PETROHAWK ENERGY CORP
Form 10-Q
November 03, 2006
Table of Contents

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, 2006

Commission file number 000-25717

PETROHAWK ENERGY CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**86-0876964**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**

1100 Louisiana, Suite 4400, Houston, Texas 77002

(Address of principal executive offices including ZIP code)

(832) 204-2700

(Registrant s telephone number)

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, par value $.001 per share	**NASDAQ Global Select Market**

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 x 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 ¨ Accelerated filer x Non-accelerated filer ¨

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 126-2 of the Exchange Act).

Yes ¨ No x

As of October 30, 2006 the Registrant had 168,444,455 shares of Common Stock, $.001 par value, outstanding.

Table of Contents

TABLE OF CONTENTS

Table of Contents

This report on Form 10-Q contains forward-looking statements within the meaning of the federal securities laws. These forward-looking statements may include, among others, the following:

- our growth strategies;
- anticipated trends in our business;
- our future results of operations;
- our ability to make or integrate acquisitions;
- our liquidity and ability to finance our exploration, acquisition and development activities;
- our ability to successfully and economically explore for and develop oil and gas resources;
- market conditions in the oil and gas industry;
- the timing, cost and procedure for proposed acquisitions;
- the impact of government regulation;
- planned capital expenditures;
- increases in oil and gas production; and
- our financial position, business strategy and other plans and objectives for future operations.

We identify forward-looking statements by use of terms such as expect, anticipate, estimate, plan, believe, intend, will, continue, should, could and similar words and expressions, although some forward-looking statements may be expressed differently. You should be aware that our actual results could differ materially from those contained in the forward-looking statements. You should consider carefully the statements under the Risk Factors section of this report and other sections of this report which describe factors that could cause our actual results to differ from those set forth in the forward-looking statements, and the following factors:

- the possibility that problems may arise in successfully integrating the businesses of Petrohawk and KCS;
- the possibility that the combined company may he unable to achieve cost-cutting synergies;

- the possibility that the industry may be subject to future regulatory or legislative actions (including any additional taxes);
- the volatility in commodity prices for oil and gas and in the supply of and demand for oil and gas;
- the presence or recoverability of estimated oil and gas reserves and the actual future production rates and associated costs;
- the ability to replace oil and gas reserves;
- environmental risks;
- drilling and operating risks;
- exploration and development risks;
- competition;
- the ability of the company s management to execute its plans to meet its goals;
- the ability of the company to retain key members of its senior management and key employees;
- general economic conditions, whether internationally, nationally or in the regional and local market areas in which Petrohawk is doing business, may be less favorable than expected;
- continued hostilities in the Middle East and other sustained military campaigns or acts of terrorism or sabotage; and
- other economic, competitive, governmental, legislative, regulatory, geopolitical and technological factors may negatively impact our businesses, operations or pricing.

All forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by the cautionary statements in this paragraph and elsewhere in this document. Other than as required under the securities laws, we do not assume a duty to update these forward-looking statements, whether as a result of new information, subsequent events or circumstances, changes in expectations or otherwise.

Table of Contents

PART I. FINANCIAL INFORMATION

PETROHAWK ENERGY CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)

(In thousands, except per share amounts)

	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Operating revenues:				
Oil and gas	$ 196,439	$ 81,447	$ 385,859	$ 149,957
Operating expenses:				
Production:				
Lease operating	17,594	10,276	40,460	19,826
Workover and other	2,720	941	5,210	2,180
Taxes other than income	15,739	6,405	30,346	10,842
Gathering, transportation and other	5,178	515	9,314	1,135
General and administrative:				
General and administrative	12,132	5,782	25,883	13,258
Stock-based compensation	3,173	780	5,041	3,003
Depletion, depreciation and amortization	89,212	22,730	164,120	45,238
Total operating expenses	145,748	47,429	280,374	95,482
Income from operations	50,691	34,018	105,485	54,475
Other income (expenses):				
Net gain (loss) on derivative contracts	68,048	(83,585)	94,495	(120,568)
Interest expense and other	(35,870)	(9,923)	(55,865)	(20,306)
Total other income (expenses)	32,178	(93,508)	38,630	(140,874)
Income (loss) before income taxes	82,869	(59,490)	144,115	(86,399)
Income tax (provision) benefit	(30,213)	23,066	(53,667)	33,521
Net income (loss)	52,656	(36,424)	90,448	(52,878)
Preferred dividends		(110)	(217)	(329)
Net income (loss) available to common shareholders	$ 52,656	$ (36,534)	$ 90,231	$ (53,207)
Earnings (loss) per share of common stock:				
Basic	$ 0.34	$ (0.56)	$ 0.84	$ (1.10)
Diluted	$ 0.33	$ (0.56)	$ 0.82	$ (1.10)
Weighted average shares outstanding:				
Basic	157,135	64,877	107,908	48,425
Diluted	159,647	64,877	110,706	48,425

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

4

Table of Contents

PETROHAWK ENERGY CORPORATION

CONSOLIDATED BALANCE SHEETS (Unaudited)

(In thousands, except share and per share amounts)

	September 30, 2006	December 31, 2005
Current assets:		
Cash	$ 6,284	$ 12,911
Accounts receivable	139,448	68,087
Deferred income taxes	11,379	18,304
Receivables from derivative contracts	44,573	1,286
Prepaid expenses and other	15,848	5,393
Total current assets	217,532	105,981
Oil and gas properties (full cost method):		
Evaluated	2,792,857	1,100,273
Unevaluated	593,816	162,133
Gross oil and gas properties	3,386,673	1,262,406
Less accumulated depletion	(286,086)	(121,456)
Net oil and gas properties	3,100,587	1,140,950
Other noncurrent assets:		
Goodwill	933,479	132,029
Debt issuance costs, net of amortization	15,615	1,969
Receivables from derivative contracts	11,401	2,252
Other	9,437	26,993
Total assets	$ 4,288,051	$ 1,410,174
Current liabilities:		
Accounts payable and accrued liabilities	$ 265,046	$ 90,017
Liabilities from derivative contracts	13,563	51,081
Current portion of long-term debt	4,594	2,788
Total current liabilities	283,203	143,886
Long-term debt	1,395,019	495,801
Liabilities from derivative contracts	15,095	35,695
Asset retirement obligations	46,286	50,133
Deferred income taxes	650,180	153,155
Other noncurrent liabilities	2,273	5,046
Commitments and contingencies (Note 6)		
Stockholders equity:		
Convertible preferred stock: 5,000,000 shares of $.001 par value authorized; no shares issued or outstanding at September 30, 2006 and 593,271 at December 31, 2005;		1
Common stock: 300,000,000 and 75,000,000 shares of $.001 par value authorized at September 30, 2006 and December 31, 2005; 168,440,308 and 73,566,117 shares issued and outstanding at September 30, 2006 and December 31, 2005	168	74

Additional paid-in capital	1,837,629	558,452
Treasury stock, at cost, 8,382 shares at December 31, 2005, retired at September 30, 2006		(36)
Retained earnings (accumulated deficit)	58,198	(32,033)
Total stockholders equity	1,895,995	526,458
Total liabilities and stockholders equity	$ 4,288,051	$ 1,410,174

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

5

Table of Contents

PETROHAWK ENERGY CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

(In thousands)

	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Cash flows from operating activities:		
Net income (loss)	$ 90,448	$ (52,878)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depletion, depreciation and amortization	164,120	45,238
Income tax provision (benefit)	53,667	(33,521)
Stock-based compensation	5,041	3,003
Net unrealized (gain) loss on derivative contracts	(106,304)	109,543
Net realized loss on derivative contracts acquired	14,597	9,657
Other	88	889
Change in assets and liabilities, net of acquisitions:		
Accounts receivable	(530)	(2,114)
Prepaid expenses and other	(4,918)	(1,460)
Accounts payable and accrued liabilities	(29,921)	7,204
Other	(3,964)	(133)
Net cash provided by operating activities	182,324	85,428
Cash flows from investing activities:		
Oil and gas capital expenditures	(222,696)	(88,427)
Acquisition of KCS, net of cash acquired of $8,260	(512,152)	
Acquisition of Winwell Resources, Inc., net of cash acquired of $14,965	(175,037)	
Acquisition of Mission Resources, net of cash acquired of $48,359		(95,816)
Acquisition of Proton Oil & Gas Corp., net of cash acquired of $870		(52,625)
Acquisition of oil and gas properties	(87,893)	
Proceeds received from sale of oil and gas properties	62,083	88,844
Other	10,117	(1,741)
Net cash used in investing activities	(925,578)	(149,765)
Cash flows from financing activities:		
Proceeds from exercise of options	2,466	11,780
Proceeds from issuance of common stock	188,500	
Acquisition of common stock	(46,200)	
Proceeds from borrowings	1,466,183	310,000
Repayment of borrowings	(828,319)	(249,000)
Debt issue costs	(14,374)	
Net realized loss on derivative contracts acquired	(14,597)	(9,657)
Offering costs	(10,725)	
Buyback of 8% cumulative preferred stock	(5,339)	
Dividends paid on 8% cumulative preferred stock	(328)	(220)
Other	(640)	(46)
Net cash provided by financing activities	736,627	62,857
Net decrease in cash	(6,627)	(1,480)

Cash at beginning of period	12,911	5,660
Cash at end of period	$ 6,284	$ 4,180

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

Table of Contents

PETROHAWK ENERGY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. FINANCIAL STATEMENT PRESENTATION

During interim periods, Petrohawk Energy Corporation (Petrohawk or the Company) follows the same accounting policies disclosed in its Report on Form 10-K for the preceding fiscal year, as amended and filed with the Securities and Exchange Commission (SEC). Please refer to the footnotes in the Form 10-K when reviewing interim financial results.

These unaudited consolidated financial statements reflect, in the opinion of the Company s management, all adjustments, consisting only of normal and recurring adjustments, necessary to present fairly the financial position as of, and results of operations for, the periods presented. Interim period results are not necessarily indicative of results of operations or cash flows for the full year.

On July 12, 2006, the Company completed its previously announced merger with KCS Energy, Inc. (KCS). Please refer to Note 2, *Acquisitions and Divestitures*, for more details on KCS s merger with and into the Company and various related transactions.

Recently Issued Accounting Pronouncements

During July 2006, the Financial Accounting Standards Board (FASB) issued Financial Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109 (FIN 48).* FIN 48 addresses the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with Statement of Financial Accounting Standards (SFAS) No. 109, *Accounting for Income Taxes*. FIN 48 prescribes specific criteria for the financial statement recognition and measurement of the tax effects of a position taken or expected to be taken in a tax return. This interpretation also provides guidance on derecognition of previously recognized tax benefits, classification of tax liabilities on the balance sheet, recording interest and penalties on tax underpayments, accounting in interim periods, and disclosure requirements. FIN 48 is effective for fiscal periods beginning after December 15, 2006. The Company is currently assessing the impact, if any, that the adoption of FIN 48 will have on its financial statements.

In December 2004, the FASB issued SFAS No. 123(R), *Share-Based Payment* (SFAS 123(R)). SFAS 123(R) revises SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS 123), and focuses on accounting for share-based payments for services provided by employee to employer. The statement requires companies to expense the fair value of employee stock options and other equity-based compensation at the grant date. The statement does not require a certain type of valuation model, and either a binomial or Black-Scholes model may be used. During the first quarter of 2005, the SEC approved a new rule for public companies to delay the adoption of this standard. In April 2005, the SEC took further action to amend Regulation S-X to state that the provisions of SFAS No. 123(R) will be effective beginning with the first annual or interim reporting period of the registrant s first fiscal year beginning on or after June 15, 2005 for all non-small business issuers. As a result, the Company did not adopt this SFAS until January 1, 2006. The Company used the modified prospective application method as detailed in SFAS No. 123(R). The adoption of this pronouncement did not materially impact the Company s operating results, financial position or cash flows. See Stock-Based Compensation below for further information.

Stock-Based Compensation

Prior to 2006, the Company followed SFAS 123 and related interpretations in accounting for its employee and director stock options and applied the fair value based method of accounting to such options. Under SFAS 123, the fair value of each option granted is estimated on the date of grant using the Black-Scholes option-pricing model. All activity in 2005 was accounted for under SFAS 123 and was included in stock-based compensation in the Company s operating results.

Table of Contents

PETROHAWK ENERGY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

As allowed by SFAS 123(R), the Company utilizes the Black-Scholes option pricing model to measure the fair value of stock options granted upon adoption of SFAS 123(R).

The assumptions used in the fair value method calculation for the nine months ended September 30, 2006 and 2005 are disclosed in the following table:

	Nine Months Ended September 30, 2006[1][2]	Nine Months Ended September 30, 2005
Weighted average value per option granted during the period[3]	$ 6.96	$ 2.29
Assumptions[4]:		
Stock price volatility	39.0%	29.2%
Risk free rate of return	4.9%	3.6%
Expected term	2.9 years	3.0 years

(1) Includes assumptions from valuation related to the KCS merger. Refer to Note 8, Stockholders Equity for further details on these assumptions.

(2) The Company s estimated future forfeiture rate is 5%.

(3) Calculated using the Black-Scholes fair value based method.

(4) The Company does not pay dividends on its common stock.

The following table sets forth the option transactions for the nine month period ended September 30, 2006 (in thousands, except share and per share amounts).

	Number of Options	Weighted Average Exercise Price Per Share	Aggregate Intrinsic Value[1]	Weighted Average Remaining Contractual Life (Years)
Outstanding at December 31, 2005	5,698,547	$ 6.16		5.6
KCS options assumed in merger[2]	2,585,950	3.96		
Granted	1,866,270	11.93		
Exercised	(403,482)	6.30		
Forfeited	(294,411)	15.88		
Outstanding at September 30, 2006	9,452,874	$ 6.38	$ 37,968	6.2
Exercisable at September 30, 2006	6,908,413	$ 4.64	$ 39,825	5.3

(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. The aggregate intrinsic value of stock options exercised during the nine month period ended September 30, 2006 was approximately $2.2 million.

(2) Includes KCS converted stock options as of July 12, 2006.

There were no options which expired in the nine month period ended September 30, 2006. The weighted average grant date fair value of options granted during the nine month period ended September 30, 2006 was $30.6 million. At September 30, 2006 the unrecognized compensation expense related to non-vested stock options totaled $6.8 million and will be recognized on a straight line basis over the weighted average remaining vesting period of 2.2 years.

In conjunction with the KCS merger, KCS stock options and shares were converted into 2.6 million Petrohawk stock options.

Table of Contents

PETROHAWK ENERGY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

The following table sets forth the restricted stock transactions for the nine month period ended September 30, 2006 (in thousands, except share and per share amounts).

	Number of Shares	Weighted Average Grant Date Fair Value Per Share	Aggregate Intrinsic Value(1)
Unvested outstanding shares at December 31, 2005	73,334	$ 10.87	
KCS shares assumed in merger(2)	616,238	12.36	
Granted	887,638	11.71	
Vested	(72,872)	11.77	
Forfeited	(7,444)	11.48	
Unvested outstanding shares at September 30, 2006	1,496,894	$ 11.94	$ 15,568

(1) *The intrinsic value of restricted stock was calculated as the closing market price on September 30, 2006 of the underlying stock multiplied by the number of restricted shares. The intrinsic value of the shares vested for the nine month period ended September 30, 2006 was $0.9 million.*

(2) *Includes KCS restricted stock as of July 12, 2006.*

The weighted average grant date fair value of the shares granted during the nine month period ended September 30, 2006 was $18.2 million. At September 30, 2006, the unrecognized compensation expense related to non-vested restricted stock totaled $13.0 million and will be recognized on a straight line basis over the weighted average remaining vesting period of 2.1 years. In conjunction with the KCS merger, KCS restricted stock was converted into 0.6 million shares of Petrohawk restricted stock.

2. ACQUISITIONS AND DIVESTITURES

KCS Energy, Inc.

On April 21, 2006, the Company and KCS announced they had entered into a definitive agreement to merge the companies. This merger was consummated on July 12, 2006 and was consistent with management s goals of acquiring properties within the Company s core operating areas that have a significant proved reserve component and which management believes have additional development and exploration opportunities.

Upon the closing of the merger, KCS stockholders became entitled to receive a combination of $9.00 cash and 1.65 shares of Petrohawk common stock for each share of KCS common stock. At the time of the merger, there were 50.0 million shares of KCS common stock outstanding that converted into 82.6 million shares of Petrohawk common stock. Total consideration for the shares of KCS common stock was comprised of approximately $1.1 billion of Petrohawk common stock, calculated based on the five day average of Petrohawk s common stock around the merger announcement date, or $13.44, approximately $450 million of cash and the assumption of $275 million of KCS debt. In addition, all outstanding options to purchase KCS common stock were converted into options to purchase Petrohawk common stock using an exchange ratio of approximately 2.3706 shares of Petrohawk common stock to one share of KCS common stock.

The merger was accounted for using the purchase method of accounting under the accounting standards established in SFAS No. 141, *Business Combinations (SFAS 141)* and No. 142*, Goodwill and Other Intangible Assets* (SFAS 142). As a result, the assets and liabilities of KCS were included in the Company s September 30, 2006 consolidated balance sheet. The Company reflected the results of operations of KCS beginning July 12, 2006. The Company recorded the estimated fair values of the assets acquired and liabilities assumed at July 12,

Table of Contents

PETROHAWK ENERGY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

2006, which primarily consisted of oil and gas properties of $1.6 billion, asset retirement obligations of $15.1 million, a deferred income tax liability of $421.6 million, a deferred income tax asset of $49.1 million and goodwill of $767.1 million. The deferred income tax liability recognizes the difference between the tax basis and the fair value of the acquired oil and gas properties. The recorded book value of the oil and gas properties was increased and goodwill was recorded to recognize this tax basis differential. The deferred income tax asset pertains to net operating loss carry-forwards and alternative minimum tax credits in the amounts of $44 million, net of tax, and $5.1 million, respectively. The purchase price allocation is preliminary and subject to change as additional information becomes available. Management does not expect to make any material changes to the original purchase price allocation.

Goodwill represents the excess of the purchase price over the estimated fair value of the assets acquired net of the fair value of liabilities assumed in the acquisition. SFAS 142 requires that intangible assets with indefinite lives, including goodwill, be evaluated on an annual basis for impairment or more frequently if an event occurs or circumstances change that could potentially result in an impairment.

The impairment test requires the allocation of goodwill and all other assets and liabilities to reporting units. The reporting unit used by the Company for testing will be the entire company. If the fair value of the reporting unit is less than the book value (including goodwill) then goodwill is reduced to its implied fair value and the amount of the writedown is charged against earnings.

The Company completed its annual impairment review during the third quarter of 2006. No impairment was deemed necessary. Downward revisions of estimated reserves or production, increases in estimated future costs or decreases in oil and gas prices could lead to an impairment of all or a portion of the Company s goodwill in future periods.

Gulf of Mexico Divestiture

On March 21, 2006, the Company completed the sale of substantially all of its Gulf of Mexico properties for $52.5 million ($43.2 million after certain closing adjustments). These proceeds were recorded as a decrease to the Company s full cost pool. The transaction had an effective date of January 1, 2006.

North Louisiana Acquisitions

On January 27, 2006, the Company completed the acquisition of all of the issued and outstanding common stock of Winwell Resources, Inc. (Winwell). The aggregate consideration paid was approximately $208 million in cash after certain closing adjustments.

The Winwell acquisition was accounted for using the purchase method of accounting under the accounting standards established in SFAS 141 and SFAS 142. As a result, the assets and liabilities of Winwell were included in the Company s March 31, 2006 consolidated balance sheet. The Company reflected the results of operations of Winwell beginning January 27, 2006. The Company recorded the estimated fair values of the assets acquired and liabilities assumed at January 27, 2006, which primarily consisted of oil and gas properties of $219.8 million, asset retirement obligations of $0.5 million, a net deferred tax liability of $78.9 million, and goodwill of $33.5 million. The deferred tax liability recognizes the difference between the historical tax basis of Winwell s assets and the acquisition cost recorded for book purposes. The recorded book value of the oil and gas properties was increased and goodwill was recorded to recognize this tax basis differential. The purchase price allocation is preliminary and subject to change as additional information becomes available. Management does not expect to make any material changes to the original purchase price allocation.

Table of Contents

PETROHAWK ENERGY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

Also on January 27, 2006, the Company completed the acquisition of certain oil and gas assets from Redley Company, Burris Run Company and Red Clay Minerals (together with the Winwell acquisition, the North Louisiana Acquisitions). The aggregate consideration paid in this transaction was approximately $86.1 million ($86.2 million after certain closing adjustments). The Company reflected the results of operations of the acquired assets beginning January 27, 2006.

The Company deposited $15 million in earnest money in connection with the Winwell acquisition, and $7.5 million in connection with the asset acquisition. The $22.5 million in deposits were included in other non-current assets at December 31, 2005 and applied to the overall purchase price in January 2006.

Mission Resources Corporation

On July 28, 2005, the Company and Mission Resources Corporation (Mission), completed a two-step merger transaction which resulted in Mission s merger with and into the Company. Total consideration for the shares of Mission common stock was comprised of 60.1% Company common stock and 39.9% cash. Accordingly, consideration paid to Mission stockholders consisted of approximately $139.5 million in cash and approximately 19.565 million shares of the Company s common stock. In addition, all outstanding options to purchase Mission common stock were converted into options to purchase Petrohawk common stock using the exchange ratio of 0.7641 shares of Petrohawk common stock per share of Mission common stock underlying each option. The Company assumed Mission s long-term debt of approximately $184 million.

The Mission merger was accounted for using the purchase method of accounting under the accounting standards established in SFAS 141 and SFAS 142. As a result, the assets and liabilities of Mission were included in the Company s September 30, 2005 consolidated balance sheet. The Company reflected the results of operations of Mission beginning July 28, 2005. The Company recorded the estimated fair values of the assets acquired and liabilities assumed at July 28, 2005, which primarily consisted of oil and gas properties of $606.7 million, derivative liabilities of $29.4 million, asset retirement obligations of $37.7 million, a net deferred income tax liability of $134.8 million, and goodwill of $138.9 million. The deferred income tax liability recognizes the difference between the historical tax basis of Mission s assets and the acquisition cost recorded for book purposes. The recorded book value of the oil and gas properties was increased and goodwill was recorded to recognize this tax basis differential.

Pro forma Results of Operations for the KCS and Mission Mergers

The Company s unaudited pro forma results of operations for the three and nine months ended September 30, 2006 and 2005 are presented below to illustrate the approximated pro forma effects on the Company s results of operations under the purchase method of accounting as if the Company had completed the KCS and Mission mergers on January 1, 2005. The unaudited pro forma results of operations do not purport to represent what the results of operations would actually have been if the transactions had in fact occurred on such date or to project the Company s results of operations for any future date or period.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(In thousands, except per share amounts)			
Pro forma:				
Oil and gas sales	$ 208,612	$ 218,557	$ 611,234	$ 509,747
Net income (loss) available (applicable) to common stockholders	$ 58,910	$ (93,934)	$ 160,611	$ (113,503)
Basic earnings (loss) per share	$ 0.35	$ (0.61)	$ 0.96	$ (0.77)
Diluted earnings (loss) per share	$ 0.35	$ (0.61)	$ 0.95	$ (0.77)

Table of Contents

PETROHAWK ENERGY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

3. OIL AND GAS PROPERTIES

The Company uses the full cost method of accounting for its investment in oil and gas properties. Under this method of accounting, all costs of acquisition, exploration and development of oil and gas reserves (including such costs as leasehold acquisition costs, geological expenditures, dry hole costs, tangible and intangible development costs and direct internal costs) are capitalized as the cost of oil and gas properties when incurred. To the extent that capitalized costs of oil and gas properties, net of accumulated depletion exceed the discounted future net revenues of proved oil and gas reserves net of deferred taxes, such excess capitalized costs would be charged to expense. Full cost companies must use the prices in effect at the end of each accounting quarter to calculate the ceiling test value of their reserves. However, subsequent commodity price increases may be utilized to calculate the ceiling value and reserves. At September 30, 2006, the ceiling test value of the Company s reserves was calculated based upon quoted market prices of $4.18 per Mcf for Henry Hub gas and $59.38 per barrel for West Texas Intermediate oil, adjusted for market differentials. Using these prices, the Company s net book value of oil and gas properties would have exceeded the ceiling amount by approximately $579.0 million (net of tax) at September 30, 2006. However, subsequent to quarter end, the market price for Henry Hub gas and West Texas Intermediate oil increased significantly. As a consequence, prior to October 31, 2006, the Company elected to use prices on October 31, 2006, which were $6.98 per Mcf for Henry Hub gas and $58.73 per barrel for West Texas Intermediate, adjusted for basis differentials. Utilizing these prices, the Company s net book value of oil and gas properties would not have exceeded the ceiling amount. As a result of the increase in the ceiling amount using the subsequent prices, the Company has not recorded a write down of its oil and gas property costs. Decreases in product price levels, as well as changes in production rates, levels of reserves, the evaluation of costs excluded from amortization, future development costs, and service costs and other factors could result in significant future ceiling test impairments.

4. LONG-TERM DEBT

Long-term debt as of September 30, 2006 and December 31, 2005 consisted of the following:

	September 30, 2006	December 31, 2005
	(In thousands)	
Senior revolving credit facility	$ 363,000	$ 210,000
Second lien term loan facility(1)		148,500
9 7/8% senior notes(2)	254	134,484
9 1/8% $650mm senior notes(3)	641,962	
9 1/8% $125mm senior notes(4)	126,374	
7 1/8% $275mm senior notes(5)	261,998	
Deferred premiums on derivatives(6)	1,431	2,817
	$ 1,395,019	$ 495,801

(1) Amount excludes $1.5 million of the total facility which was classified as current at December 31, 2005.

(2) The December 31, 2005 amount includes a $10 million premium recorded by the Company in conjunction with the assumption of $130 million face value of 9 7/8% notes payable from Mission. See 9 7/8% Senior Notes below for more details.

(3) Amount includes an $8 million discount recorded by the Company in conjunction with the issuance of the notes. See 9 1/8% Senior Notes below for more details.

Table of Contents

PETROHAWK ENERGY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

(4) *Amount includes a $1.4 million premium recorded by the Company in conjunction with the issuance of the notes. See 9 1/8% Senior Notes below for more details.*
(5) *Amount includes a $13 million discount recorded by the Company in conjunction with the assumption of the notes. See 7 1/8% Senior Notes below for more details.*
(6) *Amount excludes $4.6 million and $1.3 million of deferred premiums on derivatives which have been classified as current at September 30, 2006 and December 31, 2005, respectively.*

Senior Revolving Credit Facility

In connection with the KCS merger, the Company amended and restated its Amended and Restated Senior Revolving Credit Agreement dated July 28, 2005. The agreement provides for a $1 billion facility with a borrowing base that will be redetermined on a semi-annual basis. The Company and the lenders each have the right to one annual interim unscheduled redetermination to adjust the borrowing base based on the Company s oil and gas properties, reserves, other indebtedness and other relevant factors. At September 30, 2006, the borrowing base was $700 million. The Company expects the borrowing base to be increased to $750 million during the fourth quarter of 2006 based upon the completion of the redetermination process currently in progress. Amounts outstanding bear interest at specified margins over LIBOR of 1.00% to 1.75% for Eurodollar loans or at specified margins over ABR of 0.00% to 0.50% for ABR loans. Such margins fluctuate based on the utilization of the facility. Borrowings are secured by first priority liens on substantially all of the Company s assets, including pursuant to the terms of the Second Amended and Restated Guarantee and Collateral Agreement, all of the assets of, and equity interest in, the Company s subsidiaries. Amounts drawn down on the facility will mature on July 12, 2010.

The revolving credit facility contains customary financial and other covenants, including minimum working capital levels, minimum coverage of interest expense, and a maximum leverage ratio. In addition, the Company is subject to covenants limiting dividends and other restricted payments, transactions with affiliates, incurrence of debt, changes of control, asset sales, and liens on properties. At September 30, 2006, the Company is in compliance with all of its debt covenants under the revolving credit facility.

7 1/8% Senior Notes

Upon effectiveness of the KCS merger, the Company assumed (pursuant to the Second Supplemental Indenture relating to the 7 1/8 Notes, also referred to as the 2012 Notes), and subsidiaries of the Company guaranteed (pursuant to the Third Supplemental Indenture relating to such notes), all the obligations (approximately $275 million) of KCS under the 2012 Notes and the Indenture dated April 1, 2004 (the 2012 Indenture) among KCS, U.S. Bank National Association, as trustee, and the subsidiary guarantors named therein, which governs the terms of the 7 1/8% senior notes due 2012. The 2012 Notes are guaranteed on an unsubordinated, unsecured basis by all of the Company s current subsidiaries, including the subsidiaries of KCS that the Company acquired in the KCS merger. Interest on the 2012 Notes is payable semi-annually, on each April 1 and October 1. At any time prior to April 1, 2007, the Company may redeem up to 35% of the aggregate original principal amount of the 2012 Notes, using the net proceeds of equity offerings, at a redemption price equal to 107.125% of the principal amount of the 2012 Notes, plus accrued and unpaid interest. On or after April 1, 2008, the Company may redeem all or a portion of the 2012 Notes at a redemption price equal to 100% of the principal amount plus accrued and unpaid interest, if any, plus a specified premium which decreases annually from 3.568% in 2008 to 0% in 2010 and thereafter.

The 2012 Indenture contains a provision requiring the Company to offer to purchase the 2012 Notes at 101% of face value in the event of a change of control (as defined in the 2012 Indenture). Certain 2012 Note Holders have alleged that the KCS merger constitutes a change of control as set forth in the 2012 Indenture. Based upon consultation with counsel, Petrohawk does not believe such a change of control has occurred. See Note 6, *Commitments and Contingencies* for more details.

PETROHAWK ENERGY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

9 1/8% Senior Notes

On July 12, 2006, the Company consummated its private placement of the 9 1/8% senior notes, also referred to as the 2013 Notes pursuant to an Indenture dated as of July 12, 2006 (2013 Indenture) and the First Supplemental Indenture to the 2013 Notes (the 2013 First Supplemental Indenture), among the Company, the Company s subsidiaries named therein as guarantors, and U.S. Bank National Association, as trustee. The 2013 Notes were issued at 98.735% of the face amount for gross proceeds of approximately $642.0 million, before estimated offering expenses and the initial purchasers discount. The Company applied a portion of the net proceeds from the sale of the 2013 Notes to fund the cash consideration paid by the Company to the KCS stockholders in connection with the KCS merger and purchase of the 2011 Notes in connection with the Company s tender offer.

The 2013 Notes bear interest at the rate of 9.125% per annum, payable semi-annually on January 15 and July 15 of each year, commencing January 15, 2007. The 2013 Notes mature on July 15, 2013. The 2013 Notes are senior unsecured obligations of the Company and rank equally with all of its current and future senior indebtedness, including the 2012 Notes. The 2013 Notes rank effectively subordinate to the Company s secured debt to the extent of the collateral, including secured debt under the revolving credit facility, and senior to any future subordinated indebtedness. The 2013 Notes are jointly and severally guaranteed on a senior unsecured basis by the Company s subsidiaries, including, pursuant to the 2013 First Supplemental Indenture, the KCS subsidiaries acquired in the KCS merger.

On or before July 15, 2009, the Company may redeem up to 35% of the aggregate principal amount of the 2013 Notes with the net cash proceeds of certain equity offerings at a redemption price of 109.13% of the principal amount thereof plus accrued interest and unpaid interest to the redemption date provided that: (i) at least 65% in aggregate principal amount of the 2013 Notes originally issued under the 2013 Indenture remain outstanding immediately after the occurrence of such redemption (excluding 2013 Notes held by the Company and its subsidiaries); and (ii) each such redemption must occur within 90 days of the date of the closing of the related equity offering.

In addition, on or before July 15, 2010, the Company may redeem all or part of the 2013 Notes upon not less than 30 nor more than 60 days notice, at a redemption price equal to the sum of (i) the principal amount thereof, plus (ii) accrued and unpaid interest, if any, to the redemption date, plus (iii) the make whole premium at the redemption date.

On or after July 15, 2010, the Company may redeem some or all of the 2013 Notes at any time. If any of the 2013 Notes are redeemed during any 12-month period beginning on July 15 of the year indicated below, the Company must pay the following redemption prices (expressed as percentages of principal amount) plus accrued and unpaid interest thereon, if any, to the applicable redemption date:

Year	Percentage
2010	104.563
2011	102.281
2012	100.000

The Company may be required to offer to repurchase the 2013 Notes at a purchase price of 101% of the principal amount, plus accrued and unpaid interest, if any, to the redemption date, in the event of a change of control (as defined in the 2013 Indenture). Additionally, the Company may be required to offer to all holders of the 2013 Notes the repurchase of the 2013 Notes and to the extent required by the terms thereof, all holders of other indebtedness (as defined in the 2013 Indenture) that is *pari passu* with the 2013 Notes (at a purchase price

PETROHAWK ENERGY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

of 100% of the principal amount or accreted value in the case of any such other *pari passu* indebtedness issued with a significant original issue discount) plus accrued and unpaid interest, if any, to the date of purchase, in the event net proceeds from assets sales are not applied as required by the 2013 Indenture.

The 2013 Indenture contains covenants that, among other things, restrict or limit the ability of the Company and the guarantors to: (i) borrow money; (ii) pay dividends on stock; (iii) purchase or redeem stock or subordinated indebtedness; (iv) make investments; (v) create liens; (vi) enter into transactions with affiliates; (vii) sell assets; and (viii) merge with or into other companies or transfer all or substantially all of the Company s assets. Additionally, the Indenture covering the 2013 Notes contains a provision which provides for a rate increase of 1/8 of one percent if the Company refinances any part of its 2012 Notes on or before July 11, 2007.

On July 27, 2006, the Company consummated a private placement of an additional $125 million of 9 $^{1}/8$% senior notes due 2013. The additional 2013 Notes were issued pursuant to the same Indenture at 101.125% of the face amount, for gross proceeds of approximately $140.6 million, before estimated offering expenses and the initial purchasers discount. The Company applied the net proceeds from the sale of the additional 2013 Notes to repay indebtedness outstanding under its revolving credit facility.

Repayment of the Second Lien Term Loan Facility

On July 12, 2006, in connection with its entry into the revolving credit facility and the closing of its sale of the 2013 Notes, the Company repaid all amounts outstanding under, and terminated, its Amended and Restated Second Lien Term Loan, dated as of July 28, 2005, between the Company, each of the Lenders from time to time party thereto and BNP Paribas, as administrative agent for the Lenders.

9 $^{7}/8$% Senior Notes

On April 8, 2004, Mission issued $130.0 million of its 9 $^{7}/8$% senior notes due 2011 (the 2011 Notes). The Company assumed these notes upon the closing of the Mission merger. In conjunction with the KCS merger, the Company extinguished substantially all of its 2011 Notes for a premium of $14.9 million plus accrued interest of $3.5 million. There were approximately $0.3 million of the notes which were not redeemed and are still outstanding as of September 30, 2006.

Debt Issuance Costs

The Company capitalizes certain direct costs associated with the issuance of long-term debt. At September 30, 2006, the Company has approximately $15.6 million of net debt issuance costs being amortized over the lives of the respective debt. Debt issuance costs increased $13.6 million from December 31, 2005 primarily due to the issuance of additional debt in the third quarter of 2006.

5. ASSET RETIREMENT OBLIGATIONS

If a reasonable estimate of the fair value of an obligation to perform site reclamation, dismantle facilities or plug and abandon wells can be made, the Company records a liability (an asset retirement obligation or ARO) on the consolidated balance sheet and capitalizes the asset retirement cost in oil and gas properties in the period in which the retirement obligation is incurred. In general, the amount of an ARO and the costs capitalized will be equal to the estimated future cost to satisfy the abandonment obligation using current prices that are escalated by an assumed inflation factor up to the estimated settlement date, which is then discounted back to the date that the abandonment obligation was incurred using an assumed cost of funds for the company. After recording these amounts, the ARO is accreted to its future estimated value using the same assumed cost of funds and the additional capitalized costs are depreciated on a unit-of-production basis.

Table of Contents

PETROHAWK ENERGY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

The Company recorded the following activity related to the ARO liability for the nine months ended September 30, 2006 (in thousands):

Beginning balance as of January 1, 2006	$ 51,249
Liabilities settled and divested	(23,379)
Acquisitions[(1)]	15,985
Additions	1,341
Accretion expense	1,090
Liability for asset retirement obligation as of September 30, 2006	$ 46,286

(1) Refer to Note 2, Acquisitions and Divestitures, for more detail.

6. COMMITMENTS AND CONTINGENCIES

The Company is a defendant in various legal proceedings arising in the normal course of business. The Company has established reserves for certain legal proceedings. The establishment of a reserve involves an estimation process that includes the advice of legal counsel and subjective judgment of management. Management believes these reserves to be adequate, and does not expect the Company to incur additional losses with respect to those matters for which reserves have been established. However, future changes in the facts and circumstances could result in the actual liability exceeding the estimated ranges of loss and amounts accrued. While the outcome and impact on the Company cannot be predicted with certainty, management believes that the resolution of these proceedings through settlement or adverse judgment will not have a material adverse effect on the Company s operating results, financial position or cash flows.

In connection with the KCS merger of the Company and KCS, the Company assumed by operation of law all liabilities of KCS, including the 2012 Notes, which were originally issued by KCS in April 2004. U.S. Bank National Association served as Trustee under the indenture governing the 2012 Indenture from and after the date of issuance until October 13, 2006 when the Company believes it resigned. The Company intends to exercise its rights under the 2012 Indenture to appoint a successor trustee.

Prior to the merger, the Company carefully considered the Change of Control provisions of the 2012 Indenture and, at the consummation of the merger, the Company concluded that the transaction did not trigger a Change of Control based upon the facts and the specific language of the 2012 Indenture. Consequently, the Company did not make a Change of Control Offer within 30 days of the merger.

On September 15, 2006, The Law Debenture Company of New York filed suit in the Court of Chancery of the State of Delaware, New Castle County, against the Company, its board of directors, certain of its officers, KCS and certain former members of the board of directors and past management of KCS, based on the assertion that a Change of Control occurred as a consequence of the Company s merger with KCS. On October 9, 2006, the Company received a letter from Law Debenture alleging default on the basis of the Company s failure to make a Change of Control Offer. The Company does not believe that Law Debenture has been validly appointed Trustee and, therefore, believes that any action purportedly taken by Law Debenture in such capacity is invalid and without effect. In addition, the Company has never received a valid Notice of Default, as required by the 2012 Indenture. The Company intends to vigorously defend itself against these claims and to aggressively pursue all legal remedies available to it.

On October 2, 2006, the Company deposited a regular semi-annual interest payment on the 2012 Notes with its paying agent, The Bank of New York Trust Company, N.A., to be held in trust for payment on the 2012 Notes. In disregard of that trust, without any notice to the Company, and lacking authorization or entitlement of

Table of Contents

PETROHAWK ENERGY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

any kind, Law Debenture instructed the Company s paying agent to deduct $1.2 million from that deposit for the use of Law Debenture for its own fees, costs and expenses. This action effectively reduced interest payments to all holders by $1.2 million.

The Company believes that Law Debenture s actions are unlawful, and has filed an action in the United States District Court for the Southern District of New York asserting claims for conversion and tortious interference and asking the court to impose a constructive trust in favor of the Company. The Company seeks relief including the return of monies diverted by