAP as follows:

to require an enterprise to perform an analysis to determine whether the enterprise's variable interest or interests give it a controlling financial interest in a Variable Interest Entity (VIE), identifying the primary beneficiary of a VIE;

to require ongoing reassessment of whether an enterprise is the primary beneficiary of a VIE, rather than only when specific events occur;

to eliminate the quantitative approach previously required for determining the primary beneficiary of a VIE;

to amend certain guidance for determining whether an entity is a VIE;

to add an additional reconsideration event when changes in facts and circumstances pertinent to a VIE occur;

to eliminate the exception for troubled debt restructuring regarding VIE reconsideration; and

to require advanced disclosures that will provide users of financial statements with more transparent information about an enterprise's involvement in a VIE.

The Company adopted the pronouncement for consolidation of variable interest entities on January 1, 2010. Upon adoption, the Company reevaluated its interest in its subsidiary, Callon Entrada. Based on the evaluation performed, which is detailed below, the Company concluded that a VIE reconsideration event had taken place resulting in the determination that Callon Entrada is a VIE, for which the Company is not the primary beneficiary and as a result, Callon Entrada is deconsolidated from the Company's consolidated financial statements as of January 1, 2010. The Company included additional disclosures related to the deconsolidation of Callon Entrada in its Form 10-K for the year-ended December 31, 2009. Key events considered in this analysis include the following:

Default on non-recourse debt and CIECO's acceleration rights exercised: As a result of abandoning the Entrada project in November 2008, prior to completion, Callon Entrada's only source of payment is the proceeds from the sale of equipment purchased but not used for the Entrada project. On April 2, 2009, Callon Entrada received a notice from CIECO Entrada advising Callon Entrada that certain alleged events of default occurred under the credit agreement relating to failure to pay interest when due and the breach of various other covenants related to the decision to abandon the Entrada project. The notice of default received from CIECO Entrada invoked CIECO Entrada's rights under the Callon Entrada credit agreement to accelerate payment of the principal and interest due, and to invoke its

rights to the surplus equipment related to the Entrada project, including the proceeds from the sale of the equipment and the ability to control the decisions related to the sale of the equipment. Based on the advice of legal counsel, Callon believes that it and its other subsidiaries are not otherwise obligated to repay the principal, accrued interest or any other amount which may become due under the Callon Entrada credit facility.

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Callon Petroleum Company
Notes to the Consolidated Financial Statements

(all amounts in thousands, except per-share, per-note and per-hedge data)

Abandonment obligations satisfied: Callon guaranteed Callon Entrada's payment of all amounts to plug and abandon the wells and related facilities and for a breach of law, rule or regulation (including environmental laws) and for any losses of CIECO Entrada attributable to gross negligence of Callon Entrada. The well for which Callon Entrada was responsible was plugged and abandoned in the fourth of quarter of 2008, and the Minerals Management Service (MMS) confirmed to Callon during September 2009 that Callon had satisfied all of its abandonment obligations related to this project.

No ability to control future actions of Callon Entrada: As of December 31, 2009, the wind down of the Entrada project was complete, all of the costs related to the Entrada project were paid, and subsequent to the lease expiration June 1, 2009, control of the property reverted to the MMS. The sale of remaining equipment purchased for the Entrada project remains ongoing, and the Company believes that the amount of future operating costs of Callon Entrada, for which the Company would be responsible for, is insignificant and is limited to minimal storage fees for the surplus equipment while the equipment is being liquidated.

As a result of the events described above, the Company lost its power to direct the only remaining activities that affect Callon Entrada's future economic performance. Below is a condensed balance sheet of Callon presented to demonstrate the effect of deconsolidation on the financial statements at January 1, 2010:

	Callon Consolidated at 12/31/09	Callon Entrada Deconsolidated	Callon Consolidated at 1/1/2010
Balance Sheet (in thousands)			
Total current assets	\$ 77,684	\$ (1,767)	\$ 75,917
Total oil and gas properties	130,608		130,608
Other property and equipment	2,508		2,508
Other assets	17,191		17,191
 Total assets	 \$ 227,991	 \$ (1,767)	 \$ 226,224
 Other current liabilities	 \$ 16,889	 \$ (2,015)	 \$ 14,874
9.75% Senior Notes, due December 2010	15,820		15,820
Callon Entrada non-recourse credit facility	84,847	(84,847)	
 Total current liabilities	 117,556	 (86,862)	 30,694
Total long-term debt	179,174		179,174
Total other long-term liabilities	12,115		12,115
Total stockholders' equity (deficit)	(80,854)	85,095	4,241
 Total liabilities and stockholders' equity (deficit)	 \$ 227,991	 \$ (1,767)	 \$ 226,224

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Callon Petroleum Company
Notes to the Consolidated Financial Statements

(all amounts in thousands, except per-share, per-note and per-hedge data)

Note 3 Minerals Management Service (MMS) Royalty Recoupment

In November 2009 the Company filed for a recoupment of royalties paid in the amount of \$44,787 from inception-to-date production at the Company's Medusa field. As of December 31, 2009, Callon accrued the royalty recoupment of \$44,787 and estimated interest of \$7,681. The Company received the recoupment of principal in January 2010, and expects to receive during the second quarter of 2010 interest of \$7,927, which includes additional accrued interest for the three-months ended March 31, 2010.

Note 4 Earnings per Share

The following table sets forth the computation of basic and diluted earnings per share:

	Three Months Ended March	
	31,	
	2010	2009
(a) Net income	\$ 3,923	\$ 2,404
(b) Weighted average shares outstanding	28,738	21,607
Dilutive impact of stock options	37	
Dilutive impact of restricted stock	454	
(c) Weighted average shares outstanding for diluted net income per share	29,229	21,607
Basic net income per share (a,b)	\$ 0.14	\$ 0.11
Diluted net income per share (a,c)	\$ 0.13	\$ 0.11

The following were excluded from the diluted EPS calculation because their effect would be anti-dilutive:

Stock options	266	503
Warrants	365	365
Restricted stock	277	509

Note 5 Comprehensive Income (Loss)

The components of comprehensive income (loss), net of related taxes, are as follows:

	Three Months Ended March	
	31,	
	2010	2009
Net income	\$ 3,923	\$ 2,404
Other comprehensive loss:		
Change in fair value of derivatives	190	(6,923)
Total comprehensive income (loss)	\$ 4,113	\$ (4,519)

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Callon Petroleum Company
Notes to the Consolidated Financial Statements
(all amounts in thousands, except per-share, per-note and per-hedge data)

Note 6 Borrowings

The Company's borrowings consisted of the following at:

	March 31, 2010	December 31, 2009
Principal components:		
Senior secured revolving credit facility	\$	\$ 10,000
9.75% Senior Notes due 2010, principal (1)	16,052	16,052
13% Senior Notes due 2016, principal	137,961	137,961
Callon Entrada non-recourse credit facility (2)		84,847
Total principal outstanding	154,013	248,860
Non-cash components:		
9.75% Senior Notes, due 2010 unamortized discount	(174)	(232)
13% Senior Notes due 2016 unamortized deferred credit	30,324	31,213
Total carrying value	\$ 184,163	\$ 279,841

(1) Balance was repaid April 30, 2010. See subsequent event discussion below.

(2) Liability was removed as part of the deconsolidation of Callon Entrada. See Note 2 for additional information.

Senior Secured Revolving Credit Facility (the Credit Facility)

In January 2010, the Company amended its Credit Facility agreement to include Regions Bank as the sole arranger and administrative agent. The third amended and restated Credit Facility agreement, which matures on September 25, 2012, provides for a \$100,000 facility with an initial borrowing base of \$20,000, which will be reviewed and re-determined on a semi-annual basis during the second and fourth quarters. The third amended and restated Credit Facility bears interest at 4% above a defined base rate and in no event will the interest rate be less than 6%. As of March 31, 2010, the interest rate on the facility was 6%. In addition, a commitment fee of 0.5% per annum on the unused portion of the borrowing base, is payable quarterly.

Simultaneously with the execution of the third amended and restated Credit Facility agreement, the Company repaid the \$10,000 outstanding draw under the second amended and restated senior secured credit agreement, which was outstanding as of December 31, 2009.

9.75% Senior Notes (Old Notes) (Due December 2010)

During the fourth quarter of 2009, Callon commenced an exchange offer for any and all of its outstanding Old Notes. Holders of approximately 92% of the Old Notes tendered their Old Notes in the exchange offer. The principal amount of the remaining Old Notes was \$16,052 at March 31, 2010 and is due in 2010. The Company recorded an unamortized discount of \$174 and \$232 at March 31, 2010 and December 31, 2009, respectively. During March 2010, the Company announced its intension to redeem all remaining Old Notes by April 30, 2010 (the Redemption Date) at a redemption price of 101% of their principal amount, plus accrued and unpaid interest to the Redemption Date. Pursuant to the terms of the debt agreement, the Company mailed a notice of redemption to all registered holders of the Notes, and has posted the notice with the responsible transfer agent.

Subsequent event

On April 30, 2010, the Company completed its publically announced plans to redeem the \$16,052 remaining outstanding Old Notes for \$16,343, which included the 1% call premium and \$130 of accrued interest through the repurchase date. The Company also recognized \$179 of additional interest expense related to the accelerated amortization of the remaining discount and debt issuance costs related to the Old Notes. As of April 30, 2010, no Old Notes remain outstanding.

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Callon Petroleum Company
Notes to the Consolidated Financial Statements
(all amounts in thousands, except per-share, per-note and per-hedge data)

13% Senior Notes due 2016 (Senior Notes) and Deferred Credit

As described above, during the fourth quarter of 2009, the Company exchanged approximately 92% of the principal amount, or \$183,948, of the Old Notes for \$137,961 of Senior Notes. The exchange resulted in a 25% reduction in the principal amount of the Old Notes tendered, and included a 3.25% increase in the coupon rate from 9.75% to 13%. In addition, holders of the tendered notes received 3,794 shares of common stock and 311 shares of Convertible Preferred Stock which was valued on November 24, 2009 in the amount of \$11,527, and recorded as an increase to stockholders' equity. On December 31, 2009, each share of the Convertible Preferred Stock was automatically converted by the Company into 10 shares of common stock following shareholder approval and the filing of an amendment to the Company's charter increasing the number of authorized shares of common stock as necessary to accommodate such conversion. The Senior Notes' 13% interest coupon is payable on the last day of each quarter.

Upon issuing the Senior Notes during December 2009, the Company reduced the carrying amount of the Old Notes by the fair value of the common and preferred stock issued in the amount of \$11,527. The difference between the adjusted carrying amount of the Old Notes and the face value of the Senior Notes was recorded as a deferred credit, which is being amortized as a credit to interest expense over the life of the Senior Notes at an 8.5% effective interest rate. The following table summarizes the Company's deferred credit balance at March 31, 2010:

Gross Carrying Amount	Accumulated Amortization at March 31, 2010	Carrying Value at March 31, 2010	Amortization Recorded during 2010 as a Reduction of Interest Expense	Estimated Amortization Expected to be Recorded for the Remainder of 2010
\$31,507	\$1,183	\$30,324	\$889	\$2,706

Certain of the Company's subsidiaries guarantee the Company's obligations under the Senior Notes. The subsidiary guarantors are 100% owned, all of the guarantees are full and unconditional and joint and several, the parent company has no independent assets or operations and any subsidiaries of the parent company other than the subsidiary guarantors are minor.

Restrictive Covenants

The Indenture governing our Senior Notes and the Company's senior secured credit facility contains various covenants including restrictions on additional indebtedness and payment of cash dividends. In addition, Callon's senior secured credit facility contains covenants for maintenance of certain financial ratios. The Company was in compliance with these covenants at March 31, 2010.

Note 7 Derivative Instruments and Hedging Activities*Objectives and Strategies for Using Derivative Instruments*

The Company is exposed to fluctuations in crude oil and natural gas prices on the majority of its production. Consequently, the Company believes it is prudent to manage the variability in cash flows on a portion of its crude oil and natural gas production. The Company utilizes primarily collars and swap derivative financial instruments to manage fluctuations in cash flows resulting from changes in commodity prices. The Company does not use these instruments for trading purposes.

Counterparty Risk

The use of derivative transactions exposes the Company to counterparty credit risk, or the risk that a counterparty will be unable to meet its commitments. To reduce the Company's risk