CONTANGO OIL & GAS CO
Form 10-Q
May 10, 2011
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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 March 31, 2011

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	**95-4079863**
(State or other jurisdiction of	**(IRS Employer**
incorporation or organization)	**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 x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer , accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

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

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

The total number of shares of common stock, par value $0.04 per share, outstanding as of May 1, 2011 was 15,664,666.

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CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES

QUARTERLY REPORT ON FORM 10-Q

FOR THE NINE MONTHS ENDED MARCH 31, 2011

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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

(Unaudited)

ASSETS

	March 31, 2011	June 30, 2010
CURRENT ASSETS:		
Cash and cash equivalents	$ 80,060,707	$ 52,469,144
Accounts receivable:		
Trade receivables	44,914,288	41,938,567
Joint interest billings	5,179,499	11,758,980
Income taxes	958,781	5,410,577
Other receivables	360,943	3,164,604
Notes receivable		2,027,590
Prepaids and other current assets	3,876,405	3,103,927
Total current assets	135,350,623	119,873,389
PROPERTY, PLANT AND EQUIPMENT:		
Natural gas and oil properties, successful efforts method of accounting:		
Proved properties	581,961,464	540,215,841
Unproved properties	6,520,291	10,825,074
Furniture and equipment	256,389	276,817
Accumulated depreciation, depletion and amortization	(125,574,070)	(78,998,049)
Total property, plant and equipment, net	463,164,074	472,319,683
OTHER ASSETS:		
Cash and other assets held by affiliates	359,729	39,731
Other	522,323	32,944
Total other assets	882,052	72,675
TOTAL ASSETS	$ 599,396,749	$ 592,265,747

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

(Unaudited)

LIABILITIES AND SHAREHOLDERS EQUITY

	March 31, 2011	June 30, 2010
CURRENT LIABILITIES:		
Accounts payable	$ 2,844,500	$ 34,219,769
Royalties and working interests payable	34,315,288	30,774,444
Accrued liabilities	10,363,640	2,647,435
Joint interest advances		739,464
Accrued exploration and development	1,011,022	9,263,438
Income tax payable	2,777,181	843,755
Other current liabilities	554,721	
Total current liabilities	51,866,352	78,488,305
DEFERRED TAX LIABILITY	129,526,872	131,290,992
ASSET RETIREMENT OBLIGATION	8,909,224	5,156,642
COMMITMENTS AND CONTINGENCIES (NOTE 7)		
SHAREHOLDERS EQUITY:		
Common stock, $0.04 par value, 50,000,000 shares authorized, 20,135,107 shares issued and 15,664,666 outstanding at March 31, 2011, 19,982,563 shares issued and 15,684,666 outstanding at June 30, 2010	805,402	799,300
Additional paid-in capital	79,278,372	77,967,702
Treasury stock at cost (4,470,441 and 4,297,897 shares at March 31, 2011 and June 30, 2010, respectively)	(91,788,647)	(82,019,429)
Retained earnings	420,799,174	380,582,235
Total shareholders equity	409,094,301	377,329,808
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$ 599,396,749	$ 592,265,747

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 March 31, 2011	Three Months Ended March 31, 2010	Nine Months Ended March 31, 2011	Nine Months Ended March 31, 2010
REVENUES:				
Natural gas, oil and liquids sales	$ 55,323,793	$ 37,845,738	$ 161,660,362	$ 119,528,579
Total revenues	55,323,793	37,845,738	161,660,362	119,528,579
EXPENSES:				
Operating expenses	6,389,747	3,523,835	17,600,926	11,066,471
Exploration expenses	14,459	22,514,428	10,376,469	22,932,224
Depreciation, depletion and amortization	15,548,338	6,837,887	46,980,287	25,182,258
Impairment of natural gas and oil properties	1,674,502	735,553	1,786,439	735,553
General and administrative expenses	5,661,260	1,199,930	11,939,616	4,362,957
Total expenses	29,288,306	34,811,633	88,683,737	64,279,463
OTHER INCOME (EXPENSE):	(37,152)	539,676	(121,893)	526,717
NET INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	25,998,335	3,573,781	72,854,732	55,775,833
Provision for income taxes	(9,202,097)	(1,589,755)	(26,457,424)	(21,093,875)
NET INCOME FROM CONTINUING OPERATIONS	16,796,238	1,984,026	46,397,308	34,681,958
DISCONTINUED OPERATIONS (NOTE 10)				
Discontinued operations, net of income taxes		(241,966)	1,107,388	(362,763)
NET INCOME ATTRIBUTABLE TO COMMON STOCK	$ 16,796,238	$ 1,742,060	$ 47,504,696	$ 34,319,195
NET INCOME PER SHARE:				
Basic				
Continuing operations	$ 1.07	$ 0.13	$ 2.96	$ 2.19
Discontinued operations	$	$ (0.02)	$ 0.07	$ (0.02)
Total	$ 1.07	$ 0.11	$ 3.03	$ 2.17
Diluted				
Continuing operations	$ 1.07	$ 0.12	$ 2.95	$ 2.15
Discontinued operations	$	$ (0.01)	$ 0.07	$ (0.03)
Total	$ 1.07	$ 0.11	$ 3.02	$ 2.12
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING:				
Basic	15,664,666	15,859,618	15,665,166	15,840,607
Diluted	15,666,917	16,162,989	15,728,661	16,160,215

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)

	Nine Months Ended March 31, 2011	Nine Months Ended March 31, 2010
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income from continuing operations	$ 46,397,308	$ 34,681,958
Plus income (loss) from discontinued operations, net of income taxes	1,107,388	(362,763)
Net income	47,504,696	34,319,195
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, depletion and amortization	46,980,287	25,182,258
Impairment of natural gas and oil properties	1,786,439	735,553
Exploration expenditures	10,159,433	22,261,487
Deferred income taxes	(1,764,120)	6,856,377
Gain on disposition of assets	(2,737,539)	(112,868)
Tax benefit from exercise/cancellation of stock options	(501,767)	(122,025)
Stock-based compensation	1,369,726	447,643
Changes in operating assets and liabilities:		
Decrease (increase) in accounts receivable and other	(2,975,721)	14,736,771
Decrease (increase) in prepaids and insurance receivable	1,522,314	(491,322)
Increase in interest receivable		(874,410)
Decrease in accounts payable and advances from joint owners	(21,994,409)	(4,592,318)
Increase (decrease) in other accrued liabilities	7,760,922	(6,701,696)
Increase in income taxes payable	6,886,989	7,053,887
Other	142,102	
Net cash provided by operating activities	94,139,352	98,698,532
CASH FLOWS FROM INVESTING ACTIVITIES:		
Natural gas and oil exploration and development expenditures	(55,155,003)	(40,646,487)
Additions to furniture and equipment	(71,806)	(2,463)
Repayment of note receivable	2,027,590	
Investment in affiliates	(3,600,096)	(619,029)
Net cash used in investing activities	(56,799,315)	(41,267,979)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Tax benefit from exercise/cancellation of stock options	501,767	122,025
Dividends	(6,213)	
Purchase of common stock	(9,769,218)	(1,616,073)
Proceeds from exercised options, warrants and others		122,699
Debt issuance costs	(474,810)	
Net cash used in financing activities	(9,748,474)	(1,371,349)
NET INCREASE IN CASH AND CASH EQUIVALENTS	27,591,563	56,059,204
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	52,469,144	44,371,324
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 80,060,707	$ 100,430,528

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid for taxes, net	$ 27,648,290	$ 7,127,400
Cash paid for interest	$ 123,425	$ 187,671

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 Shares	Common Stock Amount	Paid-in Capital	Treasury Stock	Retained Earnings	Total Shareholders Equity
Balance at June 30, 2010	15,684,666	$ 799,300	$ 77,967,702	$ (82,019,429)	$ 380,582,235	$ 377,329,808
Treasury shares at cost	(20,000)			(865,816)		$ (865,816)
Expense of stock options			221,203			$ 221,203
Net income					18,941,020	$ 18,941,020
Balance at September 30, 2010	15,664,666	$ 799,300	$ 78,188,905	$ (82,885,245)	$ 399,523,255	$ 395,626,215
Exercise of stock options	152,544	6,102	(6,102)			$
Tax benefit of exercising stock options			501,767			$ 501,767
Liability adjustment for stock options			(440,034)			$ (440,034)
Treasury shares at cost	(152,544)			(8,903,402)		$ (8,903,402)
Expense of stock options			1,033,836			$ 1,033,836
Dividend					(7,287,757)	$ (7,287,757)
Net income					11,767,438	$ 11,767,438
Balance at December 31, 2010	15,664,666	$ 805,402	$ 79,278,372	$ (91,788,647)	$ 404,002,936	$ 392,298,063
Net income					16,796,238	$ 16,796,238
Balance at March 31, 2011	15,664,666	$ 805,402	$ 79,278,372	$ (91,788,647)	$ 420,799,174	$ 409,094,301

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

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CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP) for interim financial information, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC), including instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all the information and footnotes required by GAAP for complete annual financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation of the unaudited consolidated financial statements have been included. All such adjustments are of a normal recurring nature. The consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes included in Contango Oil & Gas Company s (Contango or the Company) Form 10-K for the fiscal year ended June 30, 2010. The consolidated results of operations for the three and nine months ended March 31, 2011 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2011.

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. Actual results could differ from these estimates. Contango s significant accounting policies are described below.

Successful Efforts Method of Accounting. The Company follows the successful efforts method of accounting for its natural gas and oil activities. Under the successful efforts method, lease acquisition costs and all development costs are capitalized. 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 field by field basis to the unamortized capitalized cost of the asset. If the future undiscounted net cash flows, based on the Company s estimate of future natural gas and oil prices and operating costs and anticipated production from proved reserves, are lower than the unamortized capitalized cost, then the capitalized cost is reduced to fair market value. No impairment of proved properties was recognized during the nine months ended March 31, 2011 or 2010. Unproved properties are reviewed quarterly to determine if there has been impairment of the carrying value, with any such impairment charged to expense in the period. During the nine months ended March 31, 2011, we recognized an impairment of unproved properties of approximately $1.8 million, related to certain offshore leases.

Cash Equivalents. Cash equivalents are considered to be highly liquid investment grade investments having an original maturity of 90 days or less. As of March 31, 2011, the Company had approximately $80.1 million in cash and cash equivalents. Of this amount, approximately $11.7 million was invested in U.S. Treasury money market funds, $11.0 million was invested in overnight U.S. Treasury funds, and the remaining $57.4 million was in non-interest bearing accounts.

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

Stock-Based Compensation. The Company applies the fair value based method to account for stock-based compensation. Under this method, compensation cost is measured at the grant date based on the fair value of the award and is recognized over the award vesting period. The fair value of each award is estimated using the Black-Scholes option-pricing model. The Company classifies the benefit of tax deductions in excess of the compensation cost recognized for the options (excess tax benefit) as financing cash flows.

The Company s 1999 Stock Incentive Plan expired in August 2009. There are 45,000 outstanding options issued under the plan which will be converted into securities if exercised prior to their expiration in September 2013. On September 15, 2009, the Company s Board of Directors adopted the Contango Oil & Gas Company Annual Incentive Plan (the 2009 Plan), which was approved by shareholders on November 19, 2009. Under the 2009 Plan, the Company s Board of Directors

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CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

may grant stock options, restricted stock awards and other stock-based awards to officers or other employees of the Company. Awards made under the 2009 Plan are subject to such restrictions, terms and conditions, including forfeitures, if any, as may be determined by the Board. Grants of service-based awards are valued at our common stock price at the date of grant. The Company did not grant stock-based awards to any officer or director during the nine months ended March 31, 2011. During the nine months ended March 31, 2010, the Company issued 25,000 options to a new employee with the following assumptions: (i) risk-free interest rate of 0.25 percent; (ii) expected life of five years; (iii) expected volatility of 35.43 percent and (iv) expected dividend yield of zero percent.

In November 2010, the Company s Board of Directors (the Board) approved the immediate vesting of all outstanding stock options under both the 1999 Stock Incentive Plan and the 2009 Plan. This accelerated vesting resulted in the Company immediately recognizing stock compensation expense of approximately $1.1 million.

Additionally, the Board authorized management to net-settle any outstanding stock options in cash. The option holder has a choice of receiving cash upon net settlement of options or to settle options for shares of the Company. Such modification of the stock options resulted in recognizing a liability equal to the portion of each award attributable to past service multiplied by the modified award s fair value. The initial liability of $0.4 million recognized as of December 31, 2010 did not exceed the amount of compensation expense which had been previously recognized in equity for the original award and did not result in additional compensation expense but a reduction in equity. The Company recognized additional compensation expense of $0.2 million for the three months ended March 31, 2011. The liability of $0.6 million is included in other current liabilities in the Company s balance sheet as of March 31, 2011.

The liability for the outstanding 45,000 stock options is based on the fair value of each award evaluated at the end of each quarter using the Black-Scholes option-pricing model. The following assumptions were used in calculating the liability for the 45,000 outstanding options as of March 31, 2011: (i) risk-free interest rate of 0.30 percent; (ii) expected life of 1.06 years; (iii) expected volatility of 28.19 percent and (iv) expected dividend yield of zero percent. To the extent that the liability exceeds the amount recognized at the end of the previous period, the difference is recognized as compensation cost for each period until the stock options are settled.

The accelerated vesting and modification affects no other terms or conditions of the options, including the number of outstanding options or exercise price. During the nine months ended March 31, 2011 and 2010, the Company recorded stock-based compensation charges of approximately $1.4 million (inclusive of the expense associated with the accelerated vesting) and $0.4 million, respectively, to general and administrative expense for restricted stock and option awards. These amounts do not reflect compensation actually received by the individuals, but rather represent expense recognized in the Company s consolidated financial statements that relate to option awards granted in previous fiscal years.

Recent Accounting Pronouncements

On January 1, 2011, we implemented certain provisions of Accounting Standards Update No. 2010-06, Fair Value Measurements and Disclosures (Topic 820) Improving Disclosures about Fair Value Measurements (Update 2010-06). Update 2010-06 requires entities to provide a reconciliation of purchases, sales, issuance and settlements of anything valued with a Level 3 method, which is used to price the hardest to value instruments. The implementation did not have an impact on our consolidated results of operations, financial position or cash flows.

3. Natural Gas and Oil Exploration and Production Risk

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

Other factors that have a direct bearing on the Company s financial condition are uncertainties inherent in estimating natural gas and oil reserves and future hydrocarbon production and cash flows, particularly with respect to wells that have not been fully tested and with wells having limited production histories; the timing and costs of our future drilling; development and abandonment activities; access to additional capital; changes in the price of natural gas and oil; availability and cost of services and equipment; and the presence of competitors with greater financial resources and capacity. The preparation of our consolidated financial statements in conformity with GAAP requires us to make estimates and assumptions that affect our reported results of operations, the amount of reported assets, liabilities and contingencies, and proved natural gas and oil reserves. We use the successful efforts method of accounting for our natural gas and oil activities.

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CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

4. Customer Concentration Credit Risk

The customer base for the Company is concentrated in the natural gas and oil industry. Major purchasers of our natural gas and oil for the nine months ended March 31, 2011 were ConocoPhillips Company, Shell Trading US Company, Trans Louisiana Gas Pipeline, Inc., NJR Energy Services and Enterprise Products Operating LLC. Our sales to these companies are not secured with letters of credit and in the event of non-payment, we could lose up to two months of revenues. The loss of two months of revenues would have a material adverse effect on our financial position, but there currently are numerous other potential purchasers of our production.

5. Other Receivables

On February 24, 2010, a dredge contracted by the Army Corps of Engineers to dredge the Atchafalaya River Channel ruptured the Company s 20 pipeline that runs from our Eugene Island 11 gathering platform to the Eugene Island 63 platform where our pipeline joins a third-party pipeline that transports our production to shore. The pipeline was repaired and production resumed on March 31, 2010. The repairs were covered by our insurance policy, subject to a deductible. Of the amount of other receivables recorded in the Consolidated Balance Sheets as of March 31, 2011 and June 30, 2010, approximately $0.2 million and $3.1 million, respectively, relates to this incident.

6. Net Income per Common Share

A reconciliation of the components of basic and diluted net income per share of common stock is presented in the tables below:

	Three Months Ended March 31, 2011			Three Months Ended March 31, 2010		
	Income	**Weighted Average Shares**	**Per Share**	**Income**	**Weighted Average Shares**	**Per Share**
Income from continuing operations	$ 16,796,238	15,664,666	$ 1.07	$ 1,984,026	15,859,618	$ 0.13
Discontinued operations, net of income taxes		15,664,666		(241,966)	15,859,618	(0.02)
Basic Earnings per Share:						
Net income attributable to common stock	$ 16,796,238	15,664,666	$ 1.07	$ 1,742,060	15,859,618	$ 0.11
Effect of Potential Dilutive Securities:						
Stock options, net of shares assumed purchased		2,251			303,371	
Income from continuing operations	$ 16,796,238	15,666,917	$ 1.07	$ 1,984,026	16,162,989	$ 0.12
Discontinued operations, net of income taxes		15,666,917		(241,966)	16,162,989	(0.01)
Diluted Earnings per Share:						
Net income attributable to common stock	$ 16,796,238	15,666,917	$ 1.07			