

CONTANGO OIL & GAS CO

Form 10-Q

February 09, 2009

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

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

**For the quarterly period ended December 31, 2008
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)

95-4079863
(IRS Employer Identification No.)

**3700 BUFFALO SPEEDWAY, SUITE 960
HOUSTON, TEXAS 77098
(Address of principal executive offices)
(713) 960-1901**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No
Indicate by check mark whether the registrant 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 January 31, 2009 was 16,317,680.

**CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES
QUARTERLY REPORT ON FORM 10-Q
FOR THE SIX MONTHS ENDED DECEMBER 31, 2008
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All references in this Form 10-Q to the Company, Contango, we, us or our are to Contango Oil & Gas Company and its wholly-owned Subsidiaries. Unless otherwise noted, all information in this Form 10-Q relating to natural gas and oil reserves and the estimated future net cash flows attributable to those reserves are based on estimates prepared by independent engineers and are net to our interest.

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CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
ASSETS

	December 31, 2008 (Unaudited)	June 30, 2008
CURRENT ASSETS:		
Cash and cash equivalents	\$ 77,046,546	\$ 59,884,574
Inventory tubulars	334,797	334,797
Accounts receivable:		
Trade receivables	25,787,838	72,343,761
Advances to affiliates	5,262,365	5,754,516
Joint interest billings receivable	8,961,632	18,019,847
Prepaid capital costs	1,264,278	1,264,278
Other	1,200,250	1,147,345
Total current assets	119,857,706	158,749,118
PROPERTY AND EQUIPMENT:		
Natural gas and oil properties, successful efforts method of accounting:		
Proved properties	464,182,425	442,630,193
Unproved properties	7,537,646	7,591,447
Furniture and equipment	293,301	278,737
Accumulated depreciation, depletion and amortization	(25,828,292)	(13,134,511)
Total property and equipment, net	446,185,080	437,365,866
OTHER ASSETS:		
Cash and other assets held by affiliates	3,879,470	3,299,002
Other	424,986	559,764
Total other assets	4,304,456	3,858,766
TOTAL ASSETS	\$ 570,347,242	\$ 599,973,750

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

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CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
LIABILITIES AND SHAREHOLDERS EQUITY

	December 31, 2008 (Unaudited)	June 30, 2008
CURRENT LIABILITIES:		
Accounts payable	\$ 4,789,418	\$ 22,990,887
Royalties and working interests payable	40,454,570	66,606,414
Accrued liabilities	3,201,965	10,334,008
Joint interest advances	4,106,072	15,666,389
Accrued exploration and development	4,866,990	3,082,399
Advances from affiliates		2,965,022
Debt of affiliates	3,429,990	3,261,177
Income tax payable	30,896,967	3,463,176
Other current liabilities	3,689,163	466,232
Total current liabilities	95,435,135	128,835,704
LONG-TERM DEBT		15,000,000
DEFERRED TAX LIABILITY	111,807,161	112,189,684
ASSET RETIREMENT OBLIGATION	2,347,861	1,949,881
SHAREHOLDERS EQUITY:		
Common stock, \$0.04 par value, 50,000,000 shares authorized, 19,620,334 shares issued and 16,317,680 outstanding at December 31, 2008, 19,404,746 shares issued and 16,819,746 outstanding at June 30, 2008	784,813	776,189
Additional paid-in capital	75,585,707	73,030,926
Treasury stock at cost (3,302,654 shares at December 31, 2008; 2,585,000 shares at June 30, 2008)	(40,485,660)	(6,843,900)
Retained earnings	324,872,225	275,035,266
Total shareholders equity	360,757,085	341,998,481
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	\$ 570,347,242	\$ 599,973,750

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

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

	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2008	2007	2008	2007
REVENUES:				
Natural gas, oil and liquids sales	\$ 45,516,589	\$ 16,595,383	\$ 118,237,396	\$ 25,691,126
Total revenues	45,516,589	16,595,383	118,237,396	25,691,126
EXPENSES:				
Operating expenses	5,413,883	808,076	9,952,245	1,531,922
Exploration expenses (credit)	(461,258)	413,791	7,630,882	515,427
Depreciation, depletion and amortization	6,350,014	947,665	13,247,428	1,547,905
Lease expirations	377,652		446,417	
General and administrative expenses	2,577,152	1,755,181	4,503,238	3,097,642
Total expenses	14,257,443	3,924,713	35,780,210	6,692,896
NET INCOME FROM CONTINUING OPERATIONS BEFORE OTHER INCOME AND INCOME TAXES	31,259,146	12,670,670	82,457,186	18,998,230
OTHER INCOME (EXPENSE):				
Interest expense (net of interest capitalized)	(146,263)	(1,329,499)	(442,421)	(2,159,359)
Interest income	179,361	484,195	603,513	848,509
Other income (expense)		(7,142)		2,184,023
NET INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	31,292,244	11,818,224	82,618,278	19,871,403
Provision for income taxes	(12,375,657)	(4,130,587)	(32,781,319)	(6,944,348)
NET INCOME FROM CONTINUING OPERATIONS	18,916,587	7,687,637	49,836,959	12,927,055
DISCONTINUED OPERATIONS (NOTE 8)				
Discontinued operations, net of income taxes		104,036,104		104,968,156
NET INCOME	18,916,587	111,723,741	49,836,959	117,895,211
Preferred stock dividends		450,000		900,000
NET INCOME ATTRIBUTABLE TO COMMON STOCK	\$ 18,916,587	\$ 111,273,741	\$ 49,836,959	\$ 116,995,211

NET INCOME PER SHARE:

Basic

Continuing operations	\$	1.14	\$	0.45	\$	2.98	\$	0.75
Discontinued operations				6.49				6.56

Total	\$	1.14	\$	6.94	\$	2.98	\$	7.31
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Diluted

Continuing operations	\$	1.12	\$	0.45	\$	2.92	\$	0.75
Discontinued operations				6.02				6.09

Total	\$	1.12	\$	6.47	\$	2.92	\$	6.84
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WEIGHTED AVERAGE COMMON
SHARES OUTSTANDING:

Basic	16,598,297	16,023,002	16,727,475	16,007,091
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Diluted	16,899,619	17,277,392	17,071,192	17,245,483
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The accompanying notes are an integral part of these consolidated financial statements.

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

	Six Months Ended	
	December 31,	
	2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income from continuing operations	\$ 49,836,959	\$ 12,927,055
Plus income from discontinued operations, net of income taxes		104,968,156
Net income	49,836,959	117,895,211
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, depletion and amortization	13,247,428	4,711,779
Lease expirations	446,417	
Exploration expenditures	7,123,043	361,838
Deferred income taxes	(382,523)	60,737,850
Tax benefit from exercise/cancellation of stock options	(229,761)	(225,719)
Stock-based compensation	811,065	864,712
Gain on sale of assets and other		(156,487,766)
Changes in operating assets and liabilities:		
Decrease in accounts receivable and other	45,676,247	1,541,388
Increase in notes receivable		(250,000)
Increase in prepaid insurance	(64,221)	(219,279)
Decrease (increase) in interest receivable	1,139,412	(400,453)
Increase (decrease) in accounts payable and advances from joint owners	(29,761,786)	8,363,805
Increase (decrease) in other accrued liabilities	(31,442,757)	1,305,645
Increase in income taxes payable	27,663,552	5,259,376
Other		(22,348)
Net cash provided by operating activities	84,063,075	43,436,039
CASH FLOWS FROM INVESTING ACTIVITIES:		
Natural gas and oil exploration and development expenditures	(20,626,040)	(37,809,764)
Increase in restricted cash		(199,183,422)
Increase in net investment in affiliates	(992,083)	(21,372,343)
Sale of short-term investments		2,200,576
Additions to furniture and equipment	8,699	(49,790)
Proceeds from the sale of assets		196,181,000
Investment in Contango Venture Capital Corporation		(1,166,624)
Net cash used in investing activities	(21,609,424)	(61,200,367)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Borrowings under credit facility		5,000,000
Repayments under credit facility	(15,000,000)	
Borrowings by affiliates		8,967,095
Preferred stock dividends		(900,000)

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Tax benefit from exercise/cancellation of stock options	229,761	225,719
Purchase of common stock	(31,794,019)	
Debt issuance costs	(250,000)	
Proceeds from exercised options, warrants and others	1,522,579	580,760
Net cash provided by (used in) financing activities	(45,291,679)	13,873,574
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	17,161,972	(3,890,754)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	59,884,574	6,177,618
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$ 77,046,546	\$ 2,286,864

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:

Cash paid for taxes	\$	\$
Cash paid for interest	\$ 273,608	\$ 2,413,364

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

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

	Common Stock		Paid-in	Treasury	Retained	Total
	Shares	Amount	Capital	Stock	Earnings	Shareholders
						Equity
Balance at June 30, 2008	16,819,746	\$ 776,189	\$ 73,030,926	\$ (6,843,900)	\$ 275,035,266	\$ 341,998,481
Exercise of stock options	204,500	8,180	1,413,615			\$ 1,421,795
Tax benefit of exercising stock options			120,540			\$ 120,540
Issuance of restricted common stock			78,375			\$ 78,375
Net income					30,920,372	\$ 30,920,372
Treasury shares at cost	(143,454)			(7,906,442)		\$ (7,906,442)
Expense of stock options			285,304			\$ 285,304
Balance at September 30, 2008	16,880,792	\$ 784,369	\$ 74,928,760	\$ (14,750,342)	\$ 305,955,638	\$ 366,918,425
Exercise of stock options	8,000	320	100,340			\$ 100,660
Tax benefit of exercising stock options			109,221			\$ 109,221
Issuance of restricted common stock	3,088	124	162,082			\$ 162,206
Net income					18,916,587	\$ 18,916,587
Treasury shares at cost	(574,200)			(25,735,318)		\$ (25,735,318)
Expense of stock options			285,304			\$ 285,304
Balance at December 31, 2008	16,317,680	\$ 784,813	\$ 75,585,707	\$ (40,485,660)	\$ 324,872,225	\$ 360,757,085

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

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CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES
NOTES TO 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, 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 presentation have been included. All such adjustments are of a normal recurring nature. The financial statements should be read in conjunction with the audited financial statements and notes included in the Company's Form 10-K for the fiscal year ended June 30, 2008. The results of operations for the three and six months ended December 31, 2008 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2009.

2. Summary of Significant Accounting Policies

The application of GAAP involves certain assumptions, judgments, choices and estimates that affect reported amounts of assets, liabilities, revenues and expenses. Thus, the application of these principles can result in varying results from company to company. 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. Unproved properties are reviewed quarterly to determine if there has been impairment of the carrying value, and any such impairment is charged to expense in the period. 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 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. When circumstances indicate that proved properties may be impaired, the Company compares expected undiscounted future net cash flows on a cost center 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 six months ended December 31, 2008, the Company recorded lease expiration expense of \$446,417 due to the expiration of lease block High Island 113 at our partially-owned subsidiary, Republic Exploration LLC (REX), and the expiration of lease blocks East Breaks 283, East Breaks 369, East Breaks 370 and High Island A16 at our partially-owned subsidiary, Contango Offshore Exploration LLC (COE).

An integral and on-going part of our business strategy is to sell our proved reserves from time to time in order to generate additional capital to reinvest in our offshore exploration programs. In accordance with Statement of Financial Accounting Standards (SFAS) No. 144 (SFAS 144), Accounting for the Impairment or Disposal of Long-Lived Assets, the Company classifies such property sales as discontinued operations.

Cash Equivalents. Cash equivalents are considered to be highly liquid investment grade debt investments having an original maturity of 90 days or less. As of December 31, 2008, the Company had approximately \$77.0 million in cash and cash equivalents. Of this amount, approximately \$51.3 million was invested in U.S. Treasury money market funds and the remaining \$25.7 million was invested in overnight U.S. Treasury funds.

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

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 intercompany balances and transactions. Wholly-owned subsidiaries are fully consolidated. The Company has two subsidiaries that are not wholly owned: 32.3% owned REX and 65.6% owned COE. These subsidiaries are not controlled by the Company and are proportionately consolidated.

For the fiscal year ended June 30, 2007, the Company owned 42.7% of REX and 76.0% of COE. Effective April 1, 2008, the Company sold a portion of its ownership interest in REX and COE to an existing owner for approximately \$0.8 million and \$0.9 million, respectively. As a result of the sale, the Company's equity ownership interest in REX and COE decreased to 32.3% and 65.6%, respectively.

Contango's 19.5% ownership of Mobilize Inc. (Mobilize) is accounted for using the cost method. Under the cost method, Contango records an investment in the stock of an investee at cost, and recognizes dividends received as income. Dividends received in excess of earnings subsequent to the date of investment are considered a return of investment and are recorded as reductions of cost of the investment.

Recent Accounting Pronouncements. In June 2008, the Financial Accounting Standards Board (FASB) issued Staff Position No. EITF 03-6-1 (FSP EITF 03-6-1), *Determining Whether Instruments Granted in Share-Based Payments Transactions Are Participating Securities* . FSP EITF 03-6-1 addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and, therefore, need to be included in the earnings allocation in computing earnings per share (EPS) under the two-class method described in SFAS No. 128, *Earnings per Share* . The provisions of FSP EITF 03-6-1 are effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those years. All prior-period EPS data presented shall be adjusted retrospectively (including interim financial statements, summaries of earnings, and selected financial data) to conform with the provisions of FSP EITF 03-6-1. Early application is not permitted. We do not expect FSP EITF 03-6-1 to have a material effect on our consolidated financial statements.

In May 2008, the FASB issued SFAS No. 162 (SFAS 162), *The Hierarchy of Generally Accepted Accounting Principles* . SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with GAAP (the GAAP hierarchy). SFAS 162 is effective 60 days following the Securities and Exchange Commission's approval of the Public Company Accounting Oversight Board amendments to AU section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles* . We are currently evaluating the provisions of SFAS 162 and assessing the impact, if any, it may have on our financial position and results of operations.

Effective July 1, 2009, the FASB issued SFAS No. 157-2 (SFAS 157-2), *Effective Date of FASB Statement No. 157* . This pronouncement defers the effective date of SFAS No. 157 (SFAS 157), *Fair Value Measurements* to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years, for all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). An entity that has issued interim or annual financial statements reflecting the application of the measurement and disclosure provisions of SFAS 157 prior to February 12, 2008, must continue to apply all provisions of SFAS 157. We are currently evaluating the provisions of SFAS 157-2 and assessing the impact, if any, it may have on our financial position and results of operations.

In December 2007, the FASB issued SFAS No. 141(R) (SFAS 141(R)), *Business Combinations* and SFAS No. 160 (SFAS 160), *Noncontrolling Interests in Consolidated Financial Statements* . These statements require most identifiable assets, liabilities and noncontrolling interests to be recorded at full fair value and require noncontrolling interests to be reported as a component of equity. Both statements are effective for periods beginning on or after December 15, 2008, and earlier adoption is prohibited. SFAS 141(R) will be applied to business combinations occurring after the effective date and SFAS 160 will be applied prospectively to all noncontrolling interests, including any that arose before the effective date. We are currently evaluating the provisions of SFAS 141(R) and SFAS 160 and assessing the impact, if any, they may have on our financial position and results of operations.

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**CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

Stock-Based Compensation. Effective July