CALLON PETROLEUM CO
Form 10-Q
May 09, 2013

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

x	Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
	For the quarterly period ended: March 31, 2013
	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	64-0844345
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

200 North Canal Street Natchez, Mississippi	39120
(Address of principal executive offices)	(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 x 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 x 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 x
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 x

As of May 1, 2013 there were outstanding 39,867,287 shares of the Registrant’s common stock, par value $0.01 per share.

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Part I. Financial Information
Item I. Financial Statements
Callon Petroleum Company
Consolidated Balance Sheets
(in thousands, except par value per share data)

	March 31, 2013	December 31, 2012
ASSETS	Unaudited	
Current assets:		
Cash and cash equivalents	$1,379	$1,139
Accounts receivable	15,024	15,608
Fair market value of derivatives	1,511	1,674
Other current assets	645	1,502
Total current assets	18,559	19,923
Oil and natural gas properties, full-cost accounting method:		
Evaluated properties	1,533,739	1,497,010
Less accumulated depreciation, depletion and amortization	(1,307,307)	(1,296,265)
Net oil and natural gas properties	226,432	200,745
Unevaluated properties excluded from amortization	60,976	68,776
Total oil and natural gas properties	287,408	269,521
Other property and equipment, net	9,898	10,058
Restricted investments	3,800	3,798
Investment in Medusa Spar LLC	8,260	8,568
Deferred tax asset	64,542	64,383
Other assets, net	1,998	1,922
Total assets	$394,465	$378,173
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities	$34,457	$36,016
Asset retirement obligations	2,802	2,336
Fair market value of derivatives	537	125
Total current liabilities	37,796	38,477
13% Senior Notes:		
Principal outstanding	96,961	96,961
Deferred credit, net of accumulated amortization of $18,599 and $17,800, respectively	12,908	13,707
Total 13% Senior Notes	109,869	110,668
Senior secured revolving credit facility	27,000	10,000
Asset retirement obligations	11,496	10,965
Other long-term liabilities	2,108	2,092
Total liabilities	188,269	172,202
Stockholders' equity:		
Preferred Stock, $0.01 par value, 2,500,000 shares authorized;	—	—
Common stock, $0.01 par value, 60,000,000 shares authorized; 39,843,601 and 39,800,548 shares outstanding at March 31, 2013 and December 31,	399	398

2012, respectively		
Capital in excess of par value	329,140	328,116
Retained deficit	(123,343)	(122,543)
Total stockholders' equity	206,196	205,971
Total liabilities and stockholders' equity	$394,465	$378,173

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 31,	
	2013	2012
Operating revenues:		
Crude oil sales	$19,540	$25,749
Natural gas sales	3,001	3,545
Total operating revenues	22,541	29,294
Operating expenses:		
Lease operating expenses	5,758	8,237
Production taxes	539	547
Depreciation, depletion and amortization	11,042	12,189
General and administrative	3,739	5,031
Accretion expense	565	574
Total operating expenses	21,643	26,578
Income from operations	898	2,716
Other (income) expenses:		
Interest expense	1,515	2,577
Loss (gain) on derivative contracts	418	(70)
Other income, net	(45)	(305)
Total other expenses, net	1,888	2,202
Income (loss) before income taxes	(990)	514
Income tax expense (benefit)	(169)	144
Income (loss) before equity in earnings of Medusa Spar LLC	(821)	370
Equity in earnings of Medusa Spar LLC	21	118
Net income (loss) available to common shares	$(800)	$488
Net income (loss) per common share:		
Basic	$(0.02)	$0.01
Diluted	$(0.02)	$0.01
Shares used in computing net income (loss) per common share:		
Basic	39,793	39,351
Diluted	39,793	40,254

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

Callon Petroleum Company
Consolidated Statements of Comprehensive Income (Loss)
(Unaudited, in thousands)

	Three Months Ended March 31,	
	2013	2012
Net income (loss)	$(800)	$488
Other comprehensive (loss) income:		
Change in fair value of derivatives designated as hedges, net of tax (See Note 5)	—	(1,470)
Total comprehensive income (loss)	$(800)	$(982)

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

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

	Three Months Ended March 31,	
	2013	2012
Cash flows from operating activities:		
Net (loss) income	$(800)	$488
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation, depletion and amortization	11,393	12,486
Accretion expense	565	574
Amortization of non-cash debt related items	111	122
Amortization of deferred credit	(799)	(811)
Equity in earnings of Medusa Spar LLC	(21)	(118)
Deferred income tax (benefit) expense	(169)	144
Unrealized loss (gain) on derivative contracts	1,039	(299)
Non-cash expense related to equity share-based awards	580	442
Change in the fair value of liability share-based awards	(195)	907
Payments to settle asset retirement obligations	(396)	(630)
Changes in current assets and liabilities:		
Accounts receivable	1,333	(3,177)
Other current assets	857	1,075
Current liabilities	158	(730)
Change in natural gas balancing receivable	(63)	1
Change in natural gas balancing payable	10	50
Change in other long-term liabilities	(206)	—
Change in other assets, net	(522)	(174)
Cash provided by operating activities	$12,875	$10,350
Cash flows from investing activities:		
Capital expenditures	(30,089)	(45,481)
Proceeds from sale of mineral interest and equipment	114	506
Distribution from Medusa Spar LLC	340	758
Cash used in investing activities	$(29,635)	$(44,217)
Cash flows from financing activities:		
Borrowings on senior secured revolving credit facility	17,000	—
Taxes paid related to exercise of employee stock options	—	(2)
Cash provided by (used in) financing activities	$17,000	$(2)
Net change in cash and cash equivalents	240	(33,869)
Beginning of period cash and cash equivalents	1,139	43,795
End of period cash and cash equivalents	$1,379	$9,926

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

Callon Petroleum Company
Notes to the Consolidated Financial Statements
(Unless otherwise indicated, amounts included in the footnotes to the financial statements are presented in thousands, except for per-share, per-hedge, well and acreage data.)

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1. Description of Business and Basis of Presentation
2. Property Disclosures and Operating Leases
3. Earnings Per Share
4. Borrowings
5. Derivative Instruments and Hedging Activities
6. Fair Value Measurements
7. Income Taxes
8. Asset Retirement Obligations

Note 1 - Description of Business and Basis of Presentation

Description of business

Callon Petroleum Company is an independent crude oil and natural gas company, which since 1950 has been focused on building reserves and production both onshore and offshore through efficient operations and low finding and development costs. In 2009, we began to shift our operational focus from exploration in the Gulf of Mexico to building an onshore asset portfolio in order to provide a multi-year, low-risk drilling program in both crude oil and natural gas basins. To date, a significant portion of this onshore transition has been funded by reinvesting the cash flows from our Gulf of Mexico properties. In the fourth quarter of 2012, we monetized our interest in the deepwater Habanero field in order to accelerate development of our onshore properties.

The Company’s properties and operations are geographically concentrated onshore in Texas and Louisiana and the offshore waters of the Gulf of Mexico.

Basis of presentation

Unless otherwise indicated, all amounts included within the footnotes to the financial statements are presented in thousands, except for per-share, per-hedge, well and acreage data.

The interim consolidated financial statements of the Company have been prepared in accordance with (1) accounting principles generally accepted in the United States (“US GAAP”), (2) the Securities and Exchange Commission’s instructions to Quarterly Report on Form 10-Q and (3) Rule 10-01 of Regulation S-X, and include the accounts of the Company, and its subsidiary, Callon Petroleum Operating Company (“CPOC”). CPOC also has subsidiaries, namely Callon Offshore Production, Inc., and Mississippi Marketing, Inc.

These interim consolidated financial statements should be read in conjunction with the Company’s Annual Report on Form 10-K for the year ended December 31, 2012. The balance sheet at December 31, 2012 has been derived from the audited financial statements at that date.

Operating results for the periods presented are not necessarily indicative of the results that may be expected for the year ended December 31, 2013.

In the opinion of management, the accompanying unaudited consolidated financial statements reflect all adjustments, including normal recurring adjustments and all intercompany account and transaction eliminations, necessary to present fairly the Company's financial position, the results of its operations and its cash flows for the periods indicated. When necessary to ensure consistent presentation, certain prior year amounts may be reclassified. To the extent the amounts reclassified are material, we have either footnoted them within the Company's disclosures or have

noted the items within this footnote.

New accounting standard

In February 2013, the Financial Accounting Standards Board issued an Accounting Standards Update (ASU) that clarified the reclassification requirements from accumulated other comprehensive income to net income. This ASU requires disclosure of amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present either on the face of the financial statements or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income, but only if the amount is reclassified in its entirety to net income in the same reporting period. For amounts not reclassified in their entirety to net income, an entity is required to cross-reference to the related

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note on the face of the financial statements for additional information. Callon adopted this guidance effective January 1, 2013, which did not have a material impact on its financial statements.

Note 2 - Property Disclosures and Operating Leases

In February 2012, we contracted a drilling rig for a term of two years to support our horizontal drilling program in the Permian Basin, which was delivered to the Company and began operations in April 2012. Lease cost recorded during the three months ended March 31, 2013 was $2,271. Lease payments will approximate $9,235 in 2013 (with $6,964 remaining at March 31, 2013) and $2,277 in 2014. The agreement includes early termination provisions that would reduce the minimum rentals under the agreement, assuming the lessor is unable to re-charter the rig and staffing personnel to another lessee, to $4,125 in 2013 and $1,350 in 2014.

Note 3 - Earnings Per Share

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

	Three Months Ended March 31,	
	2013	2012
(a) Net income (loss)	$(800)	$488
(b) Weighted average shares outstanding	39,793	39,351
Dilutive impact of stock options	—	20
Dilutive impact of restricted stock	—	883
(c) Weighted average shares outstanding for diluted net income (loss) per share	39,793	40,254
Basic net income (loss) per share (a/b)	$(0.02)	$0.01
Diluted net income (loss) per share (a/c)	$(0.02)	$0.01
The following underlying shares associated with the following instruments were excluded from the diluted EPS calculation because their effect would be anti-dilutive:		
Stock options	67	67
Restricted stock	40	—

Note 4 – Borrowings

The Company's borrowings consisted of the following at:

	March 31, 2013	December 31, 2012
Principal components:		
Credit Facility	$27,000	$10,000
13% Senior Notes due 2016, principal	96,961	96,961
Total principal outstanding	123,961	106,961
Non-cash components:		
13% Senior Notes due 2016 unamortized deferred credit	12,908	13,707
Total carrying value of borrowings	$136,869	$120,668

Senior Secured Revolving Credit Facility (the "Credit Facility")

The Company's $200,000 Credit Facility had an associated borrowing base at March 31, 2013 of $65,000 and a maturity of March 15, 2016. Regions Bank serves as the administrative agent for the Credit Facility, which also includes Citibank, NA, IberiaBank, Whitney Bank and OneWest Bank, FSB as participating lenders. Amounts borrowed under the Credit Facility may not exceed a borrowing base, which is generally reviewed on a semi-annual basis and is then eligible for re-determination. The Credit Facility is secured by mortgages covering the Company's major producing fields.

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In April 2013, the Credit Facility's borrowing base was increased $10,000 from $65,000 to $75,000.

As of March 31, 2013, the balance outstanding on the Credit Facility was $27,000 with an interest rate of 3.1%, calculated as the London Interbank Offered Rate (“LIBOR”) plus a tiered rate ranging from 2.5% to 3.0%, which is based on utilization of the facility. In addition, the Credit Facility carries a commitment fee of 0.5% per annum on the unused portion of the borrowing base, which is payable quarterly. As of May 6, 2013, the balance outstanding on the Credit Facility was $38,000 as the Company drew an additional $11,000 in support of the Company's ongoing capital development program.

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

The Senior Notes’ 13% interest coupon is payable on the last day of each quarter. Certain of the Company’s subsidiaries guarantee the Company’s obligations under the unsecured 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. Upon issuing the Senior Notes in November 2009, the Company recorded as a deferred credit the $31,507 difference between the adjusted carrying amount of the Senior Notes that were exchanged and the principal of the Senior Notes. This deferred credit is being amortized as a reduction of 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:

Gross Carrying Amount	Accumulated Amortization at 3/31/2013	Carrying Value at 3/31/2013	Amortization Recorded during Current Year as a Reduction of Interest Expense	Estimated Amortization to be Recorded during the Remainder of the Current Year
$31,507	$18,599	$12,908	$799	$2,500

Restrictive Covenants

The indentures governing our Senior Notes and the Company’s Credit Facility contain various covenants including restrictions on additional indebtedness and payment of cash dividends. In addition, Callon’s Credit Facility contains covenants for maintenance of certain financial ratios. The Company was in compliance with these covenants at March 31, 2013.

Note 5 - Derivative Instruments and Hedging Activities

Objectives and strategies for using derivative instruments

The Company is exposed to fluctuations in realized crude oil and natural gas prices for 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 primarily utilizes collars, put and call options 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 speculative purposes.

Counterparty risk

The use of derivative transactions exposes the Company to the risk that a counterparty will be unable to meet its commitments. To manage this risk, the Company's established counterparties for commodity derivative instruments

include a large, well-known financial institution and a large, well-known oil and gas company. The Company monitors counterparty creditworthiness on an ongoing basis; however, it cannot predict sudden changes in counterparties' creditworthiness. In addition, even if such changes are not sudden, the Company may be limited in its ability to mitigate an increase in counterparty credit risk. Should one of these counterparties not perform, the Company may not realize the benefit of some of its derivative instruments under lower commodity prices. Counterparty credit risk is considered when determining a derivative instruments' fair value; See Note 6 for additional information.

The Company executes commodity derivative transactions under master agreements that have netting provisions that provide for offsetting payables against receivables. In general, if a party to a derivative transaction incurs an event of default, as defined in the applicable agreement, the other party will have the right to demand the posting of collateral, demand a cash payment transfer or terminate the arrangement.

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Financial statement presentation and settlements

In the first quarter of 2013, the Company monetized the remaining portion (covering the period Feb13-Dec13) of its 2013 crude oil collar positions of 40 Bbls per month. The proceeds from this transaction, combined with the proceeds from the sale of the below listed put for 30 Bbls per month, were used to finance the uplift in the crude oil swap for the period Feb13-Dec13.

Listed in the table below are the outstanding crude oil and natural gas derivative contracts as of March 31, 2013:

Commodity	Instrument	Average Notional Volumes per Month	Quantity Type	Put/Call Price	Fixed-Price Swap	Period	Designation under ASC 815
Natural gas	Swap	91	MMbtu	n/a	$3.52	Apr13 - Dec13	Not Designated
Natural gas	Put Option	91	MMbtu	$3.00	n/a	Apr13 - Dec13	Not Designated
Crude oil	Swap	40	Bbls	n/a	$101.30	Apr13 - Dec13	Not Designated
Natural gas	Call Option	38	MMbtu	$4.75	n/a	Jan14 - Dec14	Not Designated
Crude oil	Swap	30	Bbls	n/a	$93.35	Jan14 - Dec14	Not Designated
Crude oil	Put	30	Bbls	$70.00	n/a	Jan14 - Dec14	Not Designated

Settlements of the Company's derivative instruments are based on the difference between the contract price or prices specified in the derivative instrument and a New York Mercantile Exchange ("NYMEX") price. The fair value of the Company's derivative instruments, depending on the type of instruments, was determined by the use of present value methods or standard option valuation models with assumptions about commodity prices based on those observed in underlying markets. See Note 6 for additional information regarding fair value.

The following table reflects the fair values of the Company's derivative instruments for the periods presented (none of which were designated as hedging instruments under ASC 815):

	Balance Sheet Presentation		Asset Fair Value		Liability Fair Value		Net Derivative Fair Value	
Commodity	Classification	Line Description	03/31/13	12/31/12	03/31/13	12/31/12	03/31/13	12/31/12
Natural gas	Current	Fair market value of derivatives	$—	$—	$(537)	$(125)	$(537)	$(125)
Natural gas	Non-current	Other long-term liabilities	—	—	(92)	(116)	(92)	(116)
Crude oil	Current	Fair market value of derivatives	1,511	1,674	—	—	1,511	1,674
Crude oil	Non-current	Other long-term assets	—	250	—	—	—	250
Crude oil	Non-current	Other long-term liabilities	—	—	(239)	—	(239)	—
	Totals		$1,511	$1,924	$(868)	$(241)	$643	$1,683

The Company's derivative contracts are subject to netting arrangements. The Company presents the fair values of its derivative contracts on the balance sheet on a net basis based on the underlying commodity being hedged. The following presents the impact of this presentation to the Company's recognized assets and liabilities at March 31, 2013:

	Presented without Effects of Netting	Effects of Netting	As Presented with Effects of Netting
Current assets: Fair value of hedging contracts	$2,347	$(836)	$1,511
Long-term assets: Fair value of hedging contracts	286	(286)	—
Current liabilities: Fair value of hedging contracts	(1,373)	836	(537)
Long-term liabilities: Fair value of hedging contracts	(617)	286	(331)

Unless otherwise indicated, amounts included in the footnotes to the financial statements are presented in thousands, except for per-share, per-hedge, well and acreage data.

Derivatives not designated as hedging instruments

As discussed in the Company's Form 10-K for the year ended December 31, 2012, the Company elected not to designate as an accounting hedge under FASB ASC 815 any of its derivative contracts executed subsequent to December 31, 2011, nor does it expect to designate future derivative contracts. Any derivative contract not designated as an accounting hedge is carried at its fair value on the balance sheet with both realized and unrealized (mark-to-market) gains or losses on these derivatives recorded on the statement of operations as a component of the Company's other income and expenses. For the periods indicated, the Company recorded the following related to its derivative instruments that were not designated as accounting hedges:

	Three Months Ended March 31,	
	2013	2012
Natural gas derivatives		
Realized gain (loss), net	$49	$—
Unrealized gain (loss), net	(388)	—
Sub-total gain (loss), net	$(339)	$—
Crude oil derivatives		
Realized gain (loss), net	$573	$—
Unrealized gain (loss), net	(652)	70
Sub-total gain (loss), net	$(79)	$70
Total gain (loss) on derivative instruments, net	$(418)	$70

Derivatives designated as hedging instruments

As previously discussed, the Company elected to discontinue hedge accounting at the start of 2012, though certain of the Company’s crude oil derivative contracts executed during 2011 and in effect during 2012 were designated as cash flow hedges. Consequently, these designated contracts were recorded at fair market value with the effective portion of the changes in fair value recorded net of tax through other comprehensive income (loss) (“OCI”) in stockholders’ equity. The cash settlements on contracts for future production are recorded as an increase or decrease in crude oil revenues. Both changes in fair value and cash settlements of ineffective derivative contracts are recognized as derivative expense (income).

The tables below present the effect of the Company's derivative financial instruments on the consolidated statements of operations as an increase (decrease) to crude oil revenues for the effective portion and as an increase (decrease) to other (income) expense for the ineffective portion and amounts excluded from effectiveness testing:

	Three Months Ended March 31,	
	2013	2012
Amount of gain (loss) reclassified from OCI into income (effective portion)	$—	$—
Amount of gain (loss) recognized in income (ineffective portion and amount excluded from effectiveness testing)	—	230

Note 6 - Fair Value Measurements

The fair value hierarchy outlined in the relevant accounting guidance gives the highest priority to Level 1 inputs, which consist of unadjusted quoted prices for identical instruments in active markets. Level 2 inputs consist of quoted prices for similar instruments. Level 3 valuations are derived from inputs that are significant and unobservable, and

these valuations have the lowest priority.

Fair value of financial instruments

Cash, cash equivalents, short-term investments. The carrying amounts for these instruments approximate fair value due to the short-term nature or maturity of the instruments.

Debt. The Company's debt is recorded at the carrying amount on its Consolidated Balance Sheet. The fair value of Callon's fixed-rate debt, which is valued using Level 2 inputs, is based upon estimates provided by an independent investment banking firm. The carrying amount of floating-rate debt approximates fair value because the interest rates are variable and reflective of market rates.

Unless otherwise indicated, amounts included in the footnotes to the financial statements are presented in thousands, except for per-share, per-hedge, well and acreage data.

The following table summarizes the respective carrying and fair values at:

	March 31, 2013		December 31, 2012	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Credit Facility	$27,000	$27,000	$10,000	$10,000
13% Senior Notes due 2016 (1)	$109,869	$100,839	$110,668	$100,112
Total	$136,869	$127,839	$120,668	$110,112

(1) Fair value is calculated only in relation to the $96,961 principal outstanding of the Senior Notes at each of the dates indicated above, respectively. The remaining $12,908 and $13,707, respectively, which the Company has recorded as a deferred credit, is excluded from the fair value calculation, and will be recognized in earnings as a reduction of interest expense over the remaining amortization period. See Note 4 for additional information.

Assets and liabilities measured at fair value on a recurring basis

Certain assets and liabilities are reported at fair value on a recurring basis (unless otherwise noted below) in the Company's Consolidated Balance Sheet. The following methods and assumptions were used to estimate the fair values:

Commodity derivative instruments: Callon’s derivative policy allows for commodity derivative instruments to consist of collars, natural gas and crude oil basis swaps, and similar commodity instrument structures. The fair value of these derivatives is derived using a valuation model that utilizes market-corroborated inputs that are observable over the term of the derivative contract, and the values are corroborated by quotes obtained from counterparties to the agreements. The Company’s fair value calculations also incorporate an estimate of the counterparties’ default risk for derivative assets and an estimate of the Company’s default risk for derivative liabilities. The Company believes that the majority of the inputs used to calculate the commodity derivative instruments fall within Level 2 of the fair-value hierarchy based on the wide availability of quoted market prices for similar commodity derivative contracts. See Note 5 for additional information regarding the Company’s derivative instruments.

The following tables present the Company’s liabilities measured at fair value on a recurring basis for each hierarchy level:

As of 3/31/2013	Balance Sheet Presentation	Level 1	Level 2	Level 3	Total
Assets					
Derivative financial instruments - current	Fair market value of derivatives	$—	$1,511	$—	$1,511
Derivative financial instruments - non-current	Other long-term assets	—	—	—	—
Sub-total assets		—	1,511	—	1,511
Liabilities					
Derivative financial instruments - current	Fair market value of derivatives	—	537	—	537
Derivative financial instruments - non-current	Other long-term liabilities	$—	$331	$—	$331
Sub-total liabilities	Other long-term liabilities	—	868	—	868
Total		$—	$643	$—	$643

As of 12/31/2012	Balance Sheet Presentation	Level 1	Level 2	Level 3	Total
Assets					
Derivative financial instruments - current	Fair market value of derivatives	—	1,674	—	1,674
Derivative financial instruments - non-current	Other long-term assets	$—	$250	$—	$250
Sub-total assets		—	1,924	—	1,924
Liabilities					
Derivative financial instruments - current	Fair market value of derivatives	—	125	—	125
Derivative financial instruments - non-current	Other long-term liabilities		$116		$116
Sub-total liabilities		—	241	—	241
Total		$—	$1,683	$—	$1,683

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The derivative fair values above are based on analysis of each contract.

Assets and liabilities measured at fair value on a nonrecurring basis

Certain assets and liabilities are reported at fair value on a nonrecurring basis in Callon's Consolidated Balance Sheet. The following methods and assumptions were used to estimate the fair values:

Asset retirement obligations incurred in current period. Callon estimates the fair value of AROs based on discounted cash flow projections using numerous estimates, assumptions and judgments regarding such factors as (1) the existence of a legal obligation for an ARO, (2) amounts and timing of settlements, (3) the credit-adjusted risk-free rate to be used and (4) inflation rates. AROs incurred during the three months ended March 31, 2013, including upward revisions of $360, were Level 3 fair value measurements. See Note 8, Asset Retirement Obligations, which provides a summary of changes in the ARO liability.

Note 7 - Income Taxes

The Company provides for income taxes at a statutory rate of 35% adjusted for permanent differences expected to be realized, which primarily relate to statutory depletion and non-deductible executive compensation expenses. The effective tax rate for the three months ended March 31, 2013 and 2012 was 17% and 28%, respectively.

We have no liability for uncertain tax positions or any accrued interest or penalties as of March 31, 2013.

Note 8 - Asset Retirement Obligations

The following table summarizes the Company's asset retirement obligations activity for the three months ended March 31, 2013:

Asset retirement obligations at January 1, 2013	$13,301	
Accretion expense	565	
Liabilities incurred	569	
Liabilities settled	(162	)
Revisions to estimate	25	
Asset retirement obligations at end of period	14,298	
Less: Current asset retirement obligations	2,802	
Long-term asset retirement obligations at March 31, 2013	$11,496	

Certain of the Company's operating agreements require that assets be restricted for future abandonment obligations. Amounts recorded on the Consolidated Balance Sheets as restricted investments were $3,800 at March 31, 2013. These investments include primarily U.S. Government securities, and are held in abandonment trusts dedicated to pay future abandonment costs for several of the Company's crude oil and natural gas properties.

Special Note Regarding Forward Looking Statements

All statements, other than historical fact or present financial information, may be deemed to be forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. All statements that address activities, outcomes and other matters that should or may occur in the future, including, without limitation, statements regarding the financial position, business strategy, production and reserve quantities, present value and growth and other plans and objectives for our future operations, are forward-looking statements. Although we believe the expectations expressed in such forward-looking statements are based on reasonable assumptions, such statements are not guarantees of future performance. We have no obligation and make no undertaking to publicly update or revise any forward-looking statements, except as may be required by law.

Forward-looking statements include the items identified in the preceding paragraph, information concerning possible or assumed future results of operations and other statements in this Form 10-K identified by words such as “anticipate,” “project,” “intend,” “estimate,” “expect,” “believe,” “predict,” “budget,” “projection,” “goal,” “plan,” “forecast,” “target” or si

You should not place undue reliance on forward-looking statements. They are subject to known and unknown risks, uncertainties and other factors that may affect our operations, markets, products, services and prices and cause our actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by the forward-looking statements. In addition to any assumptions and other factors referred to specifically in connection with forward-looking statements, risks, uncertainties and factors that could cause our actual results to differ materially from those indicated in any forward-looking statement include, but are not limited to:

- the timing and extent of changes in market conditions and prices for commodities (including regional basis differentials),
- our ability to transport our production to the most favorable markets or at all,
- the timing and extent of our success in discovering, developing, producing and estimating reserves,
- our ability to respond to low natural gas prices,
- our ability to fund our planned capital investments,
- the impact of government regulation, including any increase in severance or similar taxes, legislation relating to hydraulic fracturing, the climate and over-the-counter derivatives,
- the costs and availability of oilfield personnel services and drilling supplies, raw materials, and equipment and services,
- our future property acquisition or divestiture activities, including the possible sale of our Medusa property,
- the effects of weather,
- increased competition,
- the financial impact of accounting regulations and critical accounting policies,
- the comparative cost of alternative fuels,
- conditions in capital markets, changes in interest rates and the ability of our lenders to provide us with funds as agreed,
- credit risk relating to the risk of loss as a result of non-performance by our counterparties, and
- any other factors listed in the reports we have filed and may file with the Securities and Exchange Commission (“SEC”).

We caution you that the forward-looking statements contained in this Form 10-Q are subject to all of the risks and uncertainties, many of which are beyond our control, incident to the exploration for and development, production and sale of crude oil and natural gas. These risks include, but are not limited to, the risks described in Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2012 (the “2012 Annual Report on Form 10-K”), and all quarterly reports on Form 10-Q filed subsequently thereto (“Form 10-Qs”).

Should one or more of the risks or uncertainties described above or elsewhere in our 2012 Annual Report on Form 10-K occur, or should underlying assumptions prove incorrect, our actual results and plans could differ materially from those expressed in any forward-looking statements. We specifically disclaim all responsibility to publicly update any information contained in a forward-looking statement or any forward-looking statement in its entirety and therefore disclaim any resulting liability for potentially related damages.

All forward-looking statements attributable to us are expressly qualified in their entirety by this cautionary statement.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

General

The following management's discussion and analysis describes the principal factors affecting the Company's results of operations, liquidity, capital resources and contractual cash obligations. This discussion should be read in conjunction with the accompanying unaudited consolidated financial statements and our 2012 Annual Report on Form 10-K, which include additional information about our business practices, significant accounting policies, risk factors, and the transactions that underlie our financial results. Our website address is www.callon.com. All of our filings with the SEC are available free of charge through our website as soon as reasonably practicable after we file them with, or furnish them to, the SEC. Information on our website does not form part of this report on Form 10-Q.

We have been engaged in the exploration, development, acquisition and production of crude oil and natural gas properties since 1950. In 2009, we began to shift our operational focus from exploration in the Gulf of Mexico to building an onshore asset portfolio in order to provide a multi-year, low-risk drilling program in both crude oil and natural gas basins. To date, a significant portion of this onshore transition has been funded by reinvesting the cash flows from our Gulf of Mexico properties. In the fourth quarter of 2012, we monetized our interest in the deepwater Habanero field in order to accelerate development of our onshore properties. In furtherance of this strategy, in April 2013, we announced our intention to evaluate alternatives with respect to a potential sale of our interests in the Medusa field, our remaining deepwater asset.

Overview and Outlook

Production and highlights of our operations include:

	Net Production (MBoe)			
	Three Months Ended March 31,			
	2013	2012	Change	% Change
Onshore - Permian Basin:				
Southern Portion	93	77	16	21 %
Central Portion	49	37	12	32 %
Total Permian	142	114	28	25 %
Offshore - Deepwater Properties				
Medusa	105	136	(31)	(23)%
Habanero	—	42	(42)	(100)%
Total Deepwater	105	178	(73)	(41)%
Other:				
Haynesville Shale	8	6	2	33 %
Gulf of Mexico shelf	73	94	(21)	(22)%
Total Other	81	100	(19)	(19)%
Total	328	392	(64)	(16)%

The following table sets forth productive wells as of March 31, 2013:

	Crude Oil Wells		Natural Gas Wells	
	Gross	Net	Gross	Net
Working interest	108	87.18	10	4.3
Royalty interest	3	0.10	2	0.08
Total	111	87.28	12	4.38

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Onshore – Permian Basin

We expect that our production and reserve growth initiatives will continue to focus primarily on the Permian Basin, in which we own approximately 38,127 gross (32,962 net) acres as of May 1, 2013. In order to advance our growth plans, we are directing a significant amount of our 2013 capital budget to horizontal drilling of the Wolfcamp shale formation in the Permian Basin, in addition to our ongoing vertical Wolfberry program. The following table summarizes the Company's drilling progress in the Permian Basin for the three months ended March 31, 2013:

	Drilled		Completed	
	Gross	Net	Gross	Net
Southern portion:				
Vertical wells	—	—	—	—
Horizontal wells	4	3.95	1	1.00
Total southern portion				