

CONTANGO OIL & GAS CO
Form 10-Q
November 09, 2012

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 September 30, 2012
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 001-16317
CONTANGO OIL & GAS COMPANY
(Exact name of registrant as specified in its charter)

DELAWARE
(State or other jurisdiction of incorporation or organization)
3700 BUFFALO SPEEDWAY, SUITE 960 HOUSTON, TEXAS 77098
(Address of principal executive offices)
(713) 960-1901
(Registrant's telephone number, including area code)

95-4079863
(IRS Employer Identification No.)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) 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 large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

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

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

The total number of shares of common stock, par value \$0.04 per share, outstanding as of November 1, 2012 was 15,194,952.

CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(Unaudited)

	September 30, 2012 (thousands)	June 30, 2012
CURRENT ASSETS:		
Cash and cash equivalents	\$ 137,784	\$ 129,983
Accounts receivable:		
Trade receivables	28,332	29,688
Joint interest billings	4,695	4,768
Income taxes	12,327	4,510
Prepaid expenses	3,086	5,762
Other	1,062	502
Total current assets	187,286	175,213
PROPERTY, PLANT AND EQUIPMENT:		
Natural gas and oil properties, successful efforts method of accounting:		
Proved properties	555,680	561,713
Unproved properties	16,021	12,485
Furniture and equipment	216	213
Accumulated depreciation, depletion and amortization	(187,246	) (178,081
Total property, plant and equipment, net	384,671	396,330
OTHER ASSETS:		
Investments in affiliates	46,197	52,827
Other	255	284
TOTAL ASSETS	\$ 618,409	\$ 624,654
CURRENT LIABILITIES:		
Accounts payable	\$ 4,488	\$ 3,084
Royalties and revenue payable	18,709	22,098
Accrued liabilities	5,319	6,796
Accrued exploration and development	32,611	2,334
Total current liabilities	61,127	34,312
DEFERRED TAX LIABILITY	110,778	118,010
ASSET RETIREMENT OBLIGATIONS	9,714	7,993
SHAREHOLDERS' EQUITY:		
Common stock, \$0.04 par value, 50,000,000 shares authorized; 20,135,107 shares issued and 15,292,448 shares outstanding at September 30, 2012 and June 30, 2012	805	805
Additional paid-in capital	79,024	79,024
Treasury shares at cost (4,842,659 shares at September 30, 2012 and June 30, 2012)	(112,207	) (112,207
Retained earnings	469,168	496,717
Total shareholders' equity	436,790	464,339
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 618,409	\$ 624,654

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

CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended September 30,	
	2012	2011
	(thousands, except per share amounts)	
REVENUES:		
Natural gas, oil and liquids sales	\$29,765	\$44,203
Total revenues	29,765	44,203
EXPENSES:		
Operating expenses	6,464	5,889
Exploration expenses	44,984	24
Depreciation, depletion and amortization	9,566	10,956
Impairment of natural gas and oil properties	8,410	—
General and administrative expenses	2,580	2,248
Total expenses	72,004	19,117
Gain from investments in affiliates, net of tax of \$88	164	—
Other income/(expense)	(12	) (77
NET INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	(42,087	) 25,009
Income tax benefit (provision)	14,538	(9,423
NET INCOME (LOSS) FROM CONTINUING OPERATIONS	(27,549	) 15,586
DISCONTINUED OPERATIONS (NOTE 8)		
Discontinued operations, net of income taxes	—	(682
NET INCOME (LOSS) ATTRIBUTABLE TO COMMON STOCK	\$(27,549	) \$14,904
NET INCOME (LOSS) PER SHARE:		
Basic		
Continuing operations	\$(1.80	) \$0.99
Discontinued operations	—	(0.04
Total	\$(1.80	) \$0.95
Diluted		
Continuing operations	\$(1.80	) \$0.99
Discontinued operations	—	(0.04
Total	\$(1.80	) \$0.95
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING:		
Basic	15,292	15,639
Diluted	15,292	15,642

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

CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Three Months Ended September 30,	
	2012	2011
	(thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss) from continuing operations	\$ (27,549	) \$ 15,586
Loss from discontinued operations, net of income taxes	—	(682)
Net income (loss)	(27,549	) 14,904
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, depletion and amortization	9,566	10,956
Impairment of natural gas and oil properties	8,410	1,031
Exploration expenses	44,832	—
Deferred income taxes	(7,232	) (94)
Gain from investment in affiliates	(252) —
Changes in operating assets and liabilities:		
Decrease in accounts receivable and other	1,355	2,285
Decrease in prepaids and other receivables	200	894
Decrease in accounts payable and advances from joint owners	(1,913	) (14,625)
Decrease in other accrued liabilities	(1,477	) (4,777)
Decrease (increase) in income taxes receivable, net	(7,817	) 1,649
Other	(207	) 366
Net cash provided by operating activities	17,916	12,589
CASH FLOWS FROM INVESTING ACTIVITIES:		
Natural gas and oil exploration and development expenditures	(17,205	) (11,476)
Investment in affiliates	(733	) (140)
Return of investments in affiliates	7,823	—
Net cash used in investing activities	(10,115	) (11,616)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Purchase of common stock	—	(13,532)
Net cash used in financing activities	—	(13,532)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	7,801	(12,559)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	129,983	150,007
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$ 137,784	\$ 137,448
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid for taxes, net of cash received	\$ 600	\$ 7,500
Cash paid for interest	\$ 13	\$ 37
The accompanying notes are an integral part of these consolidated financial statements		

CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY
(Unaudited)

	Common Stock		Additional	Treasury	Retained	Total
	Shares	Amount	Paid-in	Stock	Earnings	Shareholders'
	(thousands)		Capital			Equity
Balance at June 30, 2012	15,292	\$805	\$79,024	\$(112,207)	\$496,717	\$464,339
Net loss	—	—	—	—	(27,549)	(27,549)
Balance at September 30, 2012	15,292	\$805	\$79,024	\$(112,207)	\$469,168	\$436,790

The accompanying notes are an integral part of this consolidated financial statement

CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information, pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"), including instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all the information and footnotes required by GAAP for complete annual financial statements. In the opinion of management, all adjustments considered necessary for a fair statement of the unaudited consolidated financial statements have been included. All such adjustments are of a normal recurring nature. The consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes included in Contango Oil & Gas Company's ("Contango" or the "Company") Form 10-K for the fiscal year ended June 30, 2012. The consolidated results of operations for the three months ended September 30, 2012 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2013.

2. Business

We are a Houston-based, independent natural gas and oil company. Our core business is to explore, develop, produce and acquire natural gas and oil properties onshore and offshore in the Gulf of Mexico in water-depths of less than 300 feet, using cash generated from our existing property base. We have an inventory of six offshore prospects and no debt.

In July 2012, we drilled two exploration wells (Ship Shoal 134 and South Timbalier 75) and no commercial hydrocarbons were found. For the three months ended September 30, 2012, we recorded exploration expenses of approximately \$43.7 million, including leasehold costs, related to these two wells, with additional costs incurred in October and November 2012.

As of September 30, 2012, we had invested approximately \$12.3 million with Alta Energy Canada Partnership, G.P. ("Alta Energy") for a 5% ownership interest in the Kaybob Duvernay shale play. We had also invested approximately \$33.8 million with Exaro Energy III LLC ("Exaro") in the Jonah field in Wyoming, which is primarily development of proved reserves. In addition, as of September 30, 2012, the Company had invested approximately \$8.8 million in leasehold costs in the Tuscaloosa Marine Shale ("TMS") for approximately 24,000 acres.

3. Summary of Significant Accounting Policies

The application of GAAP involves certain assumptions, judgments, decisions and estimates that affect reported amounts of assets, liabilities, revenues, expenses, contingencies and reserves. Actual results could differ from these estimates. Contango's significant accounting policies are described below.

Successful Efforts Method of Accounting. The Company follows the successful efforts method of accounting for its natural gas and oil activities. Under the successful efforts method, lease acquisition costs and all development costs are capitalized. Exploratory drilling costs are capitalized until the results are determined. If proved reserves are not discovered, the exploratory drilling costs are expensed. Other exploratory costs, such as seismic costs and other geological and geophysical expenses, are expensed as incurred. The provision for depreciation, depletion and amortization is based on the capitalized costs as determined above. Depreciation, depletion and amortization is calculated on a field by field basis using the unit of production method, with lease acquisition costs amortized over total proved reserves and other costs amortized over proved developed reserves.

Impairment of Long-Lived Assets. When circumstances indicate that proved properties may be impaired, the Company compares expected undiscounted future net cash flows on a field by field basis to the unamortized capitalized cost of the asset. If the future undiscounted net cash flows based on the Company's estimate of future natural gas and oil prices and operating costs and anticipated production from proved reserves, are lower than the unamortized capitalized cost, then the capitalized cost is reduced to fair market value. For the three months ended September 30, 2012, we recorded an impairment expense of approximately \$8.4 million related to proved properties. Of this amount, approximately \$6.3 million related to our Ship Shoal 263 well and \$2.1 million related to the Eugene

Island 24 platform and other properties. No impairment of proved properties was recognized in continuing operations for the three months ended September 30, 2011.

Unproved properties are reviewed quarterly to determine if there has been impairment of the carrying value, with any such impairment charged to expense in the period. For the three months ended September 30, 2012, the Company recognized impairment expense of approximately \$6.6 million related to leasehold costs at our dry holes at Ship Shoal 134 and South Timbalier 75, plus an additional \$1.2 million related to an unsuccessful exploration program in Jim Hogg County, Texas. These

costs are included in total exploration expense of approximately \$45.0 million, together with the drilling, plugging and abandoning costs for the two dry holes. No impairment of unproved properties was recognized during the three months ended September 30, 2011.

Cash Equivalents. Cash equivalents are considered to be highly liquid investment grade investments having an original maturity of 90 days or less. As of September 30, 2012, the Company had approximately \$137.8 million in cash and cash equivalents, all of which was held in non-interest bearing accounts.

Principles of Consolidation. The Company's consolidated financial statements include the accounts of Contango Oil & Gas Company and its subsidiaries and affiliates, after elimination of all significant intercompany balances and transactions. Wholly-owned subsidiaries are consolidated. Exploration and development affiliates not wholly owned, such as 32.3% owned Republic Exploration, LLC ("REX"), are not controlled by the Company and are proportionately consolidated in the Company's financial statements.

Other Investments. The Company has a 19.5% ownership interest in Mobilize Inc. ("Mobilize") and a 2.0% ownership interest in Alta Energy. Both of these investments are accounted for using the cost method. The Company also has a 37% ownership interest in Exaro. The Company has two seats on the board of directors of Exaro, and has significant influence, but not control, over Exaro. As a result, the Company's 37% ownership in Exaro is accounted for using the equity method.

The Company originally had a 45% ownership interest in Exaro upon its formation in April 2012. In August 2012, one of the other investors in Exaro exercised its right to assume \$15 million of the Company's commitment by making a cash payment to the Company of \$7.5 million and agreeing to assume \$7.5 million of future commitment in Exaro. This lowered the Company's ownership interest to 37%. As of November 1, 2012, the Company had invested approximately \$33.8 million in Exaro.

Recent Accounting Pronouncements. In December 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update No. 2011-11 Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities (ASU 2011-11). ASU 2011-11 requires that an entity disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. ASU 2011-11 is effective for annual and interim periods beginning on or after January 1, 2013. We are currently evaluating the provisions of ASU 2011-11 and assessing the impact, if any, it may have on the disclosures in our financial statements.

Reclassifications. Certain reclassifications have been made to the amounts included in the consolidated financial statements as of June 30, 2012 and for the three months ended September 30, 2011, in order to conform to the 2012 presentation. These reclassifications were not material.

4. Natural Gas and Oil Exploration and Production Risk

The Company's future financial condition and results of operations will depend upon prices received for its natural gas and oil production and the cost of finding, acquiring, developing and producing reserves. Substantially all of the Company's production is sold under various terms and arrangements at prevailing market prices. Prices for natural gas and oil are subject to fluctuations in response to changes in supply, market uncertainty and a variety of other factors beyond the Company's control.

Other factors that have a direct bearing on the Company's financial condition are uncertainties inherent in estimating natural gas and oil reserves and future hydrocarbon production and cash flows, particularly with respect to wells that have not been fully tested and with wells having limited production histories; the timing and costs of our future drilling; development and abandonment activities; access to additional capital; changes in the price of natural gas and oil; availability and cost of services and equipment; and the presence of competitors with greater financial resources and capacity.

5. Customer Concentration Credit Risk

The customer base for the Company is concentrated in the natural gas and oil industry. Major purchasers of our natural gas and oil for the three months ended September 30, 2012 were ConocoPhillips Company, Shell Trading US Company, Exxon Mobil Oil Corporation, Enterprise Products Operating LLC, Crosstex Energy Services, JP Morgan

Ventures Energy Corporation and Trans Louisiana Gas Pipeline, Inc. Our sales to these companies are not secured with letters of credit and in the event of non-payment, we could lose up to two months of revenues. The loss of two months of revenues would have a material adverse effect on our financial position, but there currently are numerous other potential purchasers of our production.

6. Net Income (Loss) per Common Share

A reconciliation of the components of basic and diluted net income (loss) per share of common stock is presented below:

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	Three Months Ended September 30, 2012			Three Months Ended September 30, 2011		
	Loss	Shares	Per Share	Income (loss)	Shares	Per Share
	(thousands, except per share amounts)					
Income (loss) from continuing operations	\$(27,549)	15,292	\$(1.80)	\$15,586	15,639	\$0.99
Discontinued operations, net of income tax	—	15,292	—	(682)	15,639	(0.04)
Basic Earnings per Share:						
Net income (loss) attributable to common stock	\$(27,549)	15,292	\$(1.80)	\$14,904	15,639	\$0.95
Effect of potential dilutive securities:						
Stock options, net of shares assumed purchased	—	—	—	—	3	
Income (loss) from continuing operations	\$(27,549)	15,292	\$(1.80)	\$15,586	15,642	\$0.99
Discontinued operations, net of income tax	—	15,292	—	(682)	15,642	(0.04)
Diluted Earnings per Share:						
Net income (loss) attributable to common stock	\$(27,549)	15,292	\$(1.80)	\$14,904	15,642	\$0.95

7. Credit Facility

In October 2010, the Company completed the arrangement of a secured revolving credit agreement with Amegy Bank (the "Credit Agreement"). The Credit Agreement currently has a \$40 million hydrocarbon borrowing base and is available to fund the Company's exploration and development activities, as well as repurchase shares of common stock, pay dividends and fund working capital as needed. The Credit Agreement is secured by substantially all of the assets of the Company. Borrowings under the Credit Agreement bear interest at LIBOR plus 2.5%, subject to a LIBOR floor of 0.75%. The principal is due October 1, 2014, and may be prepaid at any time with no prepayment penalty. An arrangement fee of \$300,000 was paid in connection with the facility and effective November 1, 2011, a commitment fee of 0.125% is owed on unused borrowing capacity. The Credit Agreement contains customary covenants including limitations on our current ratio and additional indebtedness. As of September 30, 2012, the Company was in compliance with all covenants and had no borrowings outstanding under the Credit Agreement.

8. Discontinued Operations

In May 2011, the Company sold its 100% working interest (72.5% net revenue interest) in Rexer #1 and a 75% working interest (54.4% net revenue interest) in Rexer-Tusa #2 to Patara Oil & Gas LLC ("Patara"). B.A. Berilgen, a member of the Company's board of directors, is the Chief Executive Officer of Patara. In October 2011, the Company sold its remaining 25% working interest (18.4% net revenue interest) in Rexer-Tusa #2 to Patara. The sale was effective October 1, 2011. The Company has accounted for the sale of Rexer #1 and Rexer-Tusa #2 as discontinued operations as of December 31, 2011 and reclassified the results of operations for these two wells to discontinued operations for all periods presented as follows:

	Three Months Ended September 30, 2011
Results of Operations:	
Revenues	\$—
Operating expenses	(10)
Exploration expenses	(1,031)
Impairment of natural gas and oil properties	(8)
Loss before income taxes	(1,049)
Income tax benefit	367
Loss from discontinued operations, net of income taxes	\$(682)

9. Income Taxes

The Company's income tax provision for continuing operations consists of the following:

	Three Months Ended September 30,	
	2012	2011
Current tax provision (benefit):		
Federal	\$ (7,874	) \$ 8,246
State	568	907
Total	\$ (7,306	) \$ 9,153
Deferred tax provision (benefit):		
Federal	\$ (7,108	) \$ 286
State	(124	) (16
Total	\$ (7,232	) \$ 270
Total tax provision (benefit):		
Federal	\$ (14,982	) \$ 8,532
State	444	891
Total	\$ (14,538	) \$ 9,423

10. Related Party Transactions

Juneau Exploration L.P. In April 2012, the Company announced that Mr. Brad Juneau, the sole manager of the general partner of Juneau Exploration, L.P. ("JEX"), had joined the Company's board of directors and that the Company had entered into an advisory agreement with JEX (the "Advisory Agreement"), whereby in addition to generating and evaluating offshore and onshore exploration prospects for the Company, JEX will direct Contango's staff on operational matters including drilling, completions and production. Pursuant to the Advisory Agreement, JEX will be paid an annual fee of \$2.0 million. In August 2012, the Company's Chairman and Chief Executive Officer, Mr. Kenneth R. Peak, took a six month leave of absence, and the Board of Directors of the Company appointed Mr. Juneau as President and Acting Chief Executive Officer of the Company. Mr. Peak remains the Company's Chairman. JEX has historically participated with the Company in the drilling and development of certain prospects through participation agreements and joint operating agreements, which specify each participant's working interest ("WI"), net revenue interest ("NRI"), and describe when such interests are earned, as well as allocate an overriding royalty interest ("ORRI") of up to 3.33% to benefit the employees of JEX, excluding Mr. Juneau, except where otherwise noted.

Republic Exploration LLC. In his capacity as sole manager of the general partner of JEX, Mr. Juneau also controls the activities of REX, an entity owned 34.4% by JEX, 32.3% by Contango, and 33.3% by a third party which contributed other assets to REX. REX generates and evaluates offshore exploration prospects and has historically participated with the Company in the drilling and development of certain prospects through participation agreements and joint operating agreements, which specify each participant's working interest, net revenue interest, and describe when such interests are earned, as well as allocate an overriding royalty interest ("ORRI") of up to 3.33% to benefit the employees of JEX. The Company proportionately consolidates the results of REX in its consolidated financial statements.

As of September 30, 2012, Contango, JEX, REX and JEX employees owned the following interests in the Company's offshore wells.

	Contango		JEX		REX		JEX Employees	
	WI	NRI	WI	NRI	WI	NRI	ORRI	
Dutch #1 - #5	47.05	% 38.12	% 1.61	% 1.29	% —	% —	% 2.02%	
Mary Rose #1	53.21	% 40.45	% 2.01	% 1.51	% —	% —	% 2.79%	
Mary Rose #2 - #3	53.21	% 38.67	% 2.01	% 1.44	% —	% —	% 2.79%	
Mary Rose #4	34.58	% 25.49	% 1.31	% 0.95	% —	% —	% 1.82%	
Mary Rose #5	37.80	% 27.88	% 1.43	% 1.04	% —	% —	% 1.54%	
Ship Shoal 263	100.00	% 80.00	% —	% —	% —	% —	% 3.33%	

Vermilion 170

83.20 % 64.83 % 4.30 % 3.35 % 12.50 % 9.74 % 3.33%

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Below is a summary of payments received from (paid to) JEX and REX in the ordinary course of business in our capacity as operator of the wells and platforms for the periods indicated. The Company made and received similar types of payments with other well owners (in thousands):

	Three months ended September 30,					
	2012		2011			
	JEX	REX	JEX	REX		
Revenue payments as well owners	\$(1,133)\$(849)	\$(1,283)\$(30)
Joint interest billing receipts	220	91	247	1,082		

Below is a summary of payments received from (paid to) JEX and REX as a result of specific transactions between the Company, JEX and REX. While these payments are in the ordinary course of business, the Company did not have similar transactions with other well owners (in thousands):

	Three months ended September 30,				
	2012		2011		
	JEX	REX	JEX	REX	
Reimbursement of certain costs	\$(146)\$—	\$ (5)\$(10)
Prospect fees	—	—	(250)—	