

EVOLUTION PETROLEUM CORP
Form 10-Q
November 14, 2008
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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 September 30, 2008

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE EXCHANGE ACT

For the transition period from to

Commission File Number 001-32942

EVOLUTION PETROLEUM CORPORATION

(Exact name of registrant as specified in its charter)

Nevada

(State or other jurisdiction of incorporation or organization)

41-1781991

(IRS Employer Identification No.)

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2500 CityWest Blvd., Suite 1300, Houston, Texas 77042

(Address of principal executive offices and zip code)

(713) 935-0122

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 definition 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 number of shares outstanding of the registrant's common stock, par value \$0.001, as of November 14, 2008, was 26,917,234.

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EVOLUTION PETROLEUM CORPORATION AND SUBSIDIARIES

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Table of Contents**PART I FINANCIAL INFORMATION****ITEM 1. CONSOLIDATED CONDENSED FINANCIAL STATEMENTS****Evolution Petroleum Corporation and Subsidiaries****Consolidated Balance Sheets**

| | September 30, 2008 (Unaudited) | June 30, 2008 |
|--|---|--------------------------|
| Assets | | |
| Current Assets | | |
| Cash and cash equivalents | \$ 9,519,049 | \$ 11,272,280 |
| Receivables | | |
| Oil and natural gas sales | 898,743 | 2,066,300 |
| Income tax | 170,730 | 478,599 |
| Other | 129,037 | 86,966 |
| Income taxes recoverable | 3,625,987 | 3,625,987 |
| Prepaid expenses and other current assets | 509,588 | 270,938 |
| Total current assets | 14,853,134 | 17,801,070 |
| Property and equipment, net of depreciation, depletion, and amortization | | |
| Oil and natural gas properties full cost method of accounting | 23,958,349 | 22,047,233 |
| Other property and equipment | 176,712 | 161,027 |
| Total property and equipment | 24,135,061 | 22,208,260 |
| Other assets, net | 354,959 | 356,518 |
| Total assets | \$ 39,343,154 | \$ 40,365,848 |
| Liabilities and Stockholders Equity | | |
| Current liabilities | | |
| Accounts payable | \$ 1,251,951 | \$ 2,892,459 |
| Accrued expenses | 301,041 | 805,262 |
| Royalties payable | 337,470 | 473,327 |
| Total current liabilities | 1,890,462 | 4,171,048 |
| Long term liabilities | | |
| Deferred income taxes | 3,204,765 | 2,901,929 |
| Asset retirement obligations | 328,544 | 215,056 |
| Deferred rent | 75,025 | 74,081 |
| Total liabilities | 5,498,796 | 7,362,114 |
| Commitments and contingencies (Note 11) | | |
| Stockholders equity | 26,917 | 26,870 |

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Common Stock; par value \$0.001; 100,000,000 shares authorized; 26,917,234 and 26,870,439 issued and outstanding as of September 30, 2008 and June 30, 2008, respectively.

| | | |
|--|---------------|---------------|
| Additional paid-in capital | 14,880,981 | 14,188,841 |
| Retained earnings | 18,936,460 | 18,788,023 |
| Total stockholders' equity | 33,844,358 | 33,003,734 |
| Total liabilities and stockholders' equity | \$ 39,343,154 | \$ 40,365,848 |

See accompanying notes to consolidated financial statements.

Table of Contents**Evolution Petroleum Corporation and Subsidiaries****Consolidated Statements of Operations****(Unaudited)**

| | Three Months Ended September 30 | |
|--|--|---------------------|
| | 2008 | 2007 |
| Revenues | | |
| Crude oil | \$ 1,579,070 | \$ 502,273 |
| Natural gas liquids | 755,445 | |
| Natural gas | 580,471 | |
| Total revenues | 2,914,986 | 502,273 |
| Operating Costs | | |
| Lease operating expense | 335,904 | 310,310 |
| Production taxes | 85,996 | 17,556 |
| Depreciation, depletion and amortization | 644,882 | 110,443 |
| Accretion of asset retirement obligation | 5,737 | 4,695 |
| General and administrative * | 1,464,840 | 1,328,318 |
| Total operating costs | 2,537,359 | 1,771,322 |
| Income (loss) from operations | 377,627 | (1,269,049) |
| Other income (expense) | | |
| Interest income | 75,305 | 341,081 |
| Other | (1,659) | |
| Net income (loss) before provision (benefit) for income taxes | 451,273 | (927,968) |
| Income tax provision (benefit) | 302,836 | (286,587) |
| Net income (loss) | \$ 148,437 | \$ (641,381) |
| Earnings (loss) per common share | | |
| Basic | \$ 0.01 | \$ (0.02) |
| Diluted | \$ 0.01 | \$ (0.02) |
| Weighted average number of common shares | | |
| Basic | 26,845,670 | 26,776,234 |
| Diluted | 29,227,071 | 26,776,234 |

*General and administrative expenses for three months ended September 30, 2008 and 2007 included non-cash stock-based compensation of \$523,725 and \$376,007, respectively.

See accompanying notes to consolidated financial statements.

Table of Contents**Evolution Petroleum Corporation and Subsidiaries****Consolidated Statements of Cash Flow****(Unaudited)**

| | Three Months Ended September 30, | |
|---|---|---------------|
| | 2008 | 2007 |
| Cash flows from operating activities | | |
| Net income (loss) | \$ 148,437 | \$ (641,381) |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: | | |
| Depreciation, depletion and amortization | 644,882 | 110,443 |
| Stock-based compensation | 523,725 | 376,007 |
| Accretion of asset retirement obligations | 5,737 | 4,695 |
| Deferred income taxes | 302,836 | |
| Deferred rent | 944 | 23,959 |
| Changes in operating assets and liabilities: | | |
| Receivables | 1,433,355 | (654,061) |
| Prepaid expenses and other current assets | (238,650) | 98,695 |
| Accounts payable and accrued expenses | (466,478) | 121,992 |
| Royalties payable | (135,857) | 120 |
| Income tax payable | | (286,587) |
| Net cash provided by (used in) operating activities | 2,218,931 | (846,118) |
| Cash flows from investing activities | | |
| Development of oil and natural gas properties | (2,836,572) | (223,492) |
| Acquisitions of oil and natural gas properties | (1,111,640) | (1,406,637) |
| Capital expenditures for other equipment | (25,509) | (21,224) |
| Other assets | 1,559 | 51,801 |
| Net cash used in investing activities | (3,972,162) | (1,599,552) |
| Cash flows from financing activities | | |
| Proceeds from issuance of common stock | | |
| Net cash provided by financing activities | | |
| Net decrease in cash and cash equivalents | (1,753,231) | (2,445,670) |
| Cash and cash equivalents, beginning of period | 11,272,280 | 27,746,942 |
| Cash and cash equivalents, end of period | \$ 9,519,049 | \$ 25,301,272 |
| Supplemental disclosure of cash flow information: | | |
| Income taxes paid | \$ 15,000 | \$ |
| Income tax refunds received | \$ 322,869 | \$ |
| Non-cash transactions: | | |
| Increase (decrease) in accounts payable used to acquire oil and natural gas leasehold interests and develop oil and natural gas properties. | \$ (1,509,789) | \$ 432,514 |
| Oil and natural gas properties incurred through recognition of asset retirement obligations. | \$ 107,751 | \$ |
| Common stock issued in lieu of a portion of 2008 cash bonus accrued at June 30, 2008 | \$ 168,462 | \$ |

See accompanying notes to consolidated financial statements.

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EVOLUTION PETROLEUM CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Organization and Basis of Preparation

Nature of Operations. Evolution Petroleum Corporation (EPM) and its subsidiaries (the Company , we , our or us), is an independent petroleum company headquartered in Houston, Texas and incorporated under the laws of the State of Nevada. We are engaged primarily in the acquisition, exploitation and development of properties for the production of crude oil and natural gas. We acquire properties with known oil and natural gas resources and exploit them through the application of conventional and specialized technology to increase production, ultimate recoveries, or both.

Interim Financial Statements. The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the appropriate rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to such rules and regulations. All adjustments (consisting of normal recurring accruals) which are, in the opinion of management, necessary for a fair presentation of the financial position and results of operations for the interim periods presented have been included. The interim financial information and notes hereto should be read in conjunction with the Company s 2008 Annual Report on Form 10-K for the year ended June 30, 2008, as filed with the SEC. The results of operations for interim periods are not necessarily indicative of results to be expected for a full fiscal year.

Principles of Consolidation and Reporting. Our consolidated financial statements include the accounts of EPM and its wholly-owned subsidiaries. All significant intercompany transactions have been eliminated in consolidation. The consolidated financial statements for the previous year include certain reclassifications that were made to conform to the current presentation. Such reclassifications have no impact on previously reported income or stockholders equity.

Use of Estimates. The preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Significant estimates include reserve quantities and estimated future cash flows associated with proved reserves, which significantly impact depletion expense and potential impairments of oil and natural gas properties, income taxes and the valuation of deferred tax assets, stock-based compensation and commitments and contingencies. We analyze our estimates based on historical experience and various other assumptions that we believe to be reasonable. While we believe that our estimates and assumptions used in preparation of the consolidated financial statements are appropriate, actual results could differ from those estimates.

Note 2 Recent Accounting Pronouncements

New Accounting Standards. The following discloses the existence and effect of accounting standards issued but not yet adopted by us with respect to accounting standards that may have an impact on the Company when adopted in the future.

Accounting for Business Combinations. In December 2007, the FASB issued SFAS No. 141R, *Business Combinations* (SFAS No. 141R), which replaces SFAS No. 141, *Business Combinations*. SFAS No. 141R establishes principles and requirements for determining how an enterprise recognizes and measures the fair value of certain assets and liabilities acquired in a business combination, including non-controlling interests, contingent consideration, and certain acquired contingencies. SFAS No. 141R also requires acquisition-related transaction expenses and restructuring costs be expensed as incurred rather than capitalized as a component of the business combination. SFAS No. 141R will be applicable prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. SFAS No. 141R would have an impact on accounting for any businesses acquired after the effective date of this pronouncement.

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EVOLUTION PETROLEUM CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 2 Recent Accounting Pronouncements (Continued)

Accounting for Fair Value Measurements. In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS No. 157). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in GAAP and expands disclosures about fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The provisions of SFAS No. 157 will be applied prospectively as of the beginning of the fiscal year in which it is initially applied except for, among other items, a financial instrument that was measured at fair value at initial recognition under Statement 133 using the transaction price in accordance with the guidance in footnote 3 of Issue 02-3 prior to initial application of SFAS No. 157. In February 2008, the FASB deferred the effective date of SFAS No. 157 by one year for nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis and amended SFAS No. 157 to exclude SFAS No. 13, *Accounting for Leases*, and its related interpretive accounting pronouncements that address leasing transactions. SFAS No. 157 did not have an impact on our financial statements when adopted on July 1, 2008. We are currently evaluating what the impact, if any, of SFAS No. 157 for nonfinancial assets and nonfinancial liabilities will have on our financial statements.

Note 3 Sale of Oil and Natural Gas Properties

On March 3, 2008, NGS Sub Corp., a Delaware corporation wholly owned by EPM (NGS Sub), pursuant to an Asset Purchase and Sale Agreement (the Asset Sale Agreement) dated February 15, 2008, completed the sale of its 100% working interest and approximately 79% average net revenue interest in producing and shut-in crude oil wells, water disposal wells, equipment and improvements located in the Tullos Urania, Colgrade and Crossroads Fields in LaSalle and Winn Parishes, Louisiana (the Tullos Field Area). The following table presents the transaction and its affect on our financial statements.

| | | |
|---|----|-------------|
| Proceeds from sale of properties in the Tullos Field Area | \$ | 4,649,241 |
| Less payout of a third party carried interest arrangement | | (168,106) |
| Less miscellaneous transaction costs | | (60,267) |
| <i>Net proceeds</i> | | 4,420,868 |
| Net book value of our properties in the Tullos Field Area on March 3, 2008 | | |
| Asset retirement obligation | | 153,886 |
| Oil and natural gas properties | | (1,721,990) |
| Other property and equipment | | (26,721) |
| Prepaid expenses and other current assets | | (178,826) |
| Other assets | | (13,347) |
| Remaining credit recorded to oil and natural gas properties | \$ | 2,633,870 |

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The following unaudited pro forma consolidated financial information is presented for illustrative purposes only and presents the pro forma operating results for the Company for the three months ended September 30, 2007 as though the disposition of our properties in the Tullos Field Area occurred at July 1, 2007. The unaudited pro forma consolidated financial information is not intended to be indicative of the operating results that actually would have occurred if the transaction had been consummated at the beginning of the period presented, nor is the information intended to be indicative of future operating results.

The unaudited pro forma consolidated financial information for the three months ended September 30, 2007 is as follows:

| | Three Months Ended September 30, 2007 | |
|---|--|------------------|
| | As Reported | Pro Forma |
| Oil and natural gas revenues | \$ 502,273 | \$ 10,306 |
| Loss from operations | \$ (1,269,049) | \$ (1,318,938) |
| Net loss | \$ (641,381) | \$ (675,863) |
| Loss per common share basic and diluted | \$ (0.02) | \$ (0.03) |

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EVOLUTION PETROLEUM CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 4 Property and Equipment

As of September 30, 2008 and June 30, 2008 our oil and natural gas properties and other property and equipment consisted of the following:

| | September 30, 2008 | June 30, 2008 |
|---|-----------------------|------------------|
| Oil and natural gas properties | | |
| Property costs subject to amortization | \$ 16,539,004 | \$ 15,105,766 |
| Less: Accumulated depreciation, depletion, and amortization | (1,267,098) | (632,040) |
| Unproved properties not subject to amortization | 8,686,443 | 7,573,507 |
| Oil and natural gas properties, net | \$ 23,958,349 | \$ 22,047,233 |
| Other property and equipment | | |
| Furniture, fixtures and equipment, at cost | 257,350 | 231,841 |
| Less: Accumulated depreciation | (80,638) | (70,814) |
| Other property and equipment, net | \$ 176,712 | \$ 161,027 |

Note 5 Asset Retirement Obligations

Our asset retirement obligations represent the estimated present value of the amount we will incur to plug, abandon and remediate our producing properties at the end of their productive lives in accordance with applicable laws. The following is a reconciliation of the beginning and ending asset retirement obligation for the three months ended September 30, 2008:

| | |
|--|------------|
| Asset retirement obligations - July 1, 2008 | \$ 215,056 |
| Liabilities incurred | 22,480 |
| Accretion expense | 5,737 |
| Revisions to previous estimates | 85,271 |
| Asset retirement obligations September 30, 2008 | \$ 328,544 |

Note 6 Stockholders Equity

On August 19, 2008, the Board of Directors authorized the issuance of 46,795 shares of common stock to certain employees who requested to receive the shares in lieu of a portion of their fiscal 2008 cash bonus. The value of the shares issued was \$168,462, based on the fair market value on the date of issuance.

Note 7 Stock-Based Incentive Plan

We have granted option awards to purchase common stock (the *Stock Options*) and restricted common stock awards (*Restricted Stock*) to employees, directors, and consultants of the Company and its subsidiaries under the Natural Gas Systems Inc. 2003 Stock Plan (the *2003 Stock Plan*) and the Evolution Petroleum Corporation Amended and Restated 2004 Stock Plan (the *2004 Stock Plan* or together, the *EPM Stock Plans*). A total of 600,000 awards to purchase an equal number of shares of common stock were issued under the 2003 Stock Plan. The 2004 Stock Plan authorized the issuance of 5,500,000 shares of common stock. There are no shares available for grant under the 2003 Stock Plan and, as of September 30, 2008, 687,974 shares remain available for grant under the 2004 Stock Plan.

Table of Contents**EVOLUTION PETROLEUM CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Note 7 Stock-Based Incentive Plan (Continued)**

We have also granted common stock warrants, as authorized by the Board of Directors, to employees in lieu of cash bonuses or as incentive awards to reward previous service or provide incentives to individuals to acquire a proprietary interest in the Company's success and to remain in the service of the Company (the Incentive Warrants). These Incentive Warrants have similar characteristics of the Stock Options. A total of 1,037,500 Incentive Warrants have been issued, through September 30, 2008, with Board of Directors approval, outside of the EPM Stock Plans.

Stock Options and Incentive Warrants

Stock-based compensation expense related to Stock Options and Incentive Warrants for the three months ended September 30, 2008 and 2007 was \$445,993 and \$301,097, respectively.

During the three months ended September 30, 2008, we granted Stock Options to purchase 591,090 shares of common stock under the 2004 Stock Plan with a weighted average exercise price of \$4.27. During the three months ended September 30, 2007, we granted Stock Options to purchase 1,135,000 shares of common stock under the 2004 Stock Plan with a weighted average exercise price of \$2.21. The exercise price was determined based on the market price of the Company's common stock on the date of grant. The Stock Options granted during the three months ended September 30, 2008 and 2007 generally vest quarterly, on a straight line basis, over a period of four years. The Stock Options granted during the three months ended September 30, 2008 and 2007 have a contractual life of seven and ten years, respectively. The weighted average assumptions used to calculate the fair value of these Stock Options and the weighted average fair value of each Stock Option granted is as follows:

| | Three Months Ended | |
|-----------------------------|---------------------------|-------------|
| | September 30, | |
| | 2008 | 2007 |
| Expected volatility | 87.1% | 93.6% |
| Expected dividends | | |
| Expected term (in years) | 4.6 | 6.1 |
| Risk-free rate | 3.10% | 4.14% |
| Fair value per Stock Option | \$ 2.62 | \$ 1.74 |

We estimated the fair value of Stock Options and Incentive Warrants issued to employees and directors under SFAS No. 123R at the date of grant using a Black-Scholes-Merton valuation model. The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant. The expected term (estimated period of time outstanding) of Stock Options and Incentive Warrants is based on the simplified method of estimated expected term for plain vanilla options allowed by the SEC Staff Accounting Bulletin (SAB) No. 107 and SAB No. 110, and varied based on the vesting period and contractual term of the Stock Options or Incentive Warrants. Expected volatility is based on the historical volatility of the Company's closing common stock price and that of an evaluation of a peer group of similar companies trading activity. We have

not declared any cash dividends on the Company's common stock.

Table of Contents**EVOLUTION PETROLEUM CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Note 7 Stock-Based Incentive Plan (Continued)**

The following summary presents information regarding outstanding Stock Options and Incentive Warrants as of September 30, 2008, and the changes during the three months then ended:

| | Number of Stock Options and Incentive Warrants | Weighted Average Exercise Price | Aggregate Intrinsic Value (1) | Weighted Average Remaining Contractual Term (in years) |
|---|---|--|--|---|
| Stock Options and Incentive Warrants outstanding at July 1, 2008 | 5,483,500 | \$ 1.81 | | |
| Granted | 591,090 | \$ 4.27 | | |
| Exercised | | | | |
| Canceled, forfeited, or expired | | | | |
| Stock Options and Incentive Warrants outstanding at September 30, 2008 | 6,074,590 | \$ 2.05 | \$ 7,076,875 | 7.2 |
| Vested or expected to vest at September 30, 2008 | 6,074,590 | \$ 2.05 | \$ 7,076,875 | 7.2 |
| Exercisable at September 30, 2008 | 3,709,125 | \$ 1.56 | \$ 5,565,181 | 6.8 |

(1) Based upon the difference between the market price of our common stock on the last trading date of the fiscal quarter (\$3.05) and the Stock Option or Incentive Warrant exercise price of in-the-money Stock Options and Incentive Warrants.

There were no Stock Options or Incentive Warrants that were exercised during the three months ended September 30, 2008 and 2007.

Table of Contents**EVOLUTION PETROLEUM CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Note 7 Stock-Based Incentive Plan (Continued)**

A summary of the status of our unvested Stock Options and Incentive Warrants as of September 30, 2008 and the changes during the three months ended September 30, 2008 and 2007, is presented below:

| | Number of Stock Options and Incentive Warrants | Weighted Average Grant- Date Fair Value |
|---------------------------------|---|--|
| Unvested at July 1, 2007 | 1,573,125 | \$ 1.50 |
| Granted | 1,135,000 | \$ 1.73 |
| Vested | (170,625) | \$ 1.39 |
| Canceled, forfeited, or expired | | |
| Unvested at September 30, 2007 | 2,537,500 | \$ 1.61 |
| Unvested at July 1, 2008 | 2,003,437 | \$ 1.83 |
| Granted | 591,090 | \$ 2.62 |
| Vested | (229,062) | \$ 1.70 |
| Canceled, forfeited, or expired | | |
| Unvested at September 30, 2008 | 2,365,465 | \$ 2.04 |

The total unrecognized compensation cost at September 30, 2008, relating to non-vested share-based compensation arrangements granted under the EPM Stock Plans and Incentive Warrants was \$4,651,821. Such unrecognized expense is expected to be recognized over a weighted average period of 3.0 years.

Restricted Stock

For the three months ended September 30, 2008 and 2007, there were no grants of restricted stock. All issuances of common stock are subject to vesting terms per individual Restricted Stock agreements.

During the three months ended September 30, 2008 and 2007, we recognized compensation expense of \$77,732 and \$74,910, respectively, related to Restricted Stock grants.

Table of Contents**EVOLUTION PETROLEUM CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Note 7 Stock-Based Incentive Plan (Continued)**

The following table sets forth the restricted stock transactions for the three months ended September 30, 2008 and 2007:

| | Number of Restricted Shares | Weighted Average Grant-Date Fair Value |
|--------------------------------|-----------------------------------|---|
| Unvested at July 1, 2007 | 59,449 | \$ 2.78 |
| Granted | | |
| Vested | (21,808) | \$ 2.81 |
| Forfeited | | |
| Unvested at September 30, 2007 | 37,641 | 2.77 |
| Unvested at July 1, 2008 | 50,898 | \$ 4.11 |
| Granted | | |
| Vested | (12,501) | 4.06 |
| Forfeited | | |
| Unvested at September 30, 2008 | 38,397 | 4.13 |

At September 30, 2008, unrecognized stock compensation expense related to Restricted Stock grants totaled \$77,731. Such unrecognized expense will be recognized over a weighted average period of 0.23 years.

Note 8 Income Taxes

We file a consolidated federal income tax return in the United States and various combined and separate filings in several state and local jurisdictions.

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There were no unrecognized tax benefits nor any accrued interest or penalties associated with unrecognized tax benefits as of the date of adoption of FIN 48 and through September 30, 2008.

Our effective tax rate was a provision of 67% and a benefit of 31% for the three months ended September 30, 2008 and 2007, respectively. The primary reconciling item of our income tax provision (benefit) at the statutory federal rate to our actual income tax provision (benefit) is the expense of stock-based compensation related to our qualified incentive stock option awards (ISO Awards). We expensed \$396,394 and \$213,551 for the three months ended September 30, 2008 and 2007, respectively, related to ISO Awards.

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EVOLUTION PETROLEUM CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 9 Related Party Transactions

Laird Q. Cagan, Chairman of our Board of Directors, is a Managing Director and co-owner of Cagan McAfee Capital Partners, LLC (CMCP). CMCP performs financial advisory services to us pursuant to a written agreement amended in November 2005, providing for a retainer of \$5,000 per month. In addition, Mr. Cagan, as a registered representative of Chadbourn Securities Inc. (Chadbourn) and a partner of CMCP, has served as the Company's placement agent in private equity financings. Under the current agreement, CMCP may earn cash fees equal to 8% of gross equity proceeds, declining to 4% subject to the amount of equity raised through CMCP, and a fixed 4% warrant fee. Mr. Cagan receives no compensation for serving as a director or as the Chairman of our Board of Directors.

Eric A. McAfee, a major shareholder of the Company, is also a Managing Director of CMCP.

During the three months ended September 30, 2008 and 2007, we expensed and paid CMCP \$15,000 through monthly retainers of \$5,000. There were no other earned fees by CMCP during the three months ended September 30, 2008 and 2007.

Note 10 Earnings (loss) Per Share (EPS)

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

| | Three Months Ended September 30 | |
|---|------------------------------------|--------------|
| | 2008 | 2007 |
| <i>Numerator used in basic and diluted EPS</i> | | |
| Net income (loss) | \$ 148,437 | \$ (641,381) |
| <i>Denominator</i> | | |
| Weighted average number of common shares used in basic EPS | 26,845,670 | 26,776,234 |
| Effect of dilutive securities: | | |
| Common stock warrants issued in connection with equity and financing Transactions | 269,699 | |
| Stock Options and Incentive Warrants | 2,092,263 | |
| Non-vested Restricted Stock | 19,439 | |
| Total weighted average dilutive securities | 2,381,401 | |
| Weighted average number of common shares and dilutive potential common shares used in diluted EPS | 29,227,071 | 26,776,234 |

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| | | | | |
|-------------|----|------|----|--------|
| Basic EPS | \$ | 0.01 | \$ | (0.02) |
| Diluted EPS | \$ | 0.01 | \$ | (0.02) |

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EVOLUTION PETROLEUM CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 10 Earnings (loss) Per Share (EPS) (Continued)

Total potentially dilutive securities outstanding as of September 30, 2008 are as follows:

| Outstanding Potentially Dilutive Securities | Weighted Average Exercise Price | Outstanding at September 30, 2008 |
|---|---------------------------------------|---|
| Common stock warrants issued in connection with equity and financing Transactions | \$ 1.40 | 401,058 |
| Stock Options and Incentive Warrants | \$ 2.05 | 6,074,590 |
| Non-vested Restricted Stock | N/A | 38,397 |
| | | 6,514,045 |

Note 11 Commitments and Contingencies

Environmental clean-up. On August 3, 2007, we were advised of an oil spill in the Tullos Field near one of our leases. At the request of field agents of the Louisiana Department of Environmental Quality and the Environmental Protection Agency (EPA), we agreed to commence a clean-up operation that was completed by the end of August 2007. A detailed analysis of the oil in the spill compared to the Company's produced oil was conducted by an EPA approved laboratory. We believe that the oil in the spill did not originate from our operations, supported by the formal findings of the laboratory. We received insurance reimbursements of \$484,197 in October 2007 and \$217,668 in March 2008. These reimbursements covered all of our actual cleanup costs except a \$5,000 insurance deductible and excluding our legal fees, in-house administrative costs, and any possible EPA expense reimbursements and fines that might be billed.

On May 5, 2008, we received a letter from the EPA proposing a \$5,500 fine related to the oil spill. In August we paid the fine under a settlement with the EPA where we agreed to pay the \$5,500 fine with no admission of liability. We have also received a bill from the United States Coast Guard of approximately \$70,000 for expense reimbursement. We believe this claim is not supported by independent investigation. As of the date of this filing, we have requested further verification from the United States Coast Guard to support their claim.

Litigation. The Company is subject to various lawsuits and other claims in the normal course of business. In addition, from time to time, we receive communications from government or regulatory agencies concerning investigations or allegations of noncompliance with laws or regulations in jurisdiction in which we operate. We establish reserves for specific liabilities in connection with regulatory and legal actions that we deem to be probable and estimable. No

amounts have been accrued in our financial statements with respect to any legal or regulatory matters as we believe the matters have a remote chance of resulting in a significant judgment.

In July 2008, a multi-plaintiff lawsuit was filed in the twenty-eighth Judicial District Court, Lasalle Parish, Louisiana, against 15 defendants, including Four Star Development Corporation, a former indirect wholly owned subsidiary of the Company, which was sold on March 3, 2008, as part of our sale of the Tullos Field Area. Plaintiffs claim that the defendants' oil and natural gas exploration, development and production activities on their properties have caused soil and ground water contamination as a result of the release of hydrocarbons and drilling fluids. Plaintiffs seek damages for testing, clean-up and remediation of the properties as well as diminution in their value and mental anguish and emotional distress to the individual plaintiffs, unjust enrichment and punitive damages for alleged concealment of ongoing activities. At this time, we are not a party to the litigation and are unable to determine the exposure, if any, to the Company.

In November 2005, a multi-plaintiff lawsuit was filed in the Fifth Judicial District Court, Richland Parish, Louisiana, against 18 defendants including NGS Sub Corp. and Arkla Petroleum LLC, the Company's direct and indirect wholly owned subsidiaries (the "Subsidiaries"), as working interest owners/operators of various oil and natural gas leases in the Delhi Field. Plaintiffs claim that the defendants' oil and natural gas exploration, development and production activities on their properties have caused soil and ground water contamination as a result of the release of hydrocarbons and drilling fluids. Plaintiffs seek damages for testing, clean-up and remediation of the properties as well as diminution in their value and mental anguish to the individual plaintiffs, unjust enrichment and punitive damages for alleged concealment of ongoing activities.

Table of Contents**EVOLUTION PETROLEUM CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Note 11 Commitments and Contingencies (Continued)**

Defendants have answered Plaintiffs' suit denying all claims. Trial is set before a jury in Richland Parish for July 13, 2009. We intend to vigorously contest all of Plaintiffs' claims. The case is currently in discovery, and, at this time, we are unable to predict the outcome of the litigation.

Lease Commitments. We have a non-cancelable operating lease for office space that expires on August 1, 2016. Future minimum lease commitments as of September 30, 2008 under this operating lease are as follows:

| Year ended September 30, | | |
|---------------------------------|-----------|------------------|
| 2009 | \$ | 138,089 |
| 2010 | | 138,089 |
| 2011 | | 141,576 |
| 2012 | | 159,011 |
| 2013 | | 159,011 |
| Thereafter | | 450,531 |
| Total | \$ | 1,186,307 |

Rent expense for the three months ended September 30, 2008 and 2007 was \$35,466.

Employment Contracts. We have entered into employment agreements with the Company's three senior executives. The employment contracts provide for a severance package for termination by the Company for any reason other than cause or permanent disability, that includes payment of base pay and certain medical and disability benefits from six months to a year after termination. The total contingent obligation under the employment contracts as of September 30, 2008 is approximately \$499,000.

Note 12 Subsequent Events

On October 30, 2008, we repurchased 788,200 shares of common stock at an average price of \$1.10 per share, plus approximately \$15,000 of transaction costs, from an unaffiliated accredited investor. At this time, the company has no plan to repurchase any more common shares.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This Form 10-Q and the information referenced herein contain forward-looking statements within the meaning of the Private Securities Litigations Reform Act of 1995, Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. The words plan, expect, project, estimate, assume, believe, anticipate, intend, budget, forecast, predict and other similar expressions are intended to identify forward-looking statements. These statements appear in a number of places and include statements regarding our plans, beliefs or current expectations, including the plans, beliefs and expectations of our officers and directors. When considering any forward-looking statement, you should keep in mind the risk factors that could cause our actual results to differ materially from those contained in any forward-looking statement. Important factors that could cause actual results to differ materially from those in the forward-looking statements herein include the timing and extent of changes in commodity prices for oil and natural gas, operating risks and other risk factors as described in our 2008 Annual Report on Form 10-K for the year ended June 30, 2008 as filed with the Securities and Exchange Commission. Furthermore, the assumptions that support our forward-looking statements are based upon information that is currently available and is subject to change. 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 Evolution Petroleum Corporation are expressly qualified in their entirety by this cautionary statement.

We use the terms, EPM, Company, we, us and our to refer to Evolution Petroleum Corporation.

Executive Overview

General

We are a petroleum company engaged primarily in the acquisition, exploitation and development of properties for the production of crude oil and natural gas. We acquire known, underdeveloped oil and natural gas resources and exploit them through the application of capital and technology to increase production, ultimate recoveries, or both.

Our strategy is intended to generate scalable development opportunities at normally pressured depths, exhibiting relatively low completion risk, generally longer and more predictable production lives, less expenditures on infrastructure and lower operational risks.

Within this overall strategy, we pursue three specific initiatives:

I Enhanced oil recovery (EOR), using miscible and immiscible gas flooding;

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- II Conventional redevelopment of bypassed primary resource within mature oil and natural gas fields utilizing modern technology and our expertise; and
- III Unconventional gas resource development, using modern stimulation and completion technologies.

Our most significant asset is within our EOR Initiative in the 13,636 acre Delhi Field, located in northeast Louisiana. Our non-operated interests consist of 7.4% in overriding and mineral royalty interests and a 25% after pay-out reversionary working interest in the Delhi Field Holt Bryant Unit, along with a 25% working interest in certain other depths in the Delhi Field resulting from the Farmout we completed on June 12, 2006 with Denbury Onshore LLC, a subsidiary of Denbury Resources Inc. (Denbury) (the Delhi Farmout). The Holt Bryant Unit is currently being redeveloped by the operator, Denbury, using CO₂ enhanced oil recovery technology and a dedicated portion of Denbury's proved CO₂ reserves in the Jackson Dome, approximately 100 miles east of Delhi. Injection of CO₂ is expected to begin during the first half of calendar 2009, followed by projected increases in oil production on or about late calendar 2009.

Since our closing of the Delhi Farmout, we have focused on developing projects in our other initiatives, particularly through conventional redevelopment of bypassed resources in the Giddings Field using horizontal drilling methods, and the leasing of unconventional gas shale projects in the Woodford Shale Trend in Oklahoma. Conceptually, our plan going forward can be illustrated as follows:

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As indicated by the above chart, (volumes are representative and not to scale), we are funding our current development projects in the Giddings Field and leasing and development in our gas shale projects with our working capital resources. We expect that net cash flows from our properties in the Giddings Field, our current cash resources and cash flows from the Delhi Project will be used to fund our gas shale projects and other new projects.

Highlights for our First Quarter 2009

- **The redeployment of our proceeds from the sale of our properties in the Tullos Field Area into the Giddings Field continues to generate positive results**

We reported positive earnings from operations for the three months ended September 30, 2008. During the three months ended September 30, 2008, operating income was \$377,627 and net income before income taxes was \$451,273. This compares to an operating loss of \$1,269,049 and a net loss before income taxes of \$927,968 for the three months ended September 30, 2007. (Non-cash stock based compensation of \$523,725 and \$376,008, for the three months ended September 30, 2008 and 2007, respectively, are included in these results.)

Sales volumes increased 385% during our first quarter in fiscal year 2009 vs. our first quarter in fiscal year 2008. Our increase in sales volumes for the quarter were solely attributable to our production in the Giddings Field. Our properties in the Tullos Field Area, which were sold on March 3, 2008, accounted for approximately 98% of total sales volumes for the three months ended September 30, 2007.

We lowered per barrel lifting costs by 73% during our most recent quarter vs. the prior year quarter, while depletion increased approximately \$6 per BOE. Lifting costs (lease operating and severance tax, on a combined per unit of sales basis) were \$12.22 per BOE during the quarter ended September 30, 2008, which included only production from our properties in the Giddings Field. During the quarter ended September 30, 2007, where primarily all our production was from our properties in the Tullos Field Area, lifting costs averaged \$44.55 per Bbl of crude oil. Due to additions of higher valued, higher cost reserves at the Giddings field during the period, our depletion rate rose from \$13.11 to \$18.63 per BOE.

- **We remained financially strong**

We ended the quarter with \$12.9 million of working capital, little changed from \$13.6 million at June 30, 2008. At September 30, 2008, our working capital consisted of \$14.3 million of cash and near cash, consisting of \$9.5 million of cash and cash equivalents, \$3.6 million of recoverable income taxes and \$1.2 million in receivables from oil and natural gas sales, income taxes and other. The \$3.6 million of recoverable income taxes is due to our estimated income tax refund from the carry-back of our fiscal 2008 taxable loss to our tax years ended June 30, 2006 and 2007. Our 2008 tax loss was significant due to the deduction of Intangible Drilling Costs incurred in fiscal 2008. We expect to file our 2008 Corporation Income Tax Return as well as the application for refund in mid November.

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We protected our short-term investments during difficult credit market conditions. We have continually avoided structurally enhanced investment securities, auction rate securities and other higher risk credit instruments. Instead, we relied upon lower yielding U.S. Government Agency money market funds until July 2008, when we shifted all of our cash equivalents into short-term U.S. Treasury money market funds.

We are still debt free, and expect to remain so during fiscal 2009.

Looking Forward in 2009

- **We reduced our fiscal 2009 capital expenditures budget.**

We expect to fund our fiscal 2009 capital expenditures budget entirely from our working capital and operating cash flow. Due in part to uncertainties caused by the recent turmoil in the financial markets and the decline in the price of oil and natural gas, we reduced our fiscal 2009 capital expenditure budget by approximately 50% to less than \$10 million (the Revised 2009 Plan), as discussed in the Liquidity and Capital Resources section that follows. We believe preserving our resources could allow us to take advantage of opportunities that may arise from the continued disruptions in the financial markets.

- **We are more focused on extending our trend of increasing underlying per share value.**

Our Revised 2009 Plan, although smaller to maintain our liquidity, is now more focused on adding proved reserves instead of converting proved reserves to production. We are placing more emphasis on proved reserve additions and increasing value per share, and less emphasis this fiscal year on converting drilling locations to producing wells. Our capital expenditures are now focused more on lease acquisitions and initial pilot drilling of expected proved reserves in our new Texas project and the drilling of relatively inexpensive wells in our properties in the Woodford Shale Trend in Oklahoma, in the expectation of establishing proved reserves, as described in the Liquidity and Capital Resources section that follows.

We recently repurchased 788,200 shares of our common shares at an average price of \$1.10 per share, plus transaction costs, from an unaffiliated accredited investor. We believe the acquisition of our shares at these levels is highly accretive to existing shareholder value. Although it is not our current intention to repurchase more shares at this time, we will keep that option open.

We expect revenues to increase in our second quarter fiscal 2009 as compared to our second quarter fiscal 2008, but will decline sequentially compared to our first quarter fiscal 2009.

- **We expect revenues to increase in our second quarter fiscal 2009 as compared to our second quarter fiscal 2008, but will decline sequentially compared to our first quarter fiscal 2009.**

Liquidity and Capital Resources

At September 30, 2008, our working capital, predominately cash and cash equivalents, was approximately \$12.9 million and we continued to be debt free. This compares to working capital of approximately \$13.6 million at June 30, 2008. Of the \$0.7 million decrease in working capital since June 2008, cash of approximately \$4.0 million was used for investing activities, primarily for development activities in the Giddings Field and leasehold acquisition costs in the Giddings Field and our Woodford Shale projects in Oklahoma, offset by cash of approximately \$2.2 million provided by operations and an increase of approximately \$1.1 million in net operating assets.

Cash flows provided by operating activities for the three months ended September 30, 2008 was approximately \$2.2 million. Cash flows provided by operations includes cash proceeds of approximately \$3.9 million from oil and natural gas production primarily from our properties in the Giddings Field, net cash proceeds of approximately \$0.4 million from interest income and income tax refunds, offset by approximately \$2.1 million of cash payments for operating activities, including lease operating expenses, production taxes, and salaries and wages. This compares to approximately \$0.8 million of cash used in operations for the three months ended September 30, 2007, which includes approximately \$0.6 million of cash proceeds from oil production primarily from our properties in the Tullos Field Area, which we sold on March 3, 2008, cash proceeds from interest income of approximately \$0.3 million, offset by approximately \$1.7 million of cash payments for operating activities, including lease operating expenses, production taxes, and salaries and wages.

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Cash flows used in investing activities totaled approximately \$4.0 million during the three months ended September 30, 2008. This compared to approximately \$1.6 million used in investing activities for the three months ended September 30, 2007. During the current period approximately \$3.9 million of cash was used for investments to acquire and develop oil and natural gas property interests, which includes net payments on accounts payable of approximately \$1.5 million from June 30, 2008 relating to expenditures for oil and natural gas properties.

There were no cash flows from financing activities during the three months ended September 30, 2008 and 2007.

We incurred approximately \$2.5 million in capital expenditures for oil and natural gas leasehold and development costs during the three months ended September 30, 2008, which includes approximately \$0.1 million related to costs incurred due to the recognition of asset retirement obligations. Of the \$2.5 million, \$1.1 million was incurred for leasehold acquisitions and approximately \$1.4 million was incurred for development activities. For the three months ended September 30, 2007, we incurred approximately \$2.1 million in capital expenditures for oil and natural gas leasehold and development costs, with the majority being used for leasehold acquisitions.

Due in part to uncertainties caused by the recent turmoil in the financial markets and the decline in the price of oil and natural gas, we have revised our capital expenditure budget for fiscal 2009 (the Revised 2009 Plan), reducing the overall program from \$19 million to less than \$10 million. Our previous capital budget, as disclosed in our 2008 annual report on Form 10-K, was approximately \$19 million of increased development activities and diminished incremental leasing in the Giddings Field and in our gas shale projects in Oklahoma, with approximately \$16 million dedicated to development drilling and the balance to leasehold acquisitions.

Our long term strategy and primary focus continue to be on increasing share value through the identification and acquisition of resources and conversion of those resources into proved reserves through our expertise and technology. Due to current market conditions, we have shifted the Revised 2009 Plan more towards higher value-added activities in (i) project identification and leasing of reserves that we believe will be categorized as proved undeveloped, (ii) drilling to move existing reserves into the proved category, and (iii) selective repurchase of common shares.

Since our wells in the Giddings Field tend to produce a large portion of their reserves relatively quickly, we believe that it is in our shareholders best interests to slow the development of our properties in the Giddings Field until expectations of higher commodity prices may be realized. Our Revised 2009 Plan provides for drilling up to three re-entry wells in the Giddings Field, which is a reduction from the previous ten well re-entry plan, subject to future changes in commodity prices and market conditions. The first Giddings Field re-entry well is expected to be drilled in November 2008.

Additionally, initial test drilling of up to five low-cost vertical wells is planned within our shallow Woodford Shale project in Oklahoma. It is our intention to potentially quantify and convert that potential resource into proved and probable reserves, with possible further proved extensions from these wells if the SEC implements its proposed new rules on proved reserves in continuous formations. Similarly, we expect to drill up to three low cost wells in our new Texas project, with the expectation of potentially establishing proved reserves of moderately heavy oil associated with water at shallow depths.

Due to our substantial working capital, no debt and no near term expiring leases, we believe we have the ability to adjust our capital expenditure budget to capture select opportunities that may arise for the benefit of our shareholders. As an example, extreme stock market volatility

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provided us with an opportunity to repurchase our common shares at a favorable price that, we believe, increases shareholder value. Thus, on October 30, 2008 we completed a block repurchase of 788,200 of our common shares from an unaffiliated institution at an average price of \$1.10 per share, plus approximately \$15,000 in transaction fees. At this time, we have no current plan to conduct any additional repurchases of our common shares.

Table of Contents**Results of Operations**

Three months ended September 30, 2008 compared with the three months ended September 30, 2007

The following table sets forth certain financial information with respect to our oil and natural gas operations:

| | Three Months Ended September 30 | | | |
|---|------------------------------------|------------|--------------|-------------|
| | 2008 | 2007 | Variance | % change |
| Production Volumes, net to the Company: | | | | |
| Crude oil and natural gas liquids (Bbl) | 12,709 | 7,360 | 5,349 | 73% |
| Natural gas liquids (NGLs) (Bbl) | 11,063 | | 11,063 | |
| Natural gas (Mcf) | 61,146 | | 61,146 | |
| Crude oil, NGLs and natural gas (BOE) | 33,963 | 7,360 | 26,603 | 361% |
| Sales Volumes, net to the Company: | | | | |
| Crude oil (Bbl) | 12,835 | 7,034 | 5,801 | 82% |
| NGLs (Bbl) | 11,063 | | 11,063 | |
| Natural gas (Mcf) | 61,146 | | 61,146 | |
| Crude oil, NGLs and natural gas (BOE) | 34,089 | 7,034 | 27,055 | 385% |
| Revenue data: | | | | |
| Crude oil | \$ 1,579,070 | \$ 502,273 | \$ 1,076,797 | 214% |
| NGLs | 755,445 | | 755,445 | |
| Natural gas | 580,471 | | 580,471 | |
| Total revenues | \$ 2,914,986 | \$ 502,273 | \$ 2,412,713 | 480% |
| Average prices: | | | | |
| Crude oil (per Bbl) | \$ 123.03 | \$ 71.41 | \$ 51.62 | 72% |
| NGLs (per Bbl) | 68.29 | | | |
| Natural gas (per Mcf) | 9.49 | | | |
| Crude oil, NGLs and natural gas (per BOE) | \$ 85.51 | \$ 71.41 | \$ 14.10 | 20% |
| Expenses (per BOE) | | | | |
| Lease operating expenses and production taxes (a) | \$ 12.22 | \$ 44.55 | \$ (32.33) | (73)% |
| Depletion expense on oil and natural gas properties (b) | \$ 18.63 | \$ 13.11 | \$ 5.52 | 42% |

- (a) Excludes non-recurring expenses related to the oil spill in the Tullos Field Area of \$5,500 and \$14,532, for the three months ended September 30, 2008 and 2007, respectively.
- (b) Excludes depreciation of furniture and fixtures of \$9,824 and \$18,251, for the three months ended September 30, 2008 and 2007, respectively.

Net income (loss). For the three months ended September 30, 2008, we reported net income of \$148,437, or \$0.01 in earnings per share (which includes approximately \$1.2 million of non-cash charges related to stock-based compensation, depreciation, depletion, and amortization, and accretion on asset retirement obligations) on total oil and natural gas revenues of \$2,914,986. This compares to a net loss of \$641,381, or \$0.02 loss per share (which includes approximately \$0.5 million of non-cash charges related to stock-based compensation, depreciation, depletion, and amortization, and accretion on asset retirement obligations) on total oil and natural gas revenues of \$502,273 for the three months ended September 30, 2007. The increase in earnings is primarily attributable to an increase in revenues of \$2,412,713, partially offset by increases in lease operating expense and production taxes of \$94,034, an increase in depreciation, depletion and amortization of \$534,438, an increase in general and administrative expenses of \$136,523 and a decrease in interest income earned of \$265,776. Additional details of the components of net loss are explained in greater detail below.

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Sales Volumes. Crude oil, natural gas liquids, and natural gas sales volumes, net to our interest, for the three months ended September 30, 2008 increased 385% to 34,089 BOE, compared to 7,034 BOE for the three months ended September 30, 2007. The increase in sales volumes is due to production of crude oil, NGLs and natural gas from our properties in the Giddings Field. Our properties in the Tullos Field Area, which were sold on March 3, 2008, accounted for approximately 98% of total sales volumes for the three months ended September 30, 2007.

Production. Oil production will vary from oil sales volumes by changes in crude oil inventories, which are not carried on our balance sheet. Crude oil, NGL and natural gas production for the three months ended September 30, 2008 increased 361% to 33,963 BOE, compared to 7,360 Bbls of crude oil for the three months ended September 30, 2007. The increase is due to oil, NGL and natural gas production from our properties in the Giddings Field. Production from our properties in the Tullos Field Area, which were sold on March 3, 2008, accounted for approximately 99% of production for the three months ended September 30, 2007.

Oil, NGL and Natural Gas Revenues. Crude oil, NGL and natural gas revenues for the three months ended September 30, 2008 increased 480% from the comparable quarter in the previous fiscal year. This was due to a 72% increase in our average price of a Bbl of oil, from \$71 per Bbl to \$123 per Bbl, along with sales of NGLs and natural gas during the three months ended September 30, 2008, whereas there were no sales of NGLs and natural gas during the three months ended September 30, 2007. Our properties in the Giddings Field generated approximately 100% our revenues for the three months ended September 30, 2008. Oil revenues from our properties in the Tullos Field Area, which was sold in March 2008, accounted for approximately 98% of total revenues for the three months September 30, 2007.

Lease Operating Expenses (including production severance taxes). Lease operating expenses and production taxes for the three months ended September 30, 2008 increased approximately 29% from the comparable three month period in the prior fiscal year. The increase for the three months ended September 30, 2008 is primarily attributable to higher production taxes in the Giddings Field as compared to the Tullos Field Area where the majority of our production was during the previous period. The higher production taxes are due to higher revenues and a higher tax rate in our Texas properties compared to our production from our Louisiana properties in the comparable quarter in the previous fiscal year. On a BOE basis, lease operating expenses (including production severance taxes) decreased by 73% over the comparable three month period in the prior fiscal year, due to higher sales volumes.

General and Administrative Expenses (G&A). G&A expenses increased 10% to approximately \$1.5 million for the three months ended September 30, 2008, compared to approximately \$1.3 million for the three months ended September 30, 2007. Higher overall compensation expenses for estimated bonuses and new hires, and including non-cash stock-based compensation, accounted for the majority of the increase. New hires are associated with a build up of our infrastructure to execute our drilling program in the Giddings Field. Non-cash stock-based compensation expense was \$523,725 (36% of total G&A) and \$376,008 (28% of total G&A) for the three months ended September 30, 2008 and 2007, respectively.

Depreciation, Depletion & Amortization Expense (DD&A). DD&A expense increased by \$534,438 to \$644,882 for the three months ended September 30, 2008, compared to \$110,444 for the three months ended September 30, 2007. The increase is primarily due to a higher depletion rate (\$19 vs. \$13) per BOE and a 385% increase in sales volumes. The increase in the depletion rate is due to the higher development cost of PUDs in the Giddings Field that we added in amount far in excess of the volume of lower cost PDP s in our properties in the Tullos Field Area, which we sold in March 2008. Proved reserves in the Giddings Field typically are higher cost, but higher valued, compared to the long life, high operating cost proved reserves in the Tullos Field Area.

Interest Income. Interest income for the three months ended September 30, 2008 decreased \$265,776 to \$75,305, compared to \$341,081 for the three months ended September 30, 2007. The decrease in interest income is due to lower available cash balances averaging approximately \$10.0 million during the three months ended September 30, 2008, as compared to cash balances averaging approximately \$26.1 million during the three months ended September 30, 2007, combined with a lower interest rate environment during the three months ended September 30, 2008. The lower cash balance is primarily due to cash used to pay for additions to our oil and natural gas properties.

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Inflation. Although the general inflation rate in the United States, as measured by the Consumer Price Index and the Producer Price Index, has been relatively low in recent years, the oil and gas industry has experienced unusually high price increases for oilfield equipment, tubulars, labor, expertise and services for the three months ended September 30, 2008 and 2007. The prices we received for our products during this period also increased dramatically and more than offset the impact of higher costs on our results of operations.

Known Trends and Uncertainties. General worldwide economic conditions have deteriorated due to credit conditions impacted by the sub-prime mortgage turmoil and other factors. Concerns over slower or declining economic growth are affecting numerous industries, companies, as well as consumers, which has resulted in reduced demand for crude oil and natural gas. If demand continues to decrease in the future it may continue to put downward pressure on crude oil and natural gas prices. Decreasing oil and natural gas prices will likely result in lower revenues and capital resources during the second quarter of fiscal year 2009, as compared to the first quarter of fiscal 2009.

Seasonality. Our business is generally not seasonal, except for certain rare instances when weather conditions may adversely affect access to our properties. Although we do not generally modify our production for changes in market demand, we do experience seasonality in the product prices we receive, generally based on higher demand for natural gas in the summer and winter and higher demand for downstream oil products during the summer driving season.

Off Balance Sheet Arrangements

The Company has no off-balance sheet arrangements to report during the first quarter ending September 30, 2008.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS

Information about market risks for the three months ended September 30, 2008, did not change materially from the disclosures in Item 7A. of our Annual Report on Form 10-K for the year ended June 30, 2008 except as noted below. As such, the information contained herein should be read in conjunction with the related disclosures in our Annual Report on Form 10-K for the year ended June 30, 2008.

Interest Rate Risk

We are exposed to changes in interest rates. Changes in interest rates affect the interest earned on our cash and cash equivalents. Under our current policies, we do not use interest rate derivative instruments to manage exposure to interest rate changes.

Commodity Price Risk

Our revenues, profitability and future growth depend substantially on prevailing prices for oil and natural gas. Prices also affect the amount of cash flow available for capital expenditures and our ability to borrow and raise additional capital, as, if and when needed. Lower prices may also reduce the amount of oil and natural gas that we can economically produce. Although our current production base may not be sufficient enough to effectively allow hedging, we may periodically use derivative instruments to hedge our commodity price risk. We may hedge a portion of our projected oil and natural gas production through a variety of financial and physical arrangements intended to support oil and natural gas prices at targeted levels and to manage our exposure to price fluctuations. We may use futures contracts, swaps and fixed price physical contracts to hedge our commodity prices. Realized gains and losses from our price risk management activities are recognized in oil and natural gas sales when the associated production occurs. We do not hold or issue derivative instruments for speculative purposes.

ITEM 4. CONTROLS AND PROCEDURES

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and that such information is accumulated and communicated to this Company's management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow for timely decisions regarding required disclosure.

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As required by Securities and Exchange Commission Rule 13a-15(b), we carried out an evaluation, under the supervision and with the participation of the Company's management, including our Chief Executive Officer and the Company's Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(c) and 15d-15(e)) as of the end of the quarter covered by this report. In designing and evaluating our disclosure controls and procedures, our management recognizes that controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving desired control objectives. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that as of September 30, 2008 our disclosure controls and procedures are effective in ensuring that the information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms.

During the quarter ended September 30, 2008 there has been no change in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On August 3, 2007, we were advised of an oil spill in the Tullos Field Area near one of our leases. At the request of field agents of the Louisiana Department of Environmental Quality and the Environmental Protection Agency (EPA), we agreed to commence a clean-up operation that was completed by the end of August 2007. A detailed analysis of the oil in the spill compared to the Company's produced oil was conducted by an EPA approved laboratory. We believe that the oil in the spill did not originate from our operations, supported by the formal findings of the laboratory. We received insurance reimbursements of \$484,197 in October 2007 and \$217,668 in March 2008. These reimbursements covered all of our actual cleanup costs except a \$5,000 insurance deductible and excluding our legal fees, in-house administrative costs, and any possible EPA expense reimbursements and fines that might be billed. On May 5, 2008, we received a letter from the EPA proposing a \$5,500 fine related to the oil spill. We have also received a bill from the United States Coast Guard of approximately \$70,000 for expense reimbursement. We believe these claims are not supported by independent investigation. As of the date of this filing, we have requested further verification from the United States Coast Guard to support their claims, and have entered into a settlement with the EPA where we have agreed to pay the \$5,500 fine with no admission of liability.

In July 2008, a multi-plaintiff lawsuit was filed in the twenty-eighth Judicial District Court, Lasalle Parish, Louisiana, against 15 defendants, including Four Star Development Corporation, a former indirect wholly owned subsidiary of the Company, which was sold on March 3, 2008, as part of our sale of the Tullos Field Area. Plaintiffs claim that the defendants' oil and natural gas exploration, development and production activities on their properties have caused soil and ground water contamination as a result of the release of hydrocarbons and drilling fluids. Plaintiffs seek damages for testing, clean-up and remediation of the properties as well as diminution in their value and mental anguish and emotional distress to the individual plaintiffs, unjust enrichment and punitive damages for alleged concealment of ongoing activities. At this time, we are not a party to the litigation and are unable to determine the exposure, if any, to the Company.

In November 2005, a multi-plaintiff lawsuit was filed in the Fifth Judicial District Court, Richland Parish, Louisiana, against 18 defendants including NGS Sub Corp. and Arkla Petroleum LLC, the Company's direct and indirect wholly owned subsidiaries (the "Subsidiaries"), as working interest owners/operators of various oil and natural gas leases in the Delhi Field. Plaintiffs claim that the defendants' oil and natural gas exploration, development and production activities on their properties have caused soil and ground water contamination as a result of the release of hydrocarbons and drilling fluids. Plaintiffs seek damages for testing, clean-up and remediation of the properties as well as diminution in their

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value and mental anguish to the individual plaintiffs, unjust enrichment and punitive damages for alleged concealment of ongoing activities.

Defendants have answered Plaintiffs' suit denying all claims. Trial is set before a jury in Richland Parish for July 13, 2009. We intend to vigorously contest all of Plaintiffs' claims. The case is currently in discovery, and, at this time, we are unable to predict the outcome of the litigation.

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ITEM 1A. RISK FACTORS

The following is an update of the risk factors set forth in the Company's Annual Report on Form 10-K for the year ended June 30, 2008. Other than set forth below, there have been no material changes in our risk factors from the information provided in Item 1A. Risk Factors in the Form 10-K.

We could be adversely affected by a recession in the United States or global economy.

A recessionary economic environment could result in lower demand for oil and natural gas and may also result in less capital available to fund future growth. These factors could negatively impact our profitability or limit our growth.

ITEM 2. UNREGISTERED SALE OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

A. Exhibits

- 31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) under the Securities Exchange Act of 1934, as amended.
- 31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) under the Securities Exchange Act of 1934, as amended.
- 32.1 Certification of Chief Executive Officer pursuant Rule 13a-14(b) or Rule 15d-14(b) under the Securities Exchange Act of 1934, as amended and 18 U.S.C. Section 1350.
- 32.2 Certification of Chief Financial Officer pursuant Rule 13a-14(b) or Rule 15d-14(b) under the Securities Exchange Act of 1934, as amended and 18 U.S.C. Section 1350.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

EVOLUTION PETROLEUM CORPORATION

(Registrant)

Date: November 14, 2008

By: /s/ STERLING H. MCDONALD
Sterling H. McDonald
Vice-President and Chief Financial Officer
Principal Financial and Accounting
Officer